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The performance, banking risks and their regulation

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Abstract

The aim of this article is to present the theoretical support of the concepts of risk and profitability and the recent measures which had been taken to regulate them on the background of the recent economic crisis. Risks and performance are interrelated, and a better definition of these concepts constitute the basis of risk management. The analysis of banks performance should be carried out in terms of efficiency, productivity, competitiveness and profitability. The recent economic and financial instability have led central banks and other competent authorities to become more concerned with understanding the vulnerabilities of banking systems.

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Keywords: performance, risks, regulation, Basel Agreement, management risc, profitability, authorities.

1. Introduction

In banking activity are involved many financial risks that affect the performance of banks. The diversity of banking risks brings difficulties in defining them, but progress in risk regulation facilitates solving these problems. Risks and performance are interrelated, and a better definition of these concepts constitute the basis of risk management. The definition and risk inventory must be made in a proper manner, especially in terms of measuring, monitoring and controlling them.

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Credit institutions must constantly to position themselves in terms of risk and profitability. A risk management has no meaning independent of expected performance and its aim to optimize the risk-profitability relationship. In the risk management should be pursued as some indicators of profitability to be maintained to certain limits *(Nagy, Solovăstru, 2012).*

Regarding banking activity, performance is associated with the creation of added value, an optimal ratio between cost and benefits. Being required by recoup of the investments in new technologies, it has led to increase the risk and thus the link between performance and risk has become inherently connected. Across the banking system, the performance is the state of affairs characterized by stability decisions, legislative, monitoring and prudential coordination "of players" *(Bolocan, 2011).*

The occurrence of multiple specific banking risks is a consequence of the movement of deregulation, re-regulation and open competition. These operating conditions have increased the vulnerability of banks to negative shocks and increased the number of bank failures. To survive and prosper, banks have assimilated new techniques and instruments for risk management.

The development of risk management policies represent the permanent concern of the management of banking institutions, these policies require to be retrieve in each level of the bank's structure by applying specific tools.

The recent international financial crisis has generated changes in terms of risk management, the solvency requirement of financial entities, the interventions of monetary authorities and the behavior of financial markets participants in crisis situations. To combat the crisis the measures aimed, first, the regulatory framework of the desire of acquiring a common set of rules to ensure consistent supervision of financial groups, considering that their actions under were becoming more opaque and the phenomenon of irresponsible relaxation of lending conditions intensified.

Prudential regulation of banking activity has experienced a continuous evolution, but the recent financial crisis highlighted a number of negative effects and its limits. Although the present international stability is questioned through the weaknesses highlighted in the national economy, the manifestation of the phenomenon of contagion and moral hazard, we can say that the wave of regulations designed to combat these pressures can improve the situation. Among the initiatives to support the financial stability we can remark the Initiative from Vienna, European Economic Recovery Plan, College of Banking Supervision, Basel III and the prudential supervision.

Regulation and supervision are two closely related concepts. Banking regulation is a set of rules of conduct banking, issued by the state authorities, adherence to which can be achieved by coercion. Banking supervision is defined as the act of observation, to observe carefully the compliance of all the rules of banking and the results of this monitoring.

Macro-prudential supervision has an overwhelming role in ensuring financial stability. Financial stability is defined as the state in which the financial system is able to withstand financial shocks and imbalances in the financial intermediation process which are severe enough to affect the allocation of savings to obtain profitable results *(Crokett, Ferguson, 2003).*

Also, there is no universally accepted the definition of systemic risk. In his conception, *O. de Bandt și P. Hartmann (2000),* the systemic risk in the general sense, is a phenomenon of the economy and financial system. The economic literature contains a number of studies on the sources of systemic risk, that there are two main sources: large shocks, large-scale shocks and widespread accumulation of imbalances, such as the credit boom. At the international level has not reached a consensus on a set of indicators that would be necessary and sufficient for monitoring the banking system as a whole.

The developments in banking activity and financial crisis consequences have indicated the need for a macro-prudential surveillance activities and the need for further work to be efficient and effective in order to limit the losses of banking systems in the event of financial crisis with serious economic and financial repercussions. The market will always be one step ahead of the supervisory authority but she must quickly adapt to developments in banking, and after monitoring activity should reach the development of prudential regulations to fade the negative effects of banking activity, allowing adequate monitoringof financial innovation, to reduce the systemic risk, both in time dimension as well structure dimension .

2. Performance and risk in commercial banks – current theoretical and methodological approaches

Bank performance from the point of view of shareholders of a bank is obtaining profitby maximizing the revenue and minimizing the costs. Economic theories show that, in the situation of perfect competition, profit maximization is equal to minimizing costs. In practice, however, can interfere factors such as changes in the regulatory framework that would disturb obtain desired performance. The factors that could explain the deviation from profit maximization can be grouped into two categories: incorrect incentives and inefficiency *(Bikker, Bos, 2008).*

The global performance of a bank characterizes its overall results, it being given by profitability level correlated with the risks taken by the bank concerned *(Olteanu, 2003).* In the literature, the banking performance is expressed through indicators of profitability and financial soundness indicators or risk. Because the control of banking risks is a factor that depends on bank profitability, the interpretation of risk indicators must be made through the causes, consequences and effects on the bank's profitability *(Stoica, 1999).*

Because banks play a central role in financial intermediation, the analysis of banks performance should be carried out in terms of efficiency, productivity, competitiveness and profitability.

Banks grant special attention to permanent monitoring indicators which expresses eficiency of banking activity and analyzing their effectiveness in close interdependence with the bank's exposure to risks or potential that can jeopardize the activity. All these activities at banks highlight the risk profile of individual banks and the exposure in order to obtain financial results. In international banking practice, optimizing risk-profitability relationship is an objective which is applied at each banking product, extending to the entire portfolio of the bank.

The global performance of banks is given by relationship between profit and risk. In the financial statements of a bank are calculated a number of financial indicators that are based on gross closely related to risk assumed by the bank and characterized, however, bank performance. But the information provided by performance indicators are useful not only internally but requires other categories of users, such as those related with external environment of the bank (banking supervisor, fiscal, non-bank customers, bank customers, rating institutions etc..) bank internal users (shareholders, general manager, employees, etc..).

The banking supervisor is always interested in the status and the economic and financial position of the bank, its position in the banking system that it supervises, and finance when its need and capitalize temporally some of his available sources. Compares the performance of each bank shares with other similar banks, with average or the banking system recorded by the bank in previous periods and helps establish the strengths and weaknesses of the banking company concerned. The overall performance of the bank aims to provide to national economy and bank safety and stability.

The overall performance of a bank characterize its overall results, being given by the profitability of capital banking company, coupled with its variation according to the risks taken by the bank concerned.

The risk can be defined as an uncertain event, but possible, that could cause some losses. The risk has its origin in uncertainty, uncertainty about the deviation from the desired outcome. The risk is seen as a phenomenon that comes from circumstances for which the decision maker is able to identify possible trends/events and even their probability, being unable to decide which of these events will actually occur.*(Niţu, 2000).*

In the financial sector in general, but especially in banking system, **the risk refers only to negative** deviations from expected or desired outcome and is associated with the probability of a loss, while positive deviations are considered to be oportunities. The risk associated with banking activity occurs in any operations, transactions or decisions which implies a certain uncertainty about the result. Since all their banking operations have a degree of uncertainty associated with, all banking operations contribute to the overall risk of a bank.

In literature**, the banking risk is associated specially with financial risks** becouse, by nature of the activities they carry out, banks are the first and most affected by the worsening economic and financial conditions in the countries where they operate.

As stated, the banking risks can be categorized into **permanent risks** (risks that are caused by a source or a factor that may change permanently) and **unique risks or events risk** (occurring as the result of a specific, discontinuous source). Banking risk can be defined as a phenomenon that occurs during the course of banking operations and causing negative effects on these activities by the deterioration in asset quality, reduced profits or even losses registration, all of which affect the functionality of the bank. Banking risk may arise because of internal or external causes, and the light of unforeseen expenses that may arise, risk management activities have a particular interest to banks *(Ciciş, Andrieş, 2009)*.

In the activity which it operates, banks may face with a multitude of events who its generating risks, including:

customers reimburses late or not pay back the loans or interest, depositors require earlier the withdrawal of deposits, market interest rateschange significantly; human error, fraud, regulatory changes, system collapse, poor organization, etc..

Derminte (2009) identified at least 15 sources of risk in the banking activity, which it groups into six categories, as follows:

- **credit risk -** is the inability of a customer to repay the principal and / or interest on the loan on time;
- **market risk -** losses caused by unfavorable evolution of interest rates, exchange rates and market prices of primary and derivative financial instruments held by the bank in transactional portfolio;
- **liquidity risk -** the bank's inability to procure the necessary short-term liquidity;
- **legal risk -** losses caused by unexpected changes in regulations;
- **operational risk -** the probability of loss on account of inadequate internal processes, employees, systems or external events;
- **strategic risk -** refers to the risk that a new competitor, company or product, alter the level of competition in the banking market.

From the perspective of National Bank of Romania, the risks that can significantly affect **the patrimonial situation and / or reputational of an credit institution** are: credit risk, country risk, transfer risk, market risk, price risk, currency risk, interest rate risk, liquidity risk , operational, legal and reputational risk.

According *Dardac, Vascu (2001)* a bank can experience two types of risks: general risks and specific risks. In the category of **general risks** include: commercial risks (customer / product risk, market risk, the risk of commercial image) risks of goods and people (the risk of accidents, risk of delicto), operational and technical risks, internal risk management (regulations risk, ethics risk, strategic risk, technologic dependency risk, communication risk). **Bank-specific risks** include: financial risks (interest rate risk, liquidity risk, the variable income securities risk) risk signature or counterparty risks (customers risk, interbank risk, country risk).

The concept of banking risk includes both the risk categories: specific to financial and banking activities and the risks affecting the activities of organizations, regardless of their field of activity, called **systemic risks**. **Systemic risk, also called market risk or undiversified** is related to the main macroeconomic indicators (GDP, the average interest rate on the market, inflation, currency exchange, etc..) and other characteristics (political situation, the risk of country, natural disasters, etc..) of the country where the bank operates.

Although in its general sense, the concept of systemic risk is not restricted to economic issues or the financial system (the most natural illustration of this concept being in the medical field), in the economic field systemic risk is considered a characteristic specific of banking system. **Systemic risk** is a complex phenomenon, very difficult to quantify and difficult to limited once triggered. This type of risk can take different forms and can develop rapidly, not having national boundaries. Systemic risk is different from other risks, being defined by its effects than by its causes. It multiforme, fast-growing and unpredictable.

Systemic risk is defined as the risk that affects the entire financial system *(Bandt and Hartmann, 2002).* The origin of this risk can be passed both in the banking system or financial markets. Systemic risk may cause the development of other risks as a result of the spread of macroeconomic shocks or due to contagion effects.

In addition to liquidity shocks and productivity challenges that have a significant influence to the increase of systemic risk, we identify another macroeconomic shock in the exchange rate. The exchange rate risk is of major importance in the analysis of systemic risk in terms of its characteristics.

The answers to counter the systemic risk must be dynamic, flexible, varied shape and incorporating the following characteristics: addressing different connections and interconnections that have led to the production of such a risk, to be based on the positive force of the market, have based on sound practices in risk management, to consider the supervision and control of the causes and effects of such risk. An excessive focus on categories defined as sources of systemic risk, as well large financial firms or deposit institutions, it is unlikely to be successful and may prove counterproductive *(Institute of International Finance, 2010).*

Liquidity risk and the productivity are considered to be the most important sources of systemic risk by the fact that the central bank has express powers in the management of such risks. In the literature we find considerations that systemic risk should be the result of **the contagion effect**, so that the failure of a bank can affect the entire banking system. It is clear that macro-economic circumstances determine the conditions under which contagion spreads, the more that we experienced events inside which there low credit performance, related whith big losses from this type of activities determined resulted in the decrease and the erosion of bank capital, reducing the resources that banks can use to counter any risks that may arise.

The contagion effect may appear through four different channels: changes made on investors expectations, values increasing in the payment system, overestimation of operations (especially in operations carried out with derivatives) and interbank markets. **The contagion effect** is defined as that behavior which is not supported by a model of economic rationality, it is an imitation, simultaneous or delayed, behaviors of similar economic entities or a similar role in the economic system generally. For this reason, the contagion effect may have a catastrophic dynamics, unpredictable and difficult to manage. The contagion effect is extremely strong in jointly and severally system, such as banking.

The contagion effect and systemic risk have been analyzed by *Allen and Gale (2000)* and *Freixas, Parigi and Rochet (2000).* All have followed to explain how the contagion effect propagates and came to the following conclusions:

- the volume of risk protection instruments adopted by banks, generally recognized to be against the credit risk, those generated by subordinated debt or probability of the claims arising from depositors, are significant sources of contagion
- the modalities to settle the bankruptcy of a bank may have an effect in the propagation of crises
- the ownership and use of assets and liabilities by banks, including the decisions taken at the payment system are essential in spreading systemic risk
- the architecture of the banking system is very important in banking management, so that a system in which each bank lends only to one bank is more fragile than the other schemes where exist more diversified funding sources.

Historical experience suggests that central banks play an important role in creating financial stability, including reducing the risk of economic contagion. This is accomplished by creating price stability and providing liquidity as quickly and on widely in situation of economic crisis *(Peptine, 2013).*

In the literature we find opinions that risks who propagates on the banking system depend on the market structure and, therefore, there must be a balance between this element and financial stability. Since this is difficult to achieve and should be made a number of compromises for this to be achieved in the banking system requires the existence of various intervention measures of prudence, but also increased surveillance activity. These regulatory interventions are more effective if they are accompanied by effective prudential rules which depend on the stability of the economic environment and the capacity of institutions.

Regarding risk management, banks adopt different techniques depending on the nature of the activities in which they engage. The banks applies different internal models to allow a proper risk management, including JP Morgan `s CreditMetrics, Credit Suisse Financial Product` s Credit Risk or Credit Monitor + by Moody `s KMV.

The experience of the recent financial crisis has led banks to be more careful with the activities performed, being registered some progress on their risk management. Reports of competent authorities show that the reforms achieved have been implemented in most credit institutions, especially in the most affected by the recent crisis.

3. The performance management and risk management

The banking management aims to achieve profit, namely a higher banking performance. The stability and the growth rate of profit are the best synthetic indicators of a performance of banks and entire banking system. One of the most efficient tools for measuring and rendering of bank performance is the system of financial indicators. **The performance indicators** show the situation of a bank at one time, and their interpretation allows managers to take appropriate measures for the proper functioning of the bank in the future.

The indicators for assessing the performance and banking solidarity are used by supervision authorities to issue regulatory rules to ensure the stability of the financial system and banks alike. In the literature, these indicators are grouped as follows: *the profitability indicators, indicators for assessing the quality of assets and capital adequacy indicators.*

The profitability offer clues about the bank's ability to take risks and expand business. The indicators used in assessing bank profitability are the *return on equity (ROE), the return on assets (ROA) and leverage or equity ratio.* To detect trends in profitability, all these indicators are observed over a period of time. From the above indicators, financial return is the most significant expression of the profit that highlight the results of the broader financial management and indicates to shareholders if their investments are efficient *(Cocriş, Chirleşan, 2007).*

The return on assets rate ROA reflects management's ability to use its resources in order to optimize profit . Asset quality reflects the potential risk may generate credits extended by banking institution, and the inherent risk of other assets and off-balance sheet operations *(Dardac, Barbu, 2005).* The indicators most commonly used to analyze the quality of assets are: *nonperforming loans (NPL) and NPL coverage.*

The capital is one of the key factors who must be taken into account when is evaluating the safety and the proper functioning of a bank. The indicators most commonly used by supervisory institutions and rating agencies to identify bank capital adequacy are solvency report and the leverage effect.

By the fact that banks have double role, independent economic entities aimed at maximizing profit and, on the other hand, parts of the banking system coordinated by the central bank to implement its monetary policy, it imposes a new dimension to risk in the sense that policies pursued by banks in order to achieve its object of activity may conflict with monetary policy measures imposed by the central bank at one time.

Risk management is one of the most important sources for the creation of surplus value at a bank and the main objective of risk management is to prevent or avoid bankruptcy and financial difficulties. **Risk management** in banking activity includes the following steps: (1) identification and risk analysis, (2) elimination and risk control, (3) evaluation and risk taking, (4) financing risk through cover the risks or risk transfer.

The modalities that can make a proper risk management are: risk avoidance, reduction (mitigation) risk, risk transfer, risk sharing, increased risk. In banking field the risk be must be considered as a complex risks that can lead to other risks. The bank risk management should be one of the components of overall bank management.

The banks activities reflect on balance sheet and off balance. By this fact , banks should properly manage its assets by choosing a diversified range of assets and accompanied by a low level of risk. Secondly, bank liabilities should include funds but not characterized by a large discrepancy between maturities. Another important element that banks should take into account is the possession of sufficient level of capital that allow their resistance in the face of unexpected losses. Regarding the choice of off-balance sheet transactions recorded, banks are free to choose which operations should be reflected on or off balance, but should not be ignored because they may trigger risks that affect their later work.

Bank's risk strategy is based on a set of principles of risk policy that includes all the rules of conduct in dealing with risks in the bank. Banks must recognize its exposure to risks arising from daily operations and the achievement of its strategic objectives. Efficient management of banking risks is considered vital by banks to achieve strategic objectives and to ensure the quality benefits to shareholders on a continuous basis. In this context, banks' significant risk management strategy provides a framework for identifying, assessing, monitoring and controlling these risks, in order to keep them at acceptable levels according to the risk appetite of the bank and its ability to cover these risks.

In general, the significant objectives of **banks' risk management strategy** are:

- determination of significant risks that may arise in the normal course of business of credit institutions and the formalization of a robust framework management and control of their overall business strategy according to the objectives of the bank, adopting best practices, adapted to the size, risk profile and strategy bank's risk;
- delimiting acceptable level of risk for each significant activity for all of the bank's activity in relation to the overall strategic lines and profit targets and with capital level established of the management structure;
- promoting a culture of raising awareness and risk management in all structures of the bank;
- ensured support for the bank's decision-making processes by providing a perspective on risk.

The experience of the recent financial crisis has led banks to be more careful with the activities performed, being registered some progress on their risk management. Reports of competent authorities show that the reforms achieved have been implemented in most credit institutions, especially in the most affected by the recent crisis.

4. Performance and risk in banks – fundamental objectives of prudential banking supervision

Prudential supervision aims to prevent the manifestation of internal and external risks to the level of an banking institution and prevent their spread. At microeconomic level, the prudential supervision consists in internal management of the business, taking into account the development constraints exercised from the outsiderespectively changes in the conduct of business or redefining prudential rules, nationally or internationally.

Internal control corresponds to self-control and those activities can improve the level of financial performance and the relationship between cost and performance. Internal control is an indispensable management instrument the proper functioning of credit institutions, complementing prudential measures.

The banking prudential rules cover the main aspects of banking management. Their observance oriented bank strategy corresponds to harmonization with european legislation and allows the integration of european countries with internationally one. At the level of the member countries of U.E., banking prudence can be measured by the following instruments: bank solvency, high risk factor, the level of financial holdings, the coefficient of adjustment to market risk, the level of minimum capital. For each country there are also own levels of relationships, such as liquidity ratio, ratio of own funds and permanent resources.

Prudential rules follow to harmonize the conditions of international competition by removing situations where a risky credit institution affects the profitability of other participants in the market or the market as a whole. The importance of harmonization work changed substantially, exercising the powers of national authorities. In the European area, national authorities may adopt more stringent measures than those included in the texts of international regulations. Thus national authorities retain their freedom of initiative to regulate the exercise of banking activities, which are not the subject of one international harmonization action *(Dardac, Vascu, 2001).*

The main objective of authorization activity, prudential regulation and supervision is the stability and viability of the entire banking system by providing rules and prudential indicators and follow their strict compliance. Thus the role of prudential supervision of banks is to prevent systemic risk, taking into account the compliance of each bank autonomy in organizing and conducting its business on a competitive basis.

The fundamental problems that stand to the attention of banking sector refers to both further development of the private banking sector and its efficiency and the restructure and settlement of non-performing loan portfolio. Although banking supervision is traditionally targeted to check compliance with laws and regulations which governing credit institutions and their activities, recent developments highlight the need to move to a new stage of prudential supervision. The aim is to shift from the accounting supervision to an supervision oriented towards risk assessment that credit institution may be exposed by their specificity. Such an approach would turn over the supervision activity to analyze the risk profile of the credit institution, measures and instruments in place to ensure an efficient management of specific risks.

The recent economic and financial instability have led central banks and other competent authorities to become more concerned with understanding the vulnerabilities of banking systems and with the techniques which can help prevent systemic crises. Thus we can see progress in terms of instruments used, the process of standardization and international cooperation to allow an proper monitoring and management of systemic risk.

The main action taken in this regard was made by international organizations such as the International Monetary Fund and the World Bank, reflected in the initiation of the Financial Sector Assessment Programme (FSAP). At the micro-prudential level, these concerns have been supplemented by the efforts of the Bank for International Settlements (BIS) to develop a framework for international convergence concerning the assessment of cuantification and the management of risk of bankruptcy. The reference framework for micro-prudential analysis is ensured by the new Basel Agreements.

The new Basel III Agreement will emphasize the link between risk and capital and will increase the banking sector capacity to cope with crisis. In these circumstances, the Basel III aims a greater protection of the banking system by combating errors previously identified, an improvement in the quantity and quality of capital and liquidity requirements for the banking system, but also a proper risk management. In addition to the effects that these new rules may have on improving the banking system also are recorded changes in the financial system as a whole so that Basel III may influence in a positive manner financial stability. On the same views stop authors like *Dedu, Nișescu (2012), Walter (2012), Lehmann, Levi, Tabak (2011) sau Admati, Parker (2012).*

These reforms found as the Basel III Agreement aimed to an greater risk coverage, plus an attenuation coefficient (prevention) designed to avoid excess accumulation of the banking system and to provide greater protection against risks and errors in mediation. In addition to these measures to micro-prudential area, the Basel capital requirements introduced macro-prudential elements in order to eliminate systemic risks derived from procyclicality and interconnections between financial entities *(Apătăchioae, 2013).*

The measures to combat the crisis are considering the regulatory framework, namely a common set of rules, an uniform surveillance of financial groups, while financial markets have become, in many areas, opaque and the irresponsible relaxation phenomenon of credit conditions on various real estate markets and other markets has intensified.

Isărescu (2012) believes that, so far, the responses to the recent crisis was too focused to prevent future financial crises and neglected that an robust economic growth can be achieved simply and without the contribution of the financial system. Moreover, in its efforts to reform the financial system, it is desirable to avoid introducing too complicated regulations which, in the long term, could have a boomerang effect, especially since after the crisis was manifested an overregulation tendency. To be effective, the crisis responses given by regulators should be characterized by simplicity.

Were registered, indeed, significant progress in improving economic governance system and introduced a major legislative package to strengthen the stability pact, of economic growth and the prevention and countering of macroeconomic imbalances. Due to the magnitude of the crisis has imposed supplement the actions of banking supervision.

Prudential regulation of banking has experienced a continuous evolution and the legislative changes that arise from the recent financial crisis aimed to combat the negative effects occurred, growth and stability of the financial system in the future.Regulatory measures taken on time and the compliance of those will cause that markets to be more correlated, with effects in reducing differences in the regulatory level, increasing the availability of information and transparency.

5. Conclusions

Banking activity is characterized by a multitude of risks that affect the performance of banks. The risks and performances are interrelated, and the definition and risk management allow to achieve the objectives of the bank. Risk management does not make sense independent of expected performance and its aim to optimize the risk-return relationship.

The risks have emerged as a consequence of actions such as deregulation, re-regulation or increased competition, and because this phenomenon of risk expansion has grown, banks and monetary authorities have assimilated new techniques and instruments for risk management.

The experience of the recent financial crisis has led banks to be more careful with the activities in the tasks performed, being registered progress in their risk management. The reports of competent authorities show that the reforms made have been implemented in most credit institutions, especially in the most affected by the recent crisis.

The recent economic and financial instability have led central banks and other competent authorities to become more concerned with understanding the vulnerabilities of banking systems and the techniques that help prevent systemic crises. Thus, we can see progress in terms of instruments used, the process of standardization and international cooperation that allow an efficient monitoring and management of systemic risk.

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