SUPERVISION OF CREDIT INSTITUTIONS SIGNIFICANT RISKS TO FINANCIAL STABILITY

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Abstract:
Financial stability of Romanian banking system is determined by the constant supervision of credit institutions significant risks.
Accession of Romania to Union Banking requires the signing of a linked protocol between the central bank and European Central Bank regarding prudential supervision to ensure financial stability. This means that from the next year, the central bank will impose a new supervision of credit institutions in our country. And especially to those credit institutions that do not fall under European supervisors, according to the procedures of the ECB. Through this study we propose to specify the main elements of management of significant risks to ensure financial stability.

Keywords: financial stability, significant risks, risk exposure, nonperforming exposures

JEL Classification: E50, E52, E58

1. Introduction

Although, Romania is not included in the eurozone, ECB assessment of the significant risk will include foreign-owned banks, from Romanian banking system.

The new macroprudential framework (MUS, MUR, SGD), which is under implementation at European level on European Systemic Risk Board recommendations, will strengthen the financial stability of credit institutions to deal with any systemic risks.

Romanian banking sistem includes 70% of banks and financial groups - foreign-owned bank, whose head office is located in countries of euro zone .

Begining with December 2014, the European Central Bank evaluates and supervises directly the 6,000 banks from **euro zone** and national banks have responsibility for evaluating the rest of the credit institutions in those countries that are not in the eurozone. Evaluation of credit institutions involves at least three groups of operations. A first group includes operations of assessment significant risks management. The second group includes an extensive exercise for assessing the quality of bank assets. And, in the third group of operations, supervision activity will result in "simulating" stress testing of banks based on macroeconomic scenarios.

At the same time the European Banking Union will create mechanisms by which European banks will finance a **single resolution fund** sufficiently well capitalized that would intervene in the event of major risks of a bank. Significant risk management is a permanent activity of credit institutions to achieve financial stability. The main risks monitored under *"Methodology"* developed by the European Banking Authority (EBA) are: credit risk, market risk, liquidity risk, operational risk and capital risk.

2. Financial stability

Financial stability objectives are pursued primarily through regulation and prudential supervision of credit institutions under the authority of the central bank of the state. Secondly objectives are pursued by identifying risks based on European procedures, both the all financial system and its components, particular in credit institutions.

The procedures that will be the base of the 'total assessment of credit institutions regards bank capital, liquidity standards, standards of governance, risk management and *cross-border* supervision ". It will track the discrepancies between the maturities of assets and liabilities (*maturity mismatch*) for banking stability. [1]

In this context, credit institutions risk assessment is a complex activity that is performed on the basis of methods, principles and standards.

To impose new Supervisory rules of Banking Union in order to financial stability is necessary both assessment of banks and the entire financial and banking group, in each European country.

,,The impact of excess consumption that has inflated loans balloon without coverage and rush for profit at any cost, led to the current social atmosphere, in which market volatility, bankruptcies of many companies, housing mortgages, lowering the value of assets, unemployment, vulnerability in support of the education system, health , retirement, have accentuated the need for awareness of the risks of the financial system, especially the risks from the banking system "[4]

Following evaluation of the entire European banking system there will not exist banks that finance long-term assets with attracted short-term funds .

Evaluation of the management significant risk will offer to commercial banks practical solutions for *financial stability*.

As a component of central banks, financial stability can not be achieved without a "*solid financial system*" to cope with financial crisis. Or, in the center of organization of the European financial system , as financial intermediaries, are situated financial and banking groups .

Evaluation of credit institutions arising after UBE procedures is based on new international standard specific to financial and banking field. Although the assessment of financial and banking groups are affected by european experts, in drafting bank regulations took into account and IFRS standards. In this context, the international evaluators proposed a series of international standards of assessment banking companies, concerning the :

- evaluation terminology;
- contents of the evaluation report;
- requirements credit institution assessment (products and services, the legal situation of the assets, financial market position);
- assessing on the economic base (current status diagnosis, according to the balance and financial statements);
- comparisons method;
- method of estimating the market value;
- assessment methods based on profit;
- analysis of assessment results;
- correction of financial documents in line with IFRS.

Establishing indicators of each bank and enforcing banking financial groups evaluation after the new standards can not be achieved without taking into account the conditions and correlations in the financial sector as a whole.

Obviously that simulation stress testing of credit institutions based on macroeconomic scenarios can not be achieved without a *risk assessment* and bank assets. Following the *stress test* operations are estimated the costs and income, are determined the losses, failures resulting from assets available for sale, which can affect both equity and especially liquidity and solvency indicators. Also it will establish the necessary adjustments for impairment under scenarios analyzed.

To determine the correct adjustments in credit institutions is necessary managing the significant risks.

3. Credit risk - the main element of the significant risks management

Credit risk is one of the significant risks of banking activities, with direct impact on financial stability.

Credit risk management „consists in using of technique whereby the bank may decrease or eliminate losses, or even to keep the credit" [5]

Credit risk management strategy involves the establishment of procedures to follow the ratio of risk and profit from granting of loans. The risk profile of the loan portfolio is determined by calculating the share of loans classified in four risk categories (low, moderate, medium and high) in total value of loans. The new elements of credit risk management can be found in:

- rigorous procedures on analyzing and classifying customer credit applications. Instruments on borrowers risks , especially regarding the type of relationship between *debt service to income* (DTI) and the ratio between the amount of the loan and the guarantee of the loan (*loan-to-value*, LTV) was found to have a good efficiency. on long-term, following the risk of default of significant customers, limited the incrase of nonperforming loans;
- appropriate scoring system;
- rigorous approval of the procedures of exposures;
- operative system of signatures for the provision and use of credits;
- operative system of protection of exposures;

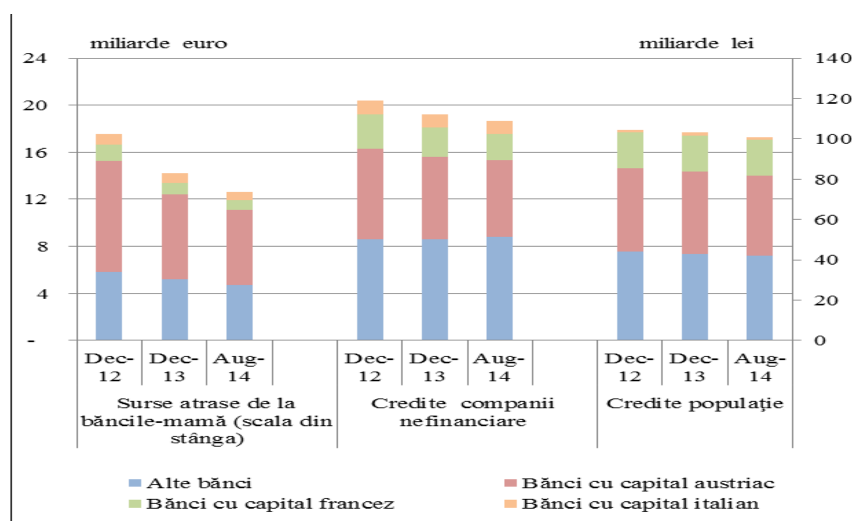
- tracking operative system of loans;
- system laying down competencies credit approval based on the quality of the loan portfolio and performances in lending;
- system of Management the limits on the level of concentration of credit risk at both the customer and portfolio level credit;
- operative system on verification and tracking collateral loans.

Romanian credit market was under the sign of balance sheet adjustments in 2013 and in early 2014 in both the supply and demand for banking products. Degree of covering of nonperforming loans generated by non-financial "banking customers' with IFRS provision, was at the end of July 2014 about 66.2 percent and 66.8 percent in August 2014.

Default risks of loans for non-financial corporations sector remain on a downward trend. Average value estimated in December 2014, being 5.6 percent compared to 6.9 percent in December 2013. Keeping important risks in the real estate sector, for loans to households and non-financial companies (71 percent in August 2014), the central bank requires new measures macroprudential, line with recommendations of the European Systemic Risk. (source: www.bnr.ro).

With the process of cleaning of credit institutions balance sheets from bad loans , the central bank cut interest rates for monetary policy and the reserve ratio. In this way was given the signal of financial stability in Romanian banking system and to resume lending bank customers.

Chart 1. Changes in lending bank customers (Source: Statistics - BNR)



Monitoring risks associated with lending activity aims to continuous improvement of macro-prudential measures for financial stability.

Administration of credit risk at the level of credit portfolio takes into account risk assessment for the portfolio of loans and financial securities. New items appear in the risk management of using derivatives, and comply with the limits for exposure to credit risk. For an effective risk management were established ceilings and limits exposure on Romanian and foreign banks. Moreover were, established exposure limits on guarantee funds and insurance companies. At the same time is managing the *concentration risk*, arising from transactions with non-bank customers recorded in the balance sheet assets and beyond.

Effective monitoring of risks, requires classification of lending operations:

- client categories: individuals and legal entities;
- geographical area;
- currency (euro, dollars, etc.);
- product category;
- credit risk categories;
- crediting periods;
- degrees of credit risk;
- activity sectors;
- real collateral issuers.

For recovery of debts due to the risks of lending activity will be initiate legal proceedings by one of the following forms:

1) giving the court judgment of opening the bankruptcy proceedings;

2) onset of forced execution procedure against natural or legal persons. Non Performing loans are evaluated at gross value (book value undiminished with adjustments for depreciation or value associated guarantees). The methodology of calculation is consistent with the recommendations of the "*Guide for compilation of financial stability indicators*" [8] developed by the FMI, being the most used internationally. (Source: Data were taken from the reports submitted by banks).

For measurement of nonperforming financial assets will use a new indicator called "*non-performing exposures rate*" according to the methodology set to "Standard Technical Implementation" developed by the European Banking Authority. This methodology has been developed under Regulation 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions (*Capital Requirements Regulation* - CRR), which will be applied uniformly across the European Union.

Under the new regulations are considered *non-performing exposures*, which will be reported following administration of significant risks, those exposures that meet one or both of the following criteria:

• debts overdue for more than 90 days, which have a higher level of materiality set by the credit institution;

• debts that, credit institutions deemed unlikely repayment in full of the loan without making cash flows generated by the sale of associated collateral.

In this sense the "*Technical Standard of Implementation*" mentions a number of new methodological elements related to the definition of non-performing exposures, like :

1) exposures are considered on a gross basis without deducting the value of collateral;

2) the term "exposure" includes all debt instruments (loans, advances and debt securities) and off-balance sheet items (funding commitments, guarantees and other ones commitments granted , both irrevocable and revocable), excluding exposures held for trading;

3) shall be considered as non-performing exposures of on- and off-balance against a particular debtor where this has an exposure of more than 90 days overdue and representing at least 20 percent of their exposures. If a borrower is part of a group, should be considered and exposures to other group entities;

4) exposures may be excluded from the category of "non-performing" only when the following conditions are met: a) exposures meet the criteria out of the category of non-performing in accordance with the definition of depreciation used by the reporting institution; b) the debtor's situation has improved, so is likely to pay all amounts due according to original maturities or terms renegotiated and c) the debtor does not have arrears greater than 90 days.

4. Market risk

Market risk management of credit institutions is carried out by two of its major elements namely:

a) interest rate risk;

b) Currency risk

The conditions that determine occurrence and development of interest rate risk are determined both by the internal activity of the institution and its external factors. Internal conditions that generate risk exposure are determined by the bank's strategy, structure of bank assets and liabilities, the volume and value of loans, loan portfolio quality, loan maturities staggered, maturity raised funds, etc.

External factors influencing interest rate risk are determined by the evolution of general economic conditions such as the present economic environment, the type of economic, monetary, financial and currency policy practiced by state authorities, correlating monetary policy to the central authority with the government's economic policy developments interbank market.

Currency risk management elements are determined by:

- net open position on each currency (excluding the reporting currency) and gold;
- total net position;

Improving romanian economic prospects for 2014-2015 timeframe, according to European Commission forecasts, led to a reduction in risk aversion perceived by foreign investors, so that national currency was repositioned on a path of appreciation against the euro since March. In the second quarter of 2014, national currency showed a contrary trends, recorded on other exchange markets in the region. Appreciation of the national currency against the euro became faster after Standard & Poor's rating agency, decided in May to increase Romania's sovereign qualification at *investment grade* (from 'BB +' from 'BBB-').

5. Liquidity risk

The main activity of bank management is to monitor risks and cover the needs of bank liquidity. As intermediaries of temporarily available funds, credit institutions accumulate financial resources on different maturity terms. This is reflected in investments with similar maturity structure terms, corresponding to each strategy of banking financial groups.

The effectiveness of liquidity risk management refers to the removal of:

- credit institutions inability to finance asset portfolio as bank customers demand;
- credit institutions inability to liquidate a deposit and to honor daily payments.

"Ensuring liquidity is a major component of banking risk management, being in essence a matter of costs." [3] Linking of banking assets position with liabilities position give the posibility of credit institutions to honor customer payments at any time and withdrawal of bank deposits.

Liquidity risk management aims to:

- how to recovers loans in terms of the possibility of turning them into cash;
- monitoring causes that can lead to risks that affect liquidity indicator and analyzing their monthly;
- daily monitoring of the liquidity GAP and its evolution;
- tracking daily liquidity difficulties to honor payments ordered by the traditional customer groups, that carrying out banking operations in large amounts;
- monthly forecasts on bank liquidity evolution over different periods of time.

"Any problem in bank liquidity or its financing activity reflects the existence of other fundamental issues. Liquidity is actually buffer between the bank and those who may react negatively to any problem of the bank. "[7]

6. Operational risk

This risk occurs due to improper management of the core business of credit institutions. Is the risk of loss or failure of planned profits. Is determined on the one hand of using processes, systems and human resources who failed to fulfilled its function in accordance with banking procedures and, on the other hand can also occur due to external events and actions.

"Credit institutions must implement adequate and effective information systems for: monitoring operational risk, data collection and analysis for operational risk and facilitating appropriate reporting to the governing body, senior management level and business line , in administration to support a proactive operational risk. "[9].

Reporting on operational risk exposures and losses actual occur in each reporting period. Credit institutions shall have procedures for the administration of the measures required for the proper conduct of banking activities and registration of estimated benefits.

7. Conclusions

Management of significant risks in a credit institution assumes the existence of a culture of risk; existence of a risk management framework; existence of appropriate policies on providing new banking products and services for proper risk management.

Following appropriate risk management provisions are significant.

Provisions covering the banks' expected losses arising from material risks of banking activity. Unexpected losses arising from any manifestation of adverse macroeconomic developments can be absorbed substantial capital reserves held by credit institutions above the mandatory minimum required by capital adequacy indicators.

The losses of operational risk, which are related to credit risk and market risk are taken into account in determining year-end capital requirement for operational risk.

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