Aspects Regarding the Risk in Banking Activity

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Abstract
The paper presents the diversity of banking risk which is found today at the center of banking business. Very important is knowledge of banking risks, because the financial activity is through its nature subject to uncertainty and risk. Banking risk must be viewed as a complex of events with adverse consequences for the bank, most often independent, through the fact that they may have common causes or through the fact producing of one that can generate in chain also other adverse events. Once with the expansion at national and international level of traditional systems of credit, financial markets have become more fragile, the uncertainty degree was emphasized, all of these having as support the multiplication of the risks specific to the financial-banking system.

Keywords: analysis, bank, bank loan, banking risk.

1. Introduction

Activity of any bank is carried out under concrete market conditions and therefore is subject to an accumulation of risks.
Risk is defined in the Dictionary of Finance and Banking as the possibility of suffering some loss or damage in transactions. [1]
Risk represents "the potential damage, to witch are exposed the heritage, the interests and the activity of the economic agent." [2] In a synthetic acceptance, risk is defined also as "the probability of producing an event with adverse consequences for the subject." [3] Other authors present risk as the "potential deviation adverse from the results expected."[4]
Banking risk is a constant presence in banking activity. Particularly important is the knowledge of banking risks, because the financial activity is through its nature subjected to uncertainty and risk.
Banking risk is pretty hard to define given the fact that the subjectivity what comes in assessment and precise quantification of banking risks.

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The concept of banking risk has not a single accepted definition, but all experts in the field recognize the fact that it can be characterized through three main features: the causes of instability of banking risks; critical point of manifestation of banking risks determined by the objectives of banking company; banking risks presents the possibility that the objectives established to be not completed. [5, 6]
In the specific case of banking risk, the subject is the banking institution. A simplified definition of the concept of banking risk refers to the present value of all losses or additional expenses they support or could support a banking institution.
Banking risk has two components: uncertainty regarding the production of an event in the future; exposure to the loss. [6]
In practice there is a set of operations and specific procedures generating banking risk. In addition to these, banks must deal with risks that are not specific to them.
In the specialized literature it has developed a multitude of theories about the causes that are at the base of the problems of witch the banks are facing. So, a part of experts consider that the risks depend on the variations of the level of provided incomes and of the level of the expenses covered from these. The main sources of income consist

from the interests on investments made and the most part of the costs are for honoring the interests on raised funds. Both incomes, but also the expenses can be estimated based on the structure of bank assets and liabilities, by the operations made and by the macro-economic factors that can influence the banking environment. Other opinions consecrate the main role of macroeconomic factors, whose variations are difficult to predict.

2. Typology of banking risks

Systematically addressing of the main risk categories specific to banking field requires their classification. In the economic literature it can be found several variants of banking risk classification. In the following we referred to the most important of these.

In the opinion of some specialists, banks must face to a number of complex risks and closely related to each other, namely: [7]

- Credit *risk* is the risk that one of the parts does not respect its position;
- *Market risk*, which assumes loss due to general and unexpected variation of market rates or interest rates;
- *Operational risk*, loss due to human errors, illegal acts or absence of internal controls;
- *Legal risk*, the risk arising from the legal regime applicable to a contract;
- *Liquidity risk*, the risk that a particular position can not be sold quickly and without significant losses, by point of view of price;
- *Regulation risk* includes exposure to market risk and credit in payment period;
- *Specific risk*, the decrease of the value of a position, decrease unrelated to the overall trend of the market.

The specific of international transactions requires to the banks a different behavior. So, according on the type of exposure, the risks can be divided into: *pure risks and lucrative* (subjective). [7]

Pure risks are characterized through the fact that the exposure is generated by the activities and banking procedures likely to produce events resulted with losses. From the category of risks is part: physical risks, financial risks, criminal and fraudulent risks and liability risks.

Speculative risks are characterized through the fact that the exposure is generated by the attempt to get higher profit, witch can cause to the bank losses and additional expenses.

Another classification of banking risks is the one that has on base, on the one hand the range of banking transactions that may generate risks and secondly the form of those risks. From this point of view, there are distinguished the following categories: [7]

- *Financial risks* that are assumed in the management of the balance sheet;
- *Risks of performance*, characteristic of banking services;
- *Environmental risks* that are generated by the operation of the bank in a competitive environment governed by banking authority and an economic area which is in a continuous dynamic.

The financial risks represent the most important group of banking risks, given the fact that an improper management of those is the most common cause of bank failures. In this category may be included:

a. *Credit risk* refers to the probability of actual receipt, at the maturity, of invested capital and of the related interest;

b. *Liquidity risk*, express the probability of funding;

c. *Market risk*, indicates the probability that a change in market conditions could adversely affect the bank profit;

d. *The risk of bankruptcy*, express the probability that the bank's own funds to be insufficient to cover the losses resulted from current activity and, also, the probability that these losses adversely affect the investments of the bank's creditors.

The problems with witch are facing a particular banking institution influence negatively the partner banks, threatening the stability of the entire banking system, taking into account the complex relationships between its components. In this case, banks must face a systemic risk and, at national level its management is ensured by the Central Bank.

Risks of performance are associated to operations from the sphere of financial services. In this category are included:

- *The operational risk*, the probability that bank to become incapable to meet customer needs in cost-effectively conditions;
- *The technological risk* is associated with quality and structure of the offer of financial products.
- *The risk of new banking product* is associated of innovations in financial products sphere.

• *Strategic risk*, the probability of not choosing the optimal strategy under the given circumstances.

Environmental risks refer to a class of risks with a strong influence on bank's performance, but witch can be controlled in a very limited measure by the banking institution. In this class are included:

• *The risk of fraud* expresses the probability of committing some acts against the interests of the bank by their employees;

• *The economic risk* associated to the evolution of economic environment in which operates the bank, and its customers;

• *The risk of competition* refers to the change of market relations in the detriment of the bank, modification resulted with the reducing of bank profits;

• *The legal risk* is associated to the compliance of the interference with legal regulations regarding to the development of banking activities. This type of risk reflects the uncertainty degree regarding the future evolution of the legal framework governing the operation of banking institutions.

The issue of risk is found also in international regulations. So, the International Accounting Standards mentions the fact that *financial risks* are associated to the transactions with financial instruments. [8]

Depending on the risk degree assessment associated to financial instruments, recognized or not in the balance sheet, **financial risks** are: *price risk; credit risk; liquidity risk; cash flow risk*.

Price risk incorporates not only the loss potential, but also the gaining one, and is groups to his turn into three categories, namely: *currency risk; risk of interest rate, market risk*.

In import-export contracts the partners sign up the prices resulted after the negotiations. In case in witch, until the payment of the value of goods/services by the buyer (importer), prices of those goods on the international market changes, it does not affect the conduct of the transaction, but can generate a "loss" or a "win" for the seller or buyer, in relation to the market price of the day.

Currency risk is the risk that the value of a financial instrument to fluctuate due to changes of market level of the exchange rate.

The risk of interest rate is the risk that the value of a financial instrument to fluctuate due to the changes of market level of interest rate.

Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices, even if these changes are caused by specific factors titles of individual value or their issuer, or factors affecting all securities titles traded in the market. [8]

Credit risk is the risk that one of the parts of the financial instrument is not to execute the assumed obligation causing to the other part a financial loss.

Liquidity risk, also named funding risk, is the risk that an enterprise encountering difficulties in procuring the needed funds to fulfill the commitments related to financial instruments. The financial risk may result from the inability to sell a financial quickly a financial asset to a value close to the fair value. [8]

Cash flow risk is the risk that the value of future cash flows, associated to a monetary financial instrument, to fluctuate. [8]

The financial risk associated to the transactions with financial instruments should be viewed from two perspectives, namely: on the one hand, through the *creditors*; on the other hand, through the *investors*.

Banks are creditors who finance the economic activity of a company. They became an autonomous economic agent, indispensable for the market economy. Commercial banks are key elements of the banking system, given the fact that they initiate the main banking operations.

The bases of entire activity of the banks are the money. The latter ones takes the form of some amounts saved that are attracted by the as deposits. For these deposits, the Bank applies the interest, that for it represents expenses. For their coverage it is necessary the using of the resources from which the bank can collect incomes. The main form of entry is granting of loans, those being most significant from the active operations. In developing these operations, the bank is subject in any moment to the risk because of the possibilities of appearance some factors in their activity.

Banking risks are phenomenon's that can occur and generate some implications for the banking activity. They can take many forms:

• *Risk of losing the capital* plays the measure in witch the risky assets are covered by capital. In the category of risky assets are included high-risk loans (personal loans, loans on witch the material guarantee is not satisfactory);

• *Liquidity risk* resulting from the report of sensitive assets to the sensitive liabilities;

• *Risk of changes the interests* for the mobilized resources;
• *Risk of capital erosion* through inflation;
• *Risk of capital repatriation* under the external lending conditions.

I believe that, from these risks, the risk of losing the capital and the lack of liquidity risk are the most important.

The risk of losing the capital occurs when the client can not repay the loan granted on established term. In this case, the bank claims can not be converted in time into cash, which has repercussions on the bank's ability to pay. In the conditions in witch this cases are frequent, the balance repayment of loans and repayment of deposits may be damaged, and consequences on medium and long-term over the bank can be negative. This situation affects depositors, who lose the confidence in the bank and withdraw their amounts deposited. The situation of the bank may further worsen for lack of financial resources in this case.

In order to prevent and avoid the bank insolvency in legal plan were adopted specific regulations. In this respect, the rules of banking operation promote the protection of depositors by imposing some rules meant to prevent the effects of insolvency of the banks. Among these rules we remember:

• Bank's obligation to pay a minimum capital;
• Establishment of a covering risk rate, expressed as a report of net own funds and granted loans, weighted by the degree of risk;
• Calculation of a decrease rate of risks who limits, depending on the banks' own funds, the sizes of loan that can be given to one customer, so that the bankruptcy of one of the clients to not influence, essentially, the bank balance.

The risk of lack of liquidity. Liquidity represents the ability to convert immediately or within a certain period of time, without losses, the material means and/or claims that it has into the liquid means on market, in money in the account and cash money. Bank liquidity represents the ability of the bank to make payments at any time by bank transfer or cash at the request of depositor holders. [9] The bank must have sufficient availability of cash to make payments directly to the customers, in cash, or payments made by customers in favor of other banks (more specifically, to the firms that have accounts open to other banks). Bank receives from current operations, automatically, currency flows, as a result of banking services developed for customer, flows that ensure favorable conditions for bank liquidity, namely:

• Through the favorable balance to the discount of interbank payments;
• Through operations of cash deposits made by customers for their accounts, when they are preponderant to the customer requests of cash in accounts;
• Through the failure by the banks and by bodies of currency regulation of the deposits of foreign currency in its accounts. In this case occurs a supply of customer accounts, while the bank registers an increase in currency deposits.

The bank is forced to turn to refinancing in case in witch in these conditions are fulfilled. For the bank, these conjuncture loans will mean costs, which must it cover in conditions in witch it aims the maximization of the profit and minimization of costs.

The problem of liquidity lack does not arise in the sense that it would not be possible obtaining the liquidities, but its price, of the obtaining cost of these liquidities.

It follows that the banks must continually analyze their degree of liquidity using various methods, in order to be able to avoid unjustified increases in expenses, while the bank's liquidity is not ensured.

For that a bank's activity to be *profitable* it required the compliance of at least *three basic conditions*, namely:

• *Providing liquidity*, meaning the bank's ability to repay to the customers the amounts deposited and related interests;
• *Bank safety* reflected in the way of annihilating of the risk of incapacity of payment;
• banking profitability reflected through that, on the one hand lending rates, related on granted loans and other incomes with character of interests are higher to the passive interests related to loans and other liabilities to third parts, and on the other hand, the incomes from other operations bank are higher to the costs of these operations.

These demands generate conflicts through their interaction. Businesses are risky, so insecure, and the liquidity supposes expenses, so it is less profitable. The Bank has the task of finding points of convergence so that from the interaction of these requirements to results a corresponding profit and adequate liquidity. To find these convergence points, it is important that the bank to formulate and define *overall strategy on lending activity.*

To remember is the fact that *the fund*s are put by the bank to the investors in various and multiple forms.

The objective of the creditors is to recover the funds borrowed and to receive at time the interest afferent to the loans granted. The difference between the point of view of the creditors and of the investors consist in the way in witch they analyze future projects. So, the investors follow that the money invested in a business to generate maximum profit. The creditors, in change, are primarily concerned by the transformation of the money into assets of value and recovery at time of credit rates and interest related to the loans granted.

In the same time, the investors are aware by the facts that, entering in a business, are exposed to certain risks of loss of the investment. For this reason, they expect that the profit generated to be on the measure of the risk to witch they expose their financial resources. Banks, in turn, insure themselves against the risk of loss the granted credits, through the formation of materials guarantees and provisions.

Classifications of banking risks present, in my opinion, a special importance in the process of managing them. Adequate management of the risks must provide to the bank the ability to identify and appreciate the banking risks, to control them, to remove or avoid them and to finance them.

In the measure in witch there are and there are achieved, the risks put a particular problem, the one of the speed with which they produce their effects and the way how are passed on the results of the banking society, actually, on costs and banking profit. Therefore, their identification is absolutely necessary in order to find the most effective reduction measures and elimination. The speed of the transmission is very important because it offers or not to the bank society the interruption to mobilize resources and to adopt appropriate measures in order to ensure an efficient management. As much this speed is bigger with that much the banking society face heavier to the risks. [9]

3. Indicators of banking risk analysis

It requires building of a system of indicators through which to monitor continuously the bank activity. Under this system a special place must occupy the evaluation and analysis indicators of the banking risk.

The activity of any bank is subject to an accumulation of risks. Thus the US economists shared the risks from the unexpected events in the following categories:

1. *Risks of system*, caused by an acceptable decrease of the money offer, and certain restrictions imposed on banks;
2. *Price risks*, which refers to the possibility that interest rates to rise suddenly while the bank has assets with a maturity longer than for liabilities;
3. *Credit risk*, which occurs when loans are not repaid in volume and on term established;
4. *Operating risk* is a managerial risk, which is characterized through incompetence or through conducting some ineffective operations;
5. *The risk from regulations* refers to unexpected changes of the regulations from banking sector that prevent banks to act effectively and safely.

Usually, risk indicator is calculated: [10]

$$\boldsymbol{RI} = \frac{PC}{VR}$$

Where: ***RI*** *- risk indicator;* ***PC*** *- primary adjusted capital;* ***VR*** *- the value of risky assets.*

Based on these calculations results a risk indicator for which there is certain framing intervals depending on which it can appreciate the level of the risk assumed with witch the bank will face in carrying out its activity.

The analysis of the activity of banking risk must be completed also in terms of the placement of that bank in the international banking system. From this point of view, must be taken into account other indicators, such as: overall risk, country risk, sovereign risk, tax risk, currency risk, etc.

Under the indicators system witch measure the existence of the risks that may occur in the financial-banking system can take part the next ones: [9-11]

Liquidity risk. It is an indicator that results from the comparison of the assets with the possibilities of immediate liquidity, with the deposits that may represent a possible dimension of the requests of the creditors. The calculation formula is:

$$\mathbf{LR} = \frac{TC + DOB}{DBC} * 100$$

Where: ***LR*** *- liquidity risk;* ***TC*** *- Total cash;* ***DOB*** *- existing deposits at other banks;* ***DBC*** *- existing deposits of the bank customers.*

A value of the indicator below 30% reflects the bank's incapacity to deal with decreasing of resources or increasing needs for financing the placements and in extreme cases lack of liquidity can generate the bank insolvency. [12] The indicator value greater than 45% highlights the bank's capacity to meet constantly the withdrawal requests of some deposits received from creditors.

Interest rate risk arising from the use of credit relations with floating interest, characterized in banking activity as claims, and the sensitive interests. [13] Relationship of this indicator is:

$$RR = \frac{SA}{PS} * 100$$

*Where: **RR** - interest rate risk; **SA**- sensitive actives to interest rate variation; **SP**- Passives sensitive to interest rate variation.*

A value of the index above 100% highlights a long position of interest of the bank, unfavorable declining of the interest rate and in witch the G.A.P is positive.

Credit risk expresses the fact that the interests or loans granted by the bank may be found in impossibility of refunding. It, actually, is a risk of employment, in the sense that, through his knowledge, it is established and is a commission of risk. The indicator is calculated following the model:

$$CR = \frac{OL}{TL} * 100$$

*Where: **CR** - credit risk; **OL** - outstanding loans, which they can not recover; **TL** - total loans granted by the bank.*

The optimal level of the indicator is below 2%, case in witch the bank can prevent the entrance in insolvency. The maximum limit allowed by international banking standards for this indicator is 6%. [13]

Capital risk shows the measure in which risky assets are covered by capital. The calculation formula is the following:

$$CP = \frac{C}{TC} * 100$$

*Where: **CP** - capital risk; **C** – own capitals; **TC**- total capitals.* [13]

This indicator is particularly important because it highlights the measure in which the bank exposed itself and can not cover risky assets through own capital. A value of the indicator greater than 6% highlights the fact that the bank is well capitalized and that the exposure of risk is low.

In practice are used also other indicators, among which: currency risk, operational risk, financial and tax regulations risk, insolvency risk, bank reputation risk, etc.

4. Conclusion

Considering those presented above, result the following conclusions:

- Bank is subject to any economic entity, on the competitive market, to market laws;
- The bank capital can be influenced, on the one hand by factors specific to the capital market, and on the other hand by economic factors, that influence indirectly the bank, through economic agents who use the bank services;
- In appreciation of the system risk should consider all typology of banking risks;
- Assessing of the viability of a bank must be based on a deep profound financial analysis in witch to be addressed both financial aspects, and also non-financial aspects of banking activity;
- Last but not least, we believe that multi-criteria approach of the banking risk is the "Gordian knot" of the development of banking sector in a functioning market economy.

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