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# The Role of Risk Management Departments in Banking Institutions

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# The role of risk management departments in banking institutions

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**Abstract.** The topic of risk and risk management is a topic where the interest of academics, field professionals but also ordinary people has increased enormously. When this topic is dealt with in the banking system, the dominant element in the overall financial system of a country, then the interest rate is even higher, especially after the global financial crisis.

In the case of the banking system, credit risk is one of the main risks to which the system is exposed. Over the last decades, loans have occupied the main weight among the assets of the banking system. Moreover, in recent years, the quality of the loan portfolio has deteriorated significantly, which is evident from the significant increase in bad loans served (otherwise known as non-performing loans as defined in the Albanian regulatory framework).

Another objective of the paper is to identify and evaluate various macroeconomic factors and factors related to the structure of bank assets and liabilities affecting the bad credit indicator. Before interpreting the variables, all the necessary statistical tests have been made and their conclusions analyzed. Further, the impact of these factors is also transferred to the probability of default and the risk index as the credit risk metering for the banking system.

**Keywords:** Management, Risk, Banking Sector, Financial Reports, Credit

## Introduction

Risk has been defined in different ways over time. Some definitions focus on the probability of an event, others refer to the uncertainty of results, positive or negative, and others to risks as a subset of uncertainty that can be quantified [1].

Risk in finance is defined as the chance of return on investment, including positive and negative results. According to this view, a greater expected return is associated with a greater variability of results. In the financial industry, the view of risk is different. Risk is determined by the uncertainty that has adverse effects on profits or wealth, or the uncertainty associated only with negative outcomes. This view is that of regulators and risk managers[3]. The regulations aim to increase the resilience of financial firms and the financial system under pronounced conditions. Risk managers see their role as responsible for identifying, assessing and controlling the likelihood and consequences of adverse events for the firm. According to this view, risk is seen as the potential for loss arising from the interaction with uncertainty. The interaction arises from the exposure of financial firms to such a coincidence. Exposure is the extent to

which a business can be affected by several factors that can have a negative impact on revenue. For example, exchange rate exposure is the size of foreign exchange earnings; interest rate exposure can be measured by the size of debt indexed at market rates. Uncertainty cannot be eliminated, but exposure to uncertainty can be changed. Examples are numerous[5]. A firm that has foreign exchange earnings can borrow in the same foreign currency to minimize the impact of gaining exchange rate fluctuations. A floating rate of strong lending can reduce fluctuations in net interest income, interest income minus interest cost, etc., by borrowing the floating rate. Exposures can be long or short. Being tall is the conventional practice of investing in assets or portfolio. The holder of an asset is tall and the risk is that the value of the asset will decrease[2]. A short position can be seen as the reflected image of long positions and gains when asset values move down. In investment, a short position is the sale of a borrowed asset, such as stock, which is later purchased to return the assets to the insurance lender. In the event of a negative move, the stock borrower again buys the stock at a lower price and therefore wins. Protective hazards can be achieved by taking inverse exposures in long positions. Holding a stock is a long position, which takes a loss if stocks fall. The short position is symmetrical. When a party has a long and short position in the same stock, gains and losses are exactly offset. Therefore, a perfectly protected position is subject to uncertainty, but is not exposed to risk. Protection can be achieved with cash instruments, but is usually done with derivatives. Derivatives are instruments, the value of which is derived from other sub-legal assets. For example, the above firm ready to hedge its long-term foreign currency exposure, may enter into a contract, setting today the next exchange rate for converting foreign income into local currency. This is easier than trying to borrow in foreign currency. Due to their flexibility, derivatives are widely used[6].

#### **a. The purpose of the research**

The purpose of this paper is to determine and evaluate the indicators for measuring the risk to the banking system and the determining factors that affect these indicators.

The first step to achieving this goal is the left of credit risk through the bad credit serviced indicator , the Z index and the transition matrices . The second step is to identify and evaluate the determinants that affect these indicators, focusing on macroeconomic factors, such as Gross Domestic Product, Consumer Price Index, Unemployment Rate, etc., and those related to the structure of assets and liabilities of banks, such as Return on Assets, loan volume, loan-to-deposit ratio, etc[4].

#### **b. Research methodology**

The methodology used in this paper consists of descriptive (descriptive) analysis and risk measurement for the banking system, as well as the use of other descriptive methods for identifying and analyzing the determining factors that affect this indicator.

The descriptive analysis used in the beginning is a necessity for the breakdown and analysis of the main indicators of the banking system development and credit risk. Through this analysis it is possible to study the average values and volatility of the

indicators taken in the analysis and further draw conclusions about the current development but also about the expectation or future developments.

### **c. Banking risk**

Banking risks are the challenges that a bank makes for certain decisions and are commonly used to determine the losses of several different sources of uncertainty. The key to tackling and limiting the impact of risks on the bank is finding the source of the uncertainty and the magnitude of its potential negative effect on profitability. Profitability refers to both accounting and market-marked measures. Different risks need different approaches so a clear definition helps better quantify the risk measures and manage them. Therefore, the risk management techniques used by the commercial banking sector are based on enumerating the risks that the banking industry has chosen to manage and illustrating how the procedure for their management is applied in each area. Risks related to the income of banking services vary according to the type of service provided. For the sector as a whole, however, risks can be divided into six general types: systemic risk, market risk, interest rate risk, exchange rate risk, credit risk, liquidity risk, operational risk and legal risk. Here we will discuss each of the risks faced by the banking institution, and below we will show how they are managed[9].

### **d. Systematic risk**

Systemic risk refers to the possibility that a failure in a firm, a market segment or a settlement system could cause a "domino effect" across all financial markets affecting one financial institution after another or a "confidence crisis" among investors, creating illiquid market conditions. The effect of the model refers to the hidden risk under the interconnection of several sectors in the market and begins when the disruption of a firm or a market segment can affect and cause failure in segments of the entire financial system. Linking liabilities between the same institutions and the cash markets exacerbates that risk. Another aspect of systemic risk refers to the possibility that certain systemic factors may affect and change the value of assets[9]. By its very nature, this risk can be protected, but it cannot be completely diversified far and wide, and this leaves it in the category of indisputable risks. All investors take this type of risk, whenever owned assets or issued claims may change in value as a result of broad economic factors meaning that systemic risk comes in various forms. However, for the banking sector two are the biggest concerns, namely variations in the overall level of interest rates and the relative value of currencies (risks discussed below). Similarly, some institutions with significant investments in a commodity such as oil, through their lending activity or geographical exclusivity, deal

with commodity price risk. Risks related to fluctuations in raw commodity prices that may have a direct or indirect negative effect on the bank's net income and net worth. Others with high concentrations in the single industry can monitor the specific risks of industry concentration as well as the forces influencing the fates of the industry involved[11].

#### **e. Market risk**

Market risks are risks arising from changes in financial market conditions and adversely affect the value of financial products and, consequently, the net income and net worth of banking institutions. Liquidation of the transaction period is critical here, especially in assessing such unfavorable deviations from the current market value. Market risk includes the risk that prices or rates will change negatively due to economic forces and includes movements in capital markets and interest rates, exchange rates and commodity prices (factors that also affect systemic risk ). Market risk may also include risks related to the cost of borrowing securities, dividend risk, correlation risk and liquidity risk[10].

### **Basel II**

The agreement focuses on active international commercial banks, holding companies, banking groups, but its basic principles must be applied by other banks as well. Basis of Basel Agreements deals with[8]:

- Improved sensitivity to arbitration and financial market innovation
- Identify different risk exposures of different banks, by applying different methods to assess the unique exposure risk
- Expanding the types of risks when assessing the level of capital required to cover credit, market and business risk
- A requirement for all banks to develop internal risk management models and stress tests to assess their level of risk exposure ( VaR )
- A requirement for each bank to determine its capital requirements based on the calculated risk exposure, with the possibility of reviewing the budget of the supervisory authority Promoting public participation with the use of the highest market risk among banks that is assumed to take greater risks. Basel II consists of three levels [4]:
  - Level I sets minimum capital requirements for credit, market and operational risk , with the possibility of using sophisticated models and techniques for their calculation. The basic requirement is that banks have at least 8 percent of equity in relation to their risk-weighted assets. Weighted risk assets are calculated by multiplying the nominal amounts of asset positions by risk factors. The minimum capital of banks ensures the solvency of banks in relation to the risks to which the bank is exposed.
  - Level II reinforces the link between capital requirements and the type and degree of risks to which a bank is exposed in its operations and by insisting on the supervision process. Supervisors check compliance with capital requirements, internal risk assessment methodologies and determine corrective actions for banks that do not meet the prescribed standards.

- Level III complements the relationship between Level I and Level II, emphasizing the importance of market discipline and the introduction of minimum requirements for the disclosure of information by banks. This standard emphasizes the importance of transparent banking information. Institutions also provide for the mandatory submission of a series of cycles of adequate information on the performance of banks, which are usually submitted quarterly or semi- annually .

## 2.2. Basel III

Agreement Defines the Basel III framework (ICAEW: 1-3)[7]:

- Higher and better quality capital: a. an increase in the minimum common capital demand from 2% to 4.5% and a capital preservation buffer of 2.5%, bringing the total capital demand to 7%; b. The minimum 8.0% Basel ratio increases to 10.5%, including a 2.5% protection buffer; c. a narrower definition of capital (gradual removal from Tier 1 non-standard, over 10 years starting in 2013, d) a stricter treatment of deductions, including minority interests, investments in other financial institutions, tax assets postponed, repeal of group 3).

- Better risk coverage, especially in relation to capital market activities: a. trade book exposures will be subject to an underscored requirement for risk value; b. higher risk weights for securities and reinsurance in both banks and trading books.

- Introduce a leverage ratio as a return on risk-based demand: a. measures to promote capital construction that can be withdrawn during periods of stress; b. a minimum leverage ratio of 3% of the capital class first in total assets will be tested and monitored since 2011, to be formally introduced until 2013.

- Introduction of two global liquidity standards: a. Liquidity Coverage Report (LCR): is subject to the observation period from 2011 and will be officially presented by 2015; b. Net Sustainable Financing Report (NSFR): is subject to the observation period since 2013 and will be officially presented from 2018.

## Conclusions

Below are the findings of the study.

- ✓ Risk Management underlines the fact that the survival of an organization largely depends on its ability to anticipate and prepare for change rather than simply waiting for change and react to it.
- ✓ purpose of risk management is not to stop or prevent risk-taking activity, but to ensure that risks are dealt with consciously with full knowledge, clear intent and understanding so that they can be measured and mitigated.
- ✓ Risk management functions should in fact be specific banks dictated by the size and quality of the balance sheet, the complexity of the functions, the technical / professional workforce and the status of the MIS in place at that bank.
- ✓ Risk Management Committee, Credit Policy Committee, the Committee of Responsibility Assets , etc. Such committees that deal with aspects of risk management.

- ✓ Banks may be more aware of risk, anticipate adverse changes and hedging as appropriate; it becomes a source of competitive advantage as it can offer its products at a better price than its competitors.
- ✓ Regarding the use of risk management techniques, concluded that the internal system of evaluation and risk. The adjusted rate of return on equity is important.
- ✓ Effectiveness of risk measurement in banks depends on efficient management in the Information System, computerization and net operation of branch activities.

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