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THE IMPACT OF FINANCIAL RISKS ON THE PROFITABILITY OF A COMMERCIAL BANK

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The article reveals the influence of Belarusian banks financial risks on banks profitability.

In current economic conditions, bank system's functioning of any state is associated with various kinds of uncertainties in internal and external environment, which means, it's associated with risks. This category was studied by scholars from various economic schools: Keynesianism, representatives of the classical school and marginalism. And now, the relevance of this term's study doesn't require confirmation. Based on our previous research, it can be noted that the risk is understood to mean the probability, or rather the risk of losing by a bank its resources, shortfall in income or making additional expenses as a result of certain financial transactions, as well as the probability of impact on human values due to some solutions.

In the course of their activities, banks face a set of different types of risks, varying in the place and time of occurrence, external and internal factors affecting their level, and, consequently, the methods of their analysis and methods of their description. All types of risks are interrelated and have an impact on the activities of a bank.

While classifying bank risks, the question of the limits of each individual risk is still acute. An example is the difficulty of determining the threshold between interest rate risk and liquidity risk. The most logical and stepwise approach to risk classification is presented in the Risk Management Standard, created in the UK (The Institute of Risk Management). The selected method is formed on the separation of groups of homogeneous risks, for each of which are given its inherent external and internal factors [1].

Schematically, this classification can be presented in the following form (fig. 1).

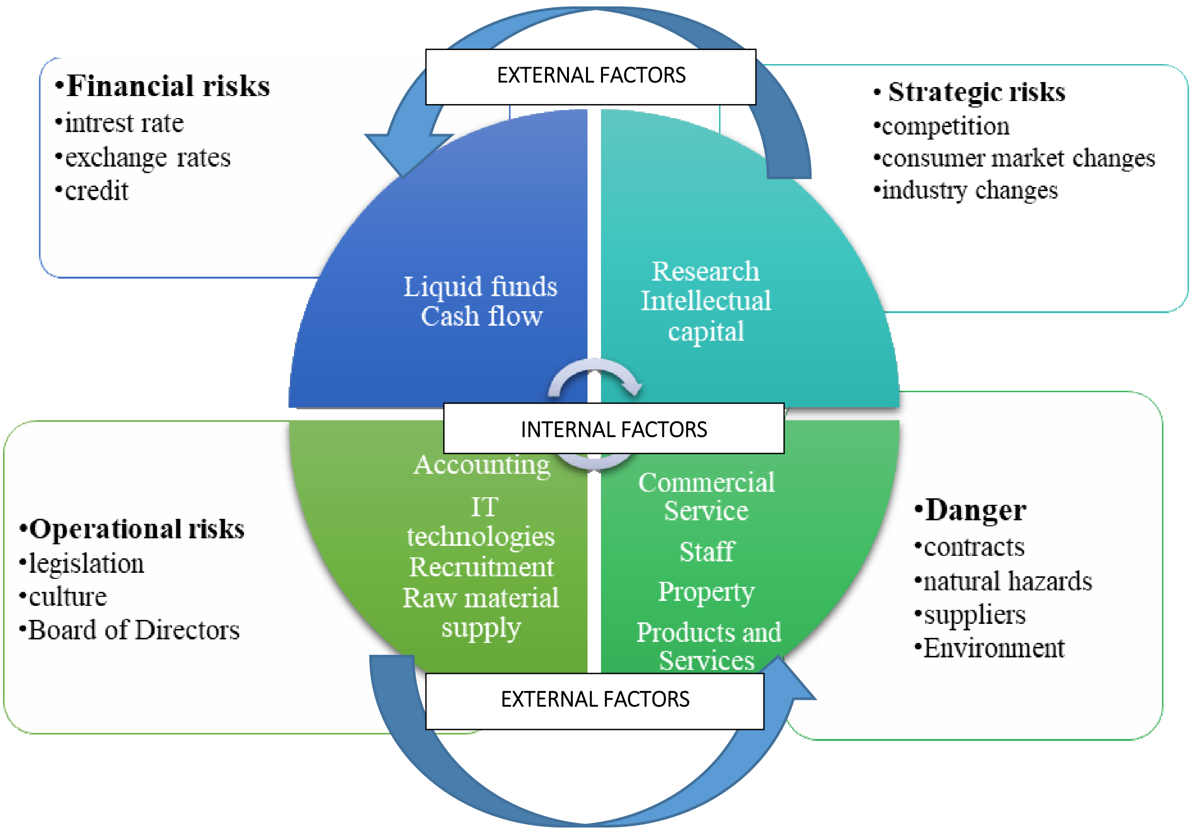

Figure 1. - Risk classification according to the Risk Management Standard [1]

However, in general, the classification of financial risks which are characteristic to commercial banks of the Republic of Belarus can be represented using the following scheme (Fig.2):

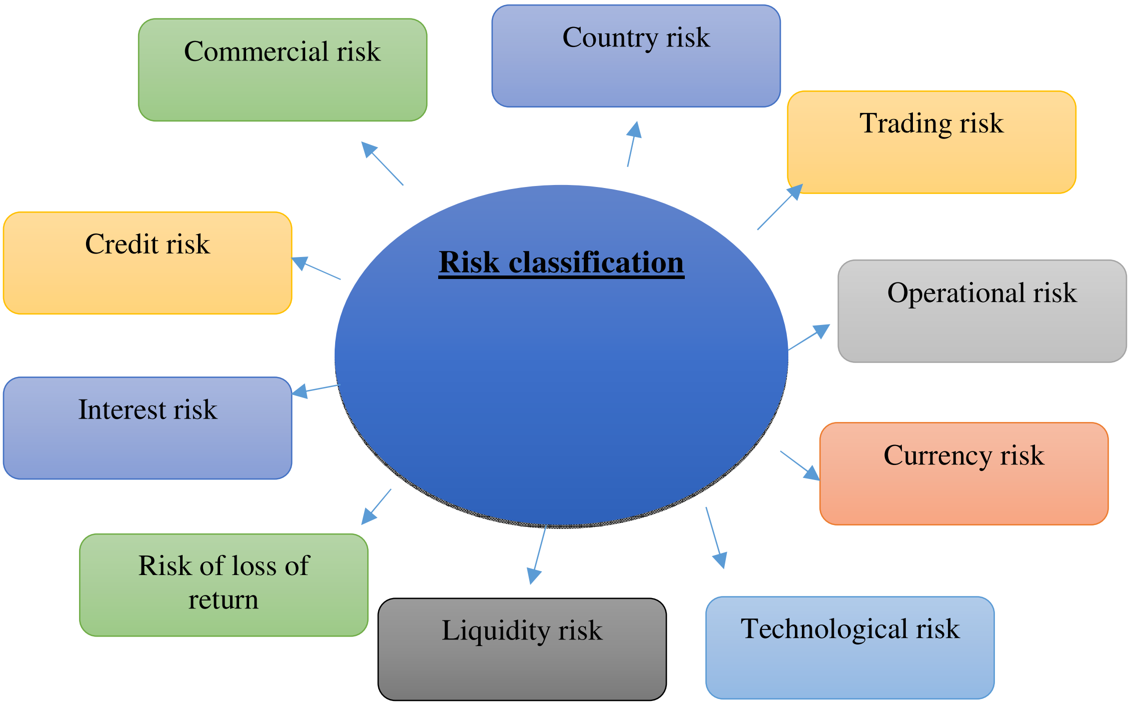

Figure 2. – General classification of financial risks of a commercial bank

Source: author's own development.

Currently, there is a large number of classification criteria and types of bank risks, but this is a scientific classification. Belarusian commercial banks in their reporting reflect an even narrower classification. There are, as a rule, credit, currency, interest, operational and liquidity risks.

Let's consider the impact of each of the selected types of risks on the profitability of a commercial bank.

Credit risk is the risk of no return or late payment on a bank loan. Credit risk may arise for each individual loan provided by a bank, or for the entire loan portfolio of a bank (aggregate credit risk).

Any commercial bank is interested in high profitability of a loan portfolio. As credit risk has a direct impact on this profitability, it is important to assess the impact of credit risk on the profitability of a loan portfolio. This work should be carried out systematically in order to be able to take prompt action to prevent negative processes accompanied by credit risk.

Currency risk is associated with the uncertainty of future interest rate movements, i.e. national currency prices in relation to foreign ones. It influences borrowers, lenders and investors who make transactions in currencies different from national currency. It includes economic risk (risk of changes in the value of assets or liabilities of a firm (or bank) due to future exchange rate changes), transaction risk and transfer risk.

Currency risk is taken into account while assessing the cost of a bank's capital by recalculating cash flows based on forecasted currency risks. The volatility of the exchange rate affects the market value of the bank through the inflow / outflow of capital, and, consequently, its profitability. If the national currency loses in its value, the domestic assets of a bank, including shares denominated in national currency, become cheaper. Depreciation will lead to an increase in the cost of capital and an increase in the demand for it. In addition, banks carry out active and passive operations in foreign currency, which contributes to currency differences after recalculation. Based on this, cash flows generated in foreign currency must be converted into evaluation currency either at forward rates or at the spot rate of the valuation date.

Interest rate risk is the risk that the average cost of a bank's borrowed funds, i.e. deposits and borrowed money associated with the provision of a loan may overtake the average interest rate on loans over the life cycle of the loan. It includes positional and structural risk.

This risk affects bank earnings, economic value of assets, liabilities and off-balance sheet instruments. Future changes in interest rates contain not only the possibility of deterioration the financial situation of a bank, but also the possibility of improvement of this situation. Interest rate risk management includes both asset and liability management. However, this management is limited by the requirements of liquidity and the risk of the loan portfolio of a bank, as well as price competition of other banks. Liability management is difficult due to the limited choice and size of debt instruments that bank can successfully place among its depositors and other lenders at any time, as well as due to price competition among other banks and NCFO for available funds. Changes in the level of interest rates can damage the profitability of a bank, increasing its financing costs, reducing revenues from assets and reducing equity capital.

Operational risk is the risk of loss in the result of inadequate or erroneous internal processes, actions of employees and systems, or external events. Operational risk is a broad discipline, close to good management and quality management. Operational risks affect customer satisfaction, reputation and shareholder value, while at the same time increase business volatility. However, operational risk is considered as manageable in order to keep losses within a certain degree of risk tolerance (i.e. the degree of risk that an organization is willing to take to achieve its goals), determined by balancing the costs of improvement versus the expected benefits. Therefore, there might be the impact of this risk on the profitability of a bank, but this will be adjustable and minimal.

Liquidity risk is the risk due to the fact that a bank may not be sufficiently liquid or may be too liquid. The risk of insufficient liquidity is the risk that the bank will not be able to fulfill its liabilities in a timely manner or this will require the sale of certain assets of the bank on unprofitable conditions. The excess liquidity risk is the risk of losing incomes by a bank due to an excess of highly liquid assets, but in the situation when there are few assets or they don't have income as a result of unjustified financing of low-income assets at the expense of attracted resources.

Any corporation has the goal to obtain the highest possible level of income, which, in turn, is usually accompanied by a high level of risk and a decrease in liquidity ratios. The effectiveness of any financial or business transaction and the value of its attendant risk are interrelated. The tasks of synchronous achievement of the required profitability and liquidity, as a rule, come into conflict. In reality, the desire of a bank to increase profitability causes a decrease in liquidity. Thus, the impact of this type of risk on profitability will be significant.

Due to the nature of its activities, a bank faces financial risks that in one way or another affect the profitability of a bank. Profitability, liquidity and risk are the "three whales" on which the work of a bank is based and which conflict with each other, therefore, the management of a bank is faced with the issue of effective optimal management of these categories, as they are reflected in the bank's performance and characterize its competitiveness in the financial market.

REFERENCES

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