

CONSIDERATIONS REGARDING CREDIT PORTFOLIO RISK MANAGEMENT OF THE BANKING INSTITUTION

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1. Introduction

Knowing the risk associated with a lending activity and of the risk profit of a credit institution determines the appearance of adequate management techniques, but mostly the prevention of the risk caused by the lending activity. There are many prevention techniques for the credit risk, starting with traditional models of limiting concentration at a portfolio level, up to the newest and most complex methods and instruments, conceived to respond strictly to the need of managing this type of risk.

The quality and the appropriate management of the credit portfolio represents the great challenge of the management of any banking institution because the development of a banking institution depends on the profitable placement of resources as well as on a decreased level of losses. Both for theoreticians and practitioners, the main banking activity is lending, precisely the investment, under different products, of the managed funds, both for physical and juridical persons irrespective of the activity field. Thus, any banking institution stands different risk levels, but the success or failure of an investment does not solely depend on this.

Many times have there been presented various quantification methods for the existing credit portfolio, but this can be done even in the preceding “formation” period if the lending operations are professionally organized and managed.

2. Some conceptual perspectives of the credit risk.

Credit risk is one of the most important risk encountered in the activity of a banking institution and it expresses the possibility that the debtors or the title issuers cannot accomplish obligations in time, as a result of the degradation of their financial situation which can be determined by the lending conditions or by the general economic situation.

There are two components within this risk: transition risk and credit risk. The first refers to different functional aspects of the business risk, like juridical, political or practical implications, while the second refers to the business profitability.

Credit risk is also known in the specialty literature under the generic name of counterparty risk. Credit risk is generally defined [2] as being that risk of financial losses determined by the non-accomplishment of the obligations by the contractor (counterparty). Its effect is evaluated by the cost of replacing the financial fluxes which might have been generated by the counterparty through the credit contract conditions.

From this perspective, the credit risk contains two components:

- The risk of the impossibility of paying or of the counterparty's bankruptcy (*default risk*) appears in case the debtor cannot, partially or completely, fulfil the contractual obligations (paying the interest and the credit rate);

➤ The spread risk (*spread risk*) appears when the market value of the credit instrument is reduced because of changes intervened in the debtor's reliability.

In practice, there are generally utilized a series of credit risk management methods and techniques:

➤ A priori management which presupposes the division and limitation of risks, the evaluation of the reimbursement ability, the grounding of guarantees;

➤ A posteriori management which presupposes the analysis of the credit portfolio and the formation of commissions, the creation of the background for general banking risks.

The following indicators can be used for the *evaluation of the bank's credit risk*:

➤ The rapport between unsuccessful assets and the total amount of credits. Unsuccessful assets comprise of income generating assets, including credits, whose payment delays surpass 90 days from the limit.

➤ The rapport between the net value of the credits outside the audit and the total credit amount.

➤ The rapport between the value of the annual commissions for credit losses and the total amount of the portfolio credits.

➤ The rapport between the unsuccessful assets and the real capital of the bank.

➤ The rapport between the total amount of credits and the total amount of deposits.

In the case of the first two indicators, the credit risk bank exposure simultaneously raises with the growth of their value. The next two indicators stress out the fact the degree at which the bank is ready to react to losses caused by the credit risk by building up some reserves. In the case of the last indicator, a growth of its value represents an alarm signal for the surveillance authorities because credits are among the most risking

assets, while the value of the deposits must be closely protected.

3. Determining factors in the formation of a credit risk.

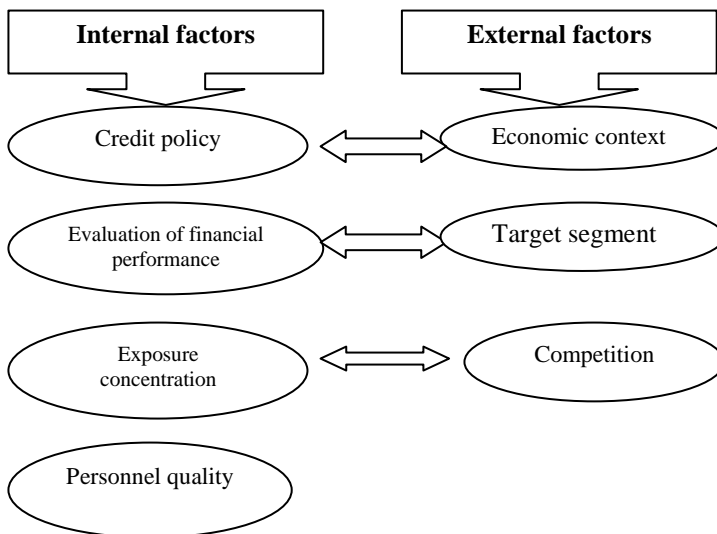
The credit portfolio of a bank depends to a great degree on the constitutive and administrative method. Thus, the factors that influence the credit portfolio of a bank can be of several types: internal factors and external factors.

The internal factors of the credit institution [3]: *the evaluation criterion of the financial performance* of the borrowers in order to correctly classify these into five categories [4]: "standard", "observing", "substandard", "ambiguous" and "loss", by simultaneously applying the following three criteria: the duty service (0-15 days, 16-30 days, 61-90 days and over 90 days), the financial performance (from A to E) and the initiation of judicial procedures [5]. In this category there is also included the observance of *the frequency with which the category of financial performance of an economic entity is determined* (revision, the management of client and indirectly of the entire portfolio), which must be identical with that of determining financial situations (at least semestrally and annually), in a period between two determinations of financial situations by keeping the last category of financial performance established, as well as the compulsoriness of being part of only one classification category for the total amount of credits given to a debtor and/or of constituent investments, respectively by taking into consideration the weakest individual classification category. Another deteriorating factor of the credit portfolio is also represented by the concentration of the exposures of a narrow number of debtors or of a certain activity segment, so that in the case of a default, the credit institution registers a considerable loss.

The external factors are somehow independent from the measures taken by a credit institution, but these also can be quantified and taken into consideration for the new clients to be included in the credit portfolio. I precisely refer to the macroeconomy elements for different activity areas to which the bank is

exposed. Following these indicators, the credit institution can monitorize the number of company bankruptcies in an activity category as well as the position of that area (industry, agriculture, buildings etc.) in the context of national economy.

Deterioration factors of the credit portfolio



Source: created by the author

The activity of banking lending takes into consideration three main lines.

Strategy in the domain of structuring banking credit portfolios determines the balance of different credit categories as a whole, the directions and lowest portfolio diversification limits, as well as the involvement degree in syndicalized credits. Being the most important banking asset, credits play a special importance part for ensuring the banking liquidity, simultaneously with ensuring the banking profitability.

The liquidity determined by the structure of the banking assets and liabilities is one of the major restrictions in the structure of the banking credit portfolios; this is so because – in the absence of a secondary market

sufficiently developed, the credits' liquidity is almost exclusively determined by their term.

Lastly, another determining line in the formation of the structure of the credit portfolio is given by the bank's aggressiveness (market level). An aggressive politics is characterized by absolute growth (value in constant prices) and relative growth (balance in total banking assets' amount). Such a direction usually has a temporary character because it has some disadvantages. On a short term, such a policy can lead to a growth in incomes, but it is less certain that this growth will also attract a growth in profitability. The rapid growth of the credit portfolio value evidently increases the risks implied by

the management of this portfolio. The most risking element is represented by the potential decrease of the portfolio value, because of the pressure imposed upon the personnel, the management of a larger amount of clients and the strategic imperative of conquering the market; if this imperative becomes a priority, then it can turn to growth at any price and, most often, this price is represented by the growth of the banking risk global exposure.

The business plan of a banking institution is primary for a good evolution of further activities, both from the profitability point of view and from the point of view of assuming the accepted risks.

The development strategy of credit institutions usually has an estimative of two years, precisely for elaborating a business plan based not on immediate results which are accompanied, most of the times, by assuming great risks, but on a healthy development, strongly footed, each step being calculated and thoroughly planned by the management strategies of that credit institution.

Certainly these statements, in the economic-financial context from the last years can be at anyone's hand, but there has always been acknowledged that a galloping development, indifferent of domain, sector, area, without a real, solid basis cannot lead, on a long term, but to a collapse, a real implosion of its own "bubble soap". The moment a business plan, a development strategy is compiled, there must be taken into consideration not only a single direction of the credit act (from the institution, its action), but a real horizon which comprises both microeconomic elements (counterparties) as well as macroeconomic ones.

I state this because a desire to expand lending to a certain activity area (niche), if not previously analyzed from all perspectives (microeconomic and macroeconomic) can firstly lead to a

positive boom for the usher, but which can later be fatal as it might choke that credited activity area with a direct impact upon the PN (nonreimbursement probability) of the counterparty. Giving credits without monitoring their utilization can be a fatal error, especially for an economy that doesn't have discipline, economic maturity, an economy in which consumption and not direct investment, even in the domain of juridical persons, is very high.

Thus, in my opinion, a business plan, which actually is a strategy, should comprise of the following steps:

- a. Introduction (presenting the history of the credit institution)
- b. Basis principles in the activity of the credit institution
- c. Clients, target markets, existing and future products and assets
- d. Strategic objectives, indicators and targets
- e. Evaluating the impact of objectives upon the credit institution
- f. Action plans for achieving the objectives
- g. Strategy implementation plan
- h. Action plan for non-achieving the objectives
- i. Conclusions

4. The impact of the economic crisis upon the quality of the bank's credit portfolios.

Financial turbulences which internationally began in 2007 have quickly transformed into a crisis. This intensified in September 2008, seriously affecting the global economic growth. The economic growth of 3,2 per cent universally estimated for the year 2008 is believed to be replaced by a decrease of 1,3 per cent in 2009. In the beginning, the crisis especially affected developed countries. Risk aversion in these countries was quickly transmitted to the emergent areas. Central and Eastern Europe (CEE) was not avoided. The feeling of the markets started to matter

more and more in the *spreads*' dynamic and in the exchange rates of the CEE countries. The region entered in a high risk area, where Romania is not immune and contagion from one country to another has increased. Forecasts for the region are pessimistic (see the table below): economic decreases are generalized, companies disinvest and unemployment increases, account deficits adjust, even brutally in some cases, fiscal deficits significantly increase. In these conditions, the rebuilding of trust in the favourable perspectives of the region is essential.

Rating changes in Central and Eastern Europe

- 2 degree	- 1 degree		+ 1 degree
	LT	Jan. 2008	HU
		Feb. 2008	
		Mar. 2008	CZ
		Apr. 2008	
		May 2008	
	UA	June 2008	
		Jul. 2008	SK
		Aug. 2008	
		Sep. 2008	
RO	LT, LV, UA, RO	Oct. 2008	
	LV, BG, HU, RO	Nov. 2008	SK
	LT	Dec. 2008	
	LV	Jan. 2009	
UA	LV, UA	Feb. 2009	
	LT, HU	Mar. 2009	
LV	LT, LV	Apr. 2009	

Source: BNR, S&P, Fitch and Moody's

The real estate balloon [6] was characterised by the excessive use of the lever effect. This was motivated by sophisticated risk management models which took into consideration the known risks, but ignored the uncertainties inherent to reflexivity [7]. Controlling the lever effect will reduce both the dimensions and the profitability of the financial industry, but it is an action publicly necessary.

Because banking institutions, rating agencies, auditors based their evaluations on the previous loss experiences, and these experiences had bettered during the growth of the dwelling prices, agencies became extremely generous in evaluating mortgage bonds in guarantee. At the same time, the initiators of mortgages became more and more aggressive in the lending practices on the residential market. In the end, houses could be bought without advance and questions. Everything held out up to when the rate of the interest started growing. So that in the spring of 2007 problems in the subprime sector led to the bankruptcy of the New Century Financial Corporation.

In this created situation, a solution for the banking institutions in order to transgress this period is the restructuring of credits by restagging, setting new terms or reducing the profit margins. Nevertheless, the banking institution cannot expect a real bettering of the credit reimbursement degree since payment delays are not caused by a temporary situation, by seasonality, but by the reduction to a chronic state of all business plans, the decrease of request and offer, the growth of unemployment, the lack of some coherent regional politics, the lack of crediting real investments etc.

The most important lesson that can be learnt in the current crisis is that banking authorities, institutions should be interested not only in some parts of the national finances, but in controlling cash flow, prices or offering credits, in all these as a whole. Not only process and production must be monitored.

4. Conclusion

Defining markets or commercial areas for the bank is a long term strategy element and achieving this objective requires time, especially when a radical orientation change is requested. Credit policy must definitely define the primary

and secondary market for the credit activities, as well as the geographic priorities. It becomes obvious that this orientation of the credit policy is valid, in content, depending on the bank type: for an international bank these appear as regions or country groups served by own banking agencies and defined by activity amount and operations. For smaller banks, the commercial area has a preponderantly national or even local (regional) character. In this context, the geographic priorities can presuppose an extension, a consolidation or a retreat from certain markets, markets defined from the point of view of the geographical area served by the bank. The actual content of this credit policy element is composed of the explicit definition of the area regularly served by branches or own agencies, the establishment outside of its commercial area, as well as the exceptional conditions of accepting other credits.

Among the different causes that can influence *the quality of the credit portfolio* there can be mentioned¹:

- lack of a thorough analysis of the market segment to which the product is addressed;
- elaborating norms based on insufficient analyses regarding the target public;
- emphasis on quantity, not quality;
- not knowing the clients' treasury flux;
- preferential crediting (waivers);
- risky concentration of credits on different markets;
- weak control upon the credit activity;
- lack of experience as regards compensating personnel;
- lack of experienced personnel in the recruiting departments of a credit institution.

In order to overcome the possible "contracted" deficiencies right

from the beginning and which now form the credit portfolio, banks must conceive and implement alarming politics, more precisely minimum and maximum limits of the assumed risk, which offer a permanent feedback for the board of the credit institution, about the efficiency of the control process of the credits' quality, of investments, so that those with problems can be detected and adjusted (as much as possible) in time.

Notes

1. Romania is in a period of "economic retrieval", in which bankruptcy and transition must be taken into consideration when lending. Romania needs flexibility and that is why risk management methods must be flexible and adapt to our economy.

2. Philippe Jorion (2007), *Value at Risk, The new benchmark for Managing Financial Risk*, third edition, McGraw-Hill Companies

3. Van Greuning, H. & Brajovic Bratanovic, S. (2003), *Analyzing and Managing banking risk*, The World Bank

4. Trenca I, (2002) *Metode și tehnici bancare, Principii, Reglementări, Experiențe*, Ed. Casa Cărții de Știință, Cluj-Napoca

5. BNR Norrn nr. 3/1994 regarding credits' classification and forming specific risk resources, BNR Regulation nr. 2/2000 and BNR Regulation nr. 5/2000, with subsequent changes and additions.

6. George Soros (2008), *Noua paradigmă a piețelor financiare*, Editura Litera Internațional, București

7. Market fundamentalism has its roots in the theory of perfect competition, like it has been presented by Adam Smith and classic economists. In the post-war period, the idea was supported by the failure of communism, socialism and other form of state interventionism. This enthusiasm is based on some wrong premises: the fact that the state intervention is always wrong doesn't make markets perfect. The basis

argument of the theory of reflexivity is that all human constructs are wrong. Financial markets don't necessarily aspire to balance; in the hands of their own instruments, they can oscillate between the extremes of euphoria and desperation. This is precisely the reason

for which they are not allowed to action at their own will – financial authorities have the duty to monitor and control them. Excessive trust in the market mechanisms – *laissez-faire* – is not always good.

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*****	Comisia Europeană (2009) „ <i>Communication from the Commission regarding an EU framework for Cross-Border Crisis Management in the Banking Sector</i> ”, http://ec.europa.eu/internal_market/bank/docs/crisis-anagement/091020_communication_en.pdf ;
*****	Basel Committe on Banking Supervision (2006): International Convergence of Capital Measurement and Capital Standards, http://www.bis.org .