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RISK MITIGATION IN THE BANKING SYSTEM IN THE CONTEXT OF INTEGRATION IN THE EUROPEAN UNION

Theoretical article

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Abstract

The article aims to highlight the measures adopted in the financial-banking system in the context of the European integration, according to risk analysis perspectives. The first part provides details on the vulnerability sources in terms of banking risks and their approach from various perspectives. Subsequently, based on the identified risks, a series of measures are proposed to limit them within the banking system. In terms of the work hypotheses, they are confirmed, thus increasing the harmonization level of theories throughout the European Union. Research was based on methods such as analysis, synthesis and induction, used to select the opinion of specialists in the field on the studied matter, and deduction, through the cross-section method, thus following the evolution and measures adopted in time. Following the analysis, a need was noticed for the implementation of an efficient banking risk management system, together with drafting additional regulations, so that the banking system is better prepared to handle new challenges generated by the crisis. The term afferent to the accession and integration in the European Union implied a stage requiring a radical change of the Romanian banking system, considering issues such as Romania's economic development, leading to an increase of the banking mediation process.

1. INTRODUCTION

Building a culture where risk management is seen as a determining business factor implies the initiation of measures to draw a risk profile, and constant communication to this respect. At the EU level, the issue deals with some of the most efficient banking systems in the world, adopting the most effective risk management practices. The most common risk prevention measures include elements such as rethinking the organizational structure of credit departments, external audit, drafting business plans according to major trends, supporting a fair risk culture within the sales force and client segmentation.

Work Hypotheses

In order to provide arguments for the risk mitigation strategies amongst credit institutions, it is important to determine the techniques and practices that are useful in identifying and assessing the financial and non-financial risks forming the basis of the banking activity. Moreover, it is necessary to outline a hypothesis according to which an identification plan can be established and best practices elements can be proposed in the financial-banking field, by analyzing the entire system.

2. CURRENT STAGE OF KNOWLEDGE

Several approaches were used in assessing the banking system integration stage (Gropp and Kashyap, 2009) to explain the cross-border banking merger situation (Kohler, 2007; Kohler, 2009) defined *de facto* by the absence of such offers compared to the number of internal mergers.

A different approach was to consider the integration perspective, starting off from the interest rate convergence analysis (Adam *et al*., 2002), studying the issue in terms of corporate credits and mortgage credits and analyzing the interest rate convergence for a five year term. Other authors (Affinito and Farabullini, 2009) prove that in the Euro area, the “price” has a wider dispersion than in Italy, reaching the conclusion that “Euro area prices seem different, since national banking products seem different or because they are differentiated according to national factors”, while there are also theories according to which the interest rate dispersion can be fully independent from banking integration (Gropp *et al.*, 2009). The latest integration analysis approaches concern the convergence of bank profitability (Gropp and Kashyap 2009). Moreover, globally, certain authors deem the profitability and the capitalization of banks to establish not only an integration factor, but also instruments ensuring a stable and safe setting (Blejer, 1998).

The theoretical and methodological bases of banking risk identification, management and assessment, of risk control and financing in banking institutions are dealt with and researched in the works of numerous authors, such as: Trenca I., Bătrâncea I., Făt C., Beju D., Alexander C., Basno C., Benninga S., Berkowitz J., Dardac N., Dănilă N., Greuning H., Bratanovic J., as well as in reference works (Roxin, 1997), (Stoica, 2002), (Trenca, 2004), (Bătrâncea and Trenca, 2008). Therefore, it seems only natural that certain authors have shown interest in studying the capital impact (Repullo, 2004; Gropp and Heider, 2009), the operational efficiency impact (Casu and Girardone, 2009) and business models (Demirgüc-Kunt and Huizinga, 2010) in banking systems, under such hypotheses. At the same time, it can be seen that there is a limited number of studies assessing the inter-temporal relations between banking risks, the capital and efficiency risks (Fioderlisi *et al.*, 2010). The risk culture of an organization starts with the management. If it understands to define and manage its organization’s appetite for risk, then it requires an executive management team with solid business and risk expertise. The management must be capable of assessing the risks that are undertaken (Tescher *et al.*, 2009).

3. RESEARCH METHODOLOGY

The following **research methods** were used to meet the main objective: the analysis and synthesis method, used to select the opinions of specialists in the field on the studied issue, and deduction, through the cross-section method, following the evolution and methods adopted in time. An important part of the study considered fundamental (theoretical) research, resorting to the research and studies of specialists in fields such as European integration, risk management, financial stability, used together with documents and materials submitted in various international studies. The research was based on objectives such as analysis in the current context of the banking system through the integration and risk perspective, as well as risk and financial stability management. The **research objective** is to analyze the theoretical and practical risk issues in the business model of commercial banks and the options to improve it under the conditions of a European integration process, from restricted competition specific to a national system, to wider competition, specific to an integrated system. The scientific approach consists of identifying the national and European practices to this extent, as well as determining the influence factors of banking risk and of trends to improve the risk mitigation strategy of commercial banks.

4. RESEARCH ANALYSIS AND RESULTS

The business practices amongst commercial banks are not only influenced by the geographical area, but also by the current context determined by the global crisis, technological innovation raising the challenge of keeping up with significant changes in the business environment and economic volatility and mainly the evolution of globalization. Influences and their impact on the business model of commercial banks in the context of European integration can be determined by: the historical and geographical context, determined by Romania’s geographical position and by the manner in which the legal model was undertaken from the European banking system, during the European integration process preparation period. Moreover, the banking business system can also be influenced by the European establishment of financial-banking institutional organization models, as well as by European banking axes (North and West), with different approaches, the profitability approach in terms of the costs on the north axis and in terms of the costs on the west axis.

A series of directions must be followed in order to draft an efficient business system:

- the supported increase of incomes and profit, as the profitability and capitalization of banks is not only an integration factor, but also a set of instruments ensuring a stable and safe setting (Blejer, 1998). This can be achieved through cost efficiency, particularly of the risk cost and the adequate use of capital.

- the constant improvement of the **balance quality**, while also leaving from the current regulation context, as well as a technical performance improvement element.

- the client value, by directing resources towards the improvement of basic elements such as organization culture, IT security systems, long term strategies, basic values and objectives and business processes in order to create customer value.

- European **shareholding and management** resulting from the influences determined by the risk culture specific to the areas they originate from;

- international and particularly European **banking regulations**.

The identification of risks, as well as establishing the location thereof is a first stage in global risk management, particularly the classification thereof according to each banking product or service type. Once identified, scenarios must be drafted to detect their occurrence frequency and extent, as well as the influence of various factors.

Having identified the risks, the control and elimination thereof is a particularly important stage in the surveillance thereof, in order to minimize the afferent costs. A special issue consists of the undertaking of risks by bankers, as they are reluctant to fully undertake the risks, with awareness, encouraged by the regular activities they deal with.

The need for an efficient banking risk management system is a measure that requires immediate implementation, together with the drafting of additional regulations, so that the banking system is better prepared to manage new challenges generated by the crisis. From this point of view, risks are grouped in two categories: the category of financial risk as the direct result of the role played by banks as a financial agent or as an inventor, and the non-financial risk category, common to all economic agents, through the nature thereof. In order to identify and assess risks in the banking system, they can be grouped in four major categories, according to their origin; therefore, they can be: credit, market, liquidity and operational risks.

In order to optimize the activity in the banking system, a series of proposals can be drafted, to mitigate the risk according to some of the most important factors. Table 1 indicates the risk management measures from this point of view.

Table 1 Risk mitigation measures in the banking system

Risk	Measures
Crediting	- developing adequate debt retrieval policies; - establishing adequate early warning indicators (debt trend); - implementing computer programs based on the analysis of the client's current activities, on the analysis of various payment incidents; - noticing the client's behavior; - performing quality analyses to determine the factors influencing the crediting decision; - introducing computerized scoring systems for the SME segment;
Market	- using different scenarios and tests to change the interest rates and the exchange rate for certain time intervals; - adapting scenarios according to the current activity; - determining the potential daily losses;
Liquidity	- the optimum credit/deposit ratio; - drafting early warning indicators;
Operational	- introducing quality indicators (operational errors, customer opinion on service quality – waiting times, the quantity and quality of the received information, cost transparency, client maintenance and protection activities); - using early warning signals for internal and external fraud (**the ratio between the number of cancellations and the total number of operations**).

Source: Created by the author

There is currently no unitary risk management system; through their nature, banks obtain profit from the activity they develop on certain market segments, which is why the bank's capacity to protect itself also greatly depends on elements such as capital size, management quality, technical expertise and staff expertise in the respective fields.

5. CONCLUSIONS

The term afferent to the accession and integration in the European Union implied a stage requiring a radical change of the Romanian banking system, considering issues such as Romania's economic development, leading to an increase of the banking mediation process, that is still set at a low level compared to other EU states, and the significant increase of the banking network, of the number of banking agencies determining the increase of the number of employees in the banking sector, as well as the development of the management skills of such a banking network. The European integration process and the steps taken by the accession date have fundamentally changed the legislative base of the banking system and the role of the central bank.

Any new regulations shall be applied in full, to all institutions, and not just those that pose major risk. Considering the variation and complexity of the influence factors over the business model of commercial banks, the guidance of the management's vision in this case should be implemented according to principles and values, which include the development of sustainable business and the implementation of corporate governance principles. Thus, European best practices must be adapted to the specific nature of the Romanian banking market.

In terms of the work hypotheses, they were confirmed through the option of approaching banking risk management from different perspectives, allowing the establishment of vulnerabilities and the highlighting of certain important issues, outlining and proposing specific security measures.

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