DEVELOPMENT OF RISK-FOCUSED BANKING MANAGEMENT:
TENDENCIES AND PERSPECTIVES

Nataliya A. TYSYACHNIKOVA
Russian Agricultural Bank, Moscow
nataliyaat@yahoo.com

Abstract

The global financial crisis showed up the weakness in the management systems quality of national and international financial institutions, especially in Internal Control and Risk-management. At the last spring meetings International Monetary Fund and World Bank approved a number of measures to strengthen a structure of supervision, including the proposals of Financial Stability Forum (FSF). FSF encourages to enhance the banking supervision for capital and liquidity.

At present time banking regulators implement the New Capital Adequacy Framework (Basel II). For credit institutions Basel II implementation is not only serious revision of organizations, principles and methods of risk-management and internal control, but change of attitude to them.

Bank of Russia has already begun a preparatory works for implementation Basel II approaches. Therefore, to not appear before the fact of banking management reforming in deadlines, Russian banks must take steps on forming the management systems according to requirements of Basel Committee on Banking Supervision.

Keywords: financial crisis, banking management, risk-management, credit institutions.

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Introduction

The global financial crisis showed up the weakness in the management systems quality of national and international financial institutions, especially in Internal Control and Risk-management. The latest events clearly illustrated the necessity of formulation more advanced risk-control methods and implementation of preventive measures in risk-management during “good years”.

The working on that task solution has been begun yet. At the last spring meetings International Monetary Fund (IMF) and World Bank approved a number of measures to strengthen a structure of world supervision and regulation, including the proposals of
Financial Stability Forum (FSF). FSF encourages to enhance the banking supervision for capital and liquidity.

At present time banking regulators implement The New Capital Adequacy Framework (commonly dubbed Basel II). Despite the fact that Basel II was implemented in none of the countries, there are calls to make the rules even tougher.

Banking community of the different countries, including Russia, demonstrate ambiguously treatment to Basel II. Amid the global financial crisis it is contravened expediency and effectiveness of Basel II implementation. Thereby the main arguments are, on the one hand, inability of the largest credit institutions, supposedly using the models of risks appraisal, proposed by Basel II, to forecast the increased risks of the new financial products, on the other hand, - “short views” and overconfidence of banking regulators, which practice was taken as a basic for evaluation of banking supervision standards. However it is rarely taken cognizance of the fact that Basel II was implemented in none of the countries, including USA – its general “ideological mastermind”.

Basel II is symbiosis of progressive methods of risks appraisal (credit, market and operational), risk-focused supervision and market discipline. In intension of Basel Committee on Banking Supervision only complex of these “pillars” can provide the financial stability.

So, using advanced approaches of risks appraisal by some financial institutes is not an indicator of Basel II implementation, but it is the fact of presence of good risk-management instruments. Basel II is the new paradigm of banking supervision, spreading to the whole national financial system.

For credit institutions Basel II implementation is not only serious revision of organizations, principles and methods of risk-management system and internal control, but change of attitude to them. For example, internal control will became a bank “internal supervisor” – a key element of the self-regulation system, the important factor of risk-focused banking management.

In this regard the orienting point for financial institutions can be recognized the Pillar II of The New Capital Adequacy Framework, which includes all necessary recommendations for quality improvement of banking practice in risk-management, activation of control risk process.

1. From mistakes to crisis

Despite a presence of methods and internal normative documents, frequently having formal correspondence with recommendations and requirement of national supervisory authorities, many credit institutions demonstrated highly irresponsibility attitude to necessity
of self-regulation system on risk control, especially in relation to the new financial instruments. So, on structured investment instruments banks marked down greatly their requirements to borrowers’ paying capacity, and generally there were not such requirements. Meantime the instruments, such as securitized subprime loans, sliced a security into several tranches, each with a different level of risk and sold separately.

There were a lot of episodes when subprime mortgages were accommodated to borrowers with no income, no job, and no assets. Internal control and risk-management of the banks did not stopped the processes of loans disbursement or make little of them. Because, the banks trusted rating agencies to evaluate the risks appropriately. Practically, it was shifted the responsibility on rating agencies for credit risks determination both on individuals borrowers, and on banking loans portfolios.

Meantime, it was not paid attention to reasonable fact that because rating agencies are paid by the issuers that request ratings, they may have the incentive to rate the underlying security too highly to ensure that the issuer can attract buyers and, when conditions deteriorate, to avoid downgrading the rating too quickly so as to appear to have a stable and credible rating system (Randall, D., Mills, P., 2008). Therefore, more than 90 (IMF 2008) percent of securitized subprime loans being turned into securities with the top rating of AAA. So, when quality of underlying securities deteriorated and flow of payment was broken, liquidity dried up and many banks were faced with default.

One of the main problems of banking risk-management was an increasing dependence on quantitative risk measurement, especially for credit risks, without applying an overall approach to risk management. In recent years, greater sophistication has been applied to the quantification of various risks, especially credit risks. For example, complex structured credit products are particularly difficult to assess because they contain not only credit risks but also liquidity risks and market risks. Even the best risk-management systems have not sufficient instruments for their classification and call upon to methods for separately examining of credit and market risks. The same situation is in the context of the risks’ assessments on different banking business portfolios – links between loans and securities are not established, and, thus, they are not stress-tested.

And even when the complexity and interrelatedness of risks were understood at the working level, that information was not communicated effectively or accepted at the top of the organization. Hence, in some cases, these risks slipped through the cracks (Kodres, L., 2008).

In turn, the internal control systems of financial institutions have appeared unable to estimate adequately scale of the problems connected with weak points of risk-management. Moreover, in the majority of cases the internal controls had the procedures prescribed by the
bank supervising legislation which frequently lags behind banking development. Formal compliance with the adjusted rules and the inspection schedules, following to sample schemes of risks’ identification and appraisal of management activity for their neutralizations, giving risk-information to a top-management according to the prevailing cliché - are the basic components of present internal control systems which have led to inefficiencies of these systems and as a result to their uselessness for banks.

Evidently, that internal control systems need to play more appreciable role in the bank management organization and to become “internal supervisor” for the bank, objectively estimating its financial stability and quality of risk-management. In this context analytical component of internal control will be strengthened. It will be got closer the cooperation between internal control and risk-management division, in particular, within the limits of development making for perfection of identification and assessment risks system, changes in variation of approaches for its organization and attitudes to it.

Internal control systems will have to raise its sensitivity to changes in regulatory environment and even to anticipate actions of supervisory authorities in the field of risk-management methodology, the control for market discipline and introduction risk-focused approach of the top-management to decision-making.

2. Future after crisis: banking sector is in waiting for changes

The global financial system and also national financial systems remain under severe stress as the crisis broadens to include households, corporations, and the banking sectors in both advanced and emerging market countries. At the same time, some attributes of financial stabilization already distinctly were outlined. For the purpose to support these improvements, to restore the trust of the population to banking and to normalize a situation in the markets, not only the national government and supervisory authorities but also the financial institutions will have to take decisive and effective measures.

Concerning financial sector the measures are directed on removing strains in funding markets for banks and corporates, repairing bank balance sheets, restoring cross-border capital flows (particularly to emerging market countries); and limit the unintended side effects of the policies being implemented to combat the crisis.

For banks it means the beginning of clearance bank balance sheets from non-performing assets, often accompanied by restructuring and, where needed, recapitalization. It was initially estimated that write-downs of finance institutions could reach a total of around $4 trillion, about two thirds of which would be incurred by banks.
In some countries the government has agreed to take up significant parts of the future losses on the groups of actives sustained by some banks. However, conditions of injection of the capital the state will be hard. Besides the account of write-downs and an available capital, the banking supervisors, spending viability evaluation of banks, should make sure in stability of their structures of financing, business-plans and managerial processes by risk, an acceptability of policy and management force. Non-viable financial institutions will be subjected to sanitation in the shortest times. Such sanitation can cause restructuring, staff reduction, and also, probably, its gradual closing, under condition of certainly, that it will not threaten system-vide financial stability.

Long-term viability of the financial institutions will be estimated both national supervisory authorities, and from top-managers of those institutions. It is necessary to define banks’ demands for the capital in view of an actual losses assessment up to the present instant and perspectives of the further write-downs.

Working on the stable financial system has begun already now, during crisis, therefore there are no doubts, that it will amplify and after the crisis. Cleansing of banks’ balance sheets of impaired assets is only one of measures on financial stability reconstruction. There are no doubts that crisis will demand far-reaching changes in structure and functioning of the financial markets and that the financial system will be characterized by a low level of borrowings, smaller financing structure gaps, lower risk of default from obligations by counterparts both more transparent and simple financial tools, than during the pre-crisis period.

As both the market discipline, and the supervision have appeared insufficient for an appropriate system risks’ assessment and restriction of its growth, improvement of financial regulation and supervision, as well as creating of effective system of self-regulation inside of the financial institutions are key elements of the future crises prevention. Clearly, that by virtue of the settled practice, banks will unwillingly take any measures on creating risk-focused management system without motivation from a regulator. However change of the banks attitude to the organization of intrabank management and control is undoubted because the system stability is the public interest.

As regards regulatory reforms, the financial institutions should expect changes in five basic directions:

- tightening of the prudential regulation and supervision and extending the perimeter of regulation to cover all systemically important institutions and activities;
- strengthening of the control over a leverage and stimulating of its reduction;
- addressing market discipline and information gaps;
• strengthening systemic liquidity management;
• improving cross-border and cross-functional regulation.

Many of these directions of regulatory reforms are already taken for a basis worldwide, and their implementation has begun long before crisis. What is meant here is Basel II which provides transition to risk-focused banking management and supervision.

In spite of the fact that Basel II has been accepted to 2004 year, its implementation was outstretched – it has begun only in 2007 and only in the G10 countries. Thus, in view of Basel II complexity, regulators decided to use firstly the basic approaches to risks assessment which are a transit stage between Basel I and Basel II and have a number of the full shown during last financial crisis.

The full Basel II implementation will promote to disadvantages negotiations of risk-management and the internal control which are the root of shocks in the advanced countries. This process will be strengthened by Basel II revision with world crisis lessons, passing now by Basel Committee on Banking Supervision.

Basel Committee on Banking Supervision calls on national supervisory authorities to accelerate as more as possible Basel’s advanced approaches and to provide a high level transparency of banking. The Committee underlines, that because of procyclicality, which Basel II does not solve, and even, can exacerbate, supervisors should develop measures, capable to adjust financial intermediaries’ behavior according to a stage of national economy development.

Problems of implementation of the new capital requirements become complicated by financial turmoils, and transition period can be stretched for a long time, despite of recommendations and appeals of Basel Committee on Banking Supervision. Thus standards on supervisory process and market discipline or Pillar II and Pillar III of Basel II, should be introduced in the nearest future as restoration of financial stability depends on it.

3. Pillar II as a strategy for risk-focused management

The numerous researches, spending by such organizations as Financial Stability Forum, International Monetary Fund, and also the international rating companies, show that banks’ community associates Basel II with capital adequacy requirements, i.e. with Pillar I, supposing Pillar II and Pillar III are the supervisory authorities’ competence.

However capital adequacy requirements cannot prevent the banks’ mistakes and replace the responsibility of banks for risks assessment and properly risk-management. In this context
Basel Committee on Banking Supervision directs a banking sector’s attention to relevance not only the first, but also the second Pillars of Basel II.

Pillar II makes a basis for risk-focused banking management and adds a reputable element in judgment of the internal control. Pillar II consists of some principles defining a role and duties of banks’ management at an assessment of internal financial stability. These principles allow banks’ management to be flexible in development of capital adequacy monitoring and control methods. They also provide a sequence of measures which banking management should accept as «urgent correcting measures» when their capital adequacy is lower than the banking risks.

One of the principles the risk-focused management is a principle of conformity a process for assessing banks overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels of procedures of an estimation of the general sufficiency of the capital concerning character of risk of bank and presence of strategy of maintenance of a level of the capital.

In connection with this principle it is possible to approve with confidence, the time, when banks’ strategy had cleanly formal character, was over. Banks in their strategies should show, that planned benchmarks of the capital adequacy are proved and answered the general risk level and an operational environment. And the internal control become the “internal censor” of these strategic documents.

Pillar II recommends to supervisory authorities to review and evaluate banks’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisory authorities should take appropriate supervisory action if they are not satisfied with the result of this process.

Introduction of this principle means for banks, that they should be ready to regularly review the process from the supervisory authorities and to provide a sound internal process to assess capital adequacy, high quality of the bank’s risk management and controls.

Supervisors also should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum. In other words, banks should have the "buffer" capital in a case of force-major circumstances, such as financial turmoils. Audit of banking system’s capital adequacy probably will be done in Russia for the purpose of how many Russian banks are capable to sustain threats from financial turmoils. It is possible, the weakest bank for that matter will be the largest systemic banks which can show to nothing in reply to an environment challenge except for the states’ support.

Maintenance of the "buffer" capital is necessary not only for supervisory requirements satisfaction, but also for bank. Firstly, banking scale and character of bank are changed over
time, as well as the risk profile changes, causing fluctuations in a level of capital adequacy. Secondly, mobilization of the additional capital can be money-losing for banks, especially if it necessary to make in short terms or in negative conditions. Thirdly, not all risks can be take into account by the capital adequacy calculation and banks should be ready for these risks. Illustrations of gravity of "non-financial" risks are crises of derivative tools in Bankers Trust (New York), districts Oranges (California) bankruptcy, crash of Barings Bank (Great Britain) because of trader fraud, losses of French bank Societe Generale as a result of not authorized operations conducting by one of traders.

If supervisory authorities have a doubt in banking risk-management of internal audit systems, as well as in a possibility of bank to conform to capital adequacy requirements, they, according to Basel II, will have to require rapid remedial actions. These actions may include intensifying the monitoring of the bank, restricting the payment of dividends, requiring the bank to prepare and implement a satisfactory capital adequacy restoration plan, and requiring the bank to raise additional capital immediately. Supervisors will be given the discretion to use the tools best suited to the circumstances of the bank and its operating environment.

Pillar II implementation means an expansion of transboundary communications and cooperation for supervision goals, especially for control over the international bank groups. For the financial institutions it means, that national banking supervision will be adapted to innovations offered by the international organizations, such as Basel Committee on Banking Supervision or the International Monetary Fund. Therefore national banks need to be ready to these innovations and to take steps on painless transition to them.

4. Transition to risk-focused management in the Russian Federation

The Russian banking system should begin application of Pillar I selected option in 2008 – the Simplified Standardized Approach and the Basic Indicator Approach. However, because of financial stability threats and fears that systemic banks can lack capital, the Bank of Russia has postponed implementation of Pillar I selected option for uncertain term.

Nevertheless, for the period of preparation for implementation of the Basel II selected option (4 years) have happened qualitative changes both in supervising, and in banking management practices. The main beneficial effect is the dialogue between Bank of Russia and commercial banks. It is organized as public discussions of actual questions on development of banking management and supervising practice, and of supervisors projects on which the remarks and offers can be directed by banks. The dialogue has given an impulse to positive changes in character of relations between banking supervisory authorities and credit institutions.
The increasing number of the Russian banks change their attitude to the organization of risk-management system. If one or two years before the Russian banks were basically interested in credit and liquidity risks management, today operational, legal, reputation and strategic risks are attached importance by banks not less than to the above listed ones. Many banks have already started to conduct databases on the events, capable to cause losses. The methodological base on risks management has qualitatively improved.

It is necessary to note the increasing of transparency level of the credit institutions activity. On the 1st of January 2009 more than 86% from total of the actual credit institutions (it is on 2,6 percentage items more than in 2007) opened the information about their activity in the Internet-representation of Bank of Russia. On the beginning of 2009, 729 credit institutions, or more than 65% from total of the actual credit institutions, have agreed to information disclosing about their balance and financial results.

Unfortunately, at present time complex risk-management systems in the Russian banks are in a stage of development. The independent service risk-management is organized in nearby 40% of banks, in the others – risk-management functions are allocated between divisions. Not all banks have bailout packages. Economic and mathematical methods of the environment analysis for risks assessment are applied hardly more than 5% of banks, and the stress-testing for financial stability in various conditions are spent only 16% of banks on regular basis1.

Origins of instability in the world financial markets lay in the qualitative organization of risk-management, that also has been acknowledged by the Russian banks. Results of numerous interviews and researches of the well-known Russian and foreign consulting organizations, and also Bank of Russia have shown, that the Russian banks are interested in construction risk-focused banking supervision and support initiatives of Basel Committee on Banking Supervision and Bank of Russia in this direction.

Bank of Russia has already begun a preparatory works for implementation of the advanced approaches of risks assessment in the Russian banks practice though one year before such opportunity basically was not considered. In particular, in the answers on banks comments to offers and remarks under statutory acts projects prepared in connection with transition to Basel II, the Bank of Russia marks, that in parallel with work on Pillar II and Pillar III implementation, it works over the minimal requirements and qualifying standards which should be observed by the credit institutions for possibility to use the advanced approaches.

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1 By results of questionnaire the Russian banks on condition of supervising practice in Russia and ways of its perfection which were prepared by Association of regional banks “Russia”, Moscow, 2008
As early as 2004 Bank of Russia did not exclude an opportunity of the advanced approaches realization for credit risk assessment as the internal ratings-based (IRB) approach. However only upon condition that there will be created the reliable databases, improved the quality of intrabank management systems and there will be positive experience of these methods application in foreign banks practice.

Accelerating of work on adaptation and implementation of the advanced approaches of Basel II in the Russian banks practice is caused by an necessity to raise risks sensitivity and, consequently, efficiency of banking risk-management systems in conditions of financial instability in the world and taking into account the recommendations of Basel Committee on Banking Supervision.

At the same time, success of Basel II implementation in Russia, as well as in many other countries, first of all depends on a degree of banking system and supervision readiness. Therefore term of the internal ratings-based (IRB) approach implementation, in the Russian banks system will probably depend on intrabanks theoretic-methodological frameworks and on banks’ capacity to prove its validity to supervisory authorities. It means, that in the near future it will be necessary for Russian commercial banks to meet requirements the Pillars II and III of Basel II, which introduction responsibility lays down on risk-management and internal control systems.

The second and third Pillars of Basel II, according to official declaration of Bank of Russia, should be entered in current 2009. In performances of representatives of supervisory authorities it is emphasized, that such work is already doing and, particularly, doing in cooperation with supervisory authorities of the European Union countries. Therefore, to not appear before the fact of banking management reforming in deadlines, Russian banks must take steps on forming the management systems according to requirements of Basel Committee on Banking Supervision.

References
