RISK MANAGEMENT IN CREDIT INSTITUTIONS - NEW TRENDS

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Abstract: *he new Basel II enhancements cover all three pillars and they refer mainly to more strict rules and higher capital allocation for resecuritization and liquidity facilities, extension of prudent valuation guidance to the banking book, disclosure of liquidity information, more complex stress testing models, reputational risk coverage, conducting own credit analysis, more detailed disclosures especially trading book quantitative disclosures. In a very dynamic and innovative market, risk coverage is one of the keys for success and survival. Therefore, each institution should invest in both human capital and IT system in order to have a complex and advanced risk monitoring system, to be able to implement fast and with transparency the newest risk management regulation, to anticipate the risks and mitigate them.*
Keywords: banks, Basel II, risk management, market discipline.
JEL classification: G_{21}, G_{32}.

Introduction

The objective of the bank's management is to maximize the shareholder value so that the investors remain interested and satisfied by their investments. In the last years, the desire to exponentially increase profit generated a large range of innovative products with higher risks, while the proper management system implementation for the mitigation of the relevant risks remained behind as dynamic. Organizations were willing to accept much more risks and use much more leverage, and this is usually a recipe for disaster. The Bank of International Satlement issued in 2006 very complex regulations regarding the minimum capital that companies must

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allocate as buffer for many risks coverage: credit, operational, market, reputational... But the financial crisis from 2008 proved that there is still place for the regulation improvement and new Basel II enhancements are elaborated. More analysts speak even about a future Basel III regulation.

1. Risk management weaknesses

Financial innovation was used to avoid regulators and reduce the capital allocation for the risks. Good business trend, good liquidity, credit instruments, low default rates and low loss experience led to even less capital for the risks. Financial organizations were using off-balance sheet items and Special Investment Vehicles to "manage" tax, and to exploit weaknesses in the accounting standards and the frameworks. The Basel II regulations were meant to accelerate the risk control improvement process and the proper capital allocation, but its fully implementation and results could not make face to the financial crisis in 2007-2008.

Japanese banks implemented Basel II in 2007, and European banks at the start of 2008. US regulators are scheduled to switch over in 2009. The more advanced Basel 11 implementation in Europe had not the result of a much better risk capability, which raised the question how effective the implementation was and how good the regulation is. Basel II continues to be progress towards the right direction: generate transparency, set up processes to manage identified risk, monitoring and reporting. This implies more strict rules.

The financial crisis underlined some drawbacks of Basel II:

- Basel II is being applied inconsistently around the world, and even within individual markets, leading to very different risk weights and capital charges for identical assets;
- The internal risk measurement systems used to compute Basel II ratios were developed in inadequate conditions. They are based on banks' internal models that are not enough tested during a downturn;
- Basel II is not too severe with certain risk categories, especially trading risk and sub-prime mortgage;
- There is an in-built pro-cyclicality in how it will be applied that is likely to lead to volatile capital measures during the cycle, with many cases of inadequate provisioning during boom times.

2. Risk management - new trends

The Basel Committee on Banking Supervision issued in January 2009 a package of consultative documents to strengthen the Basel II capital framework.

These Basel II enhancements include a number of amendments to the Pillar 1 capital requirements for securitisation and traded market risk, to Pillar 2 internal capital adequacy assessment process (ICAAP), as well as to the Pillar 3 securitisation disclosure requirements. All these enhancements will lead to a higher capital allocation for market risk.

a. Basel II: Pillar 1 new enhancements - Minimum capital requirements

➢ *Resecuritizations* - The Basel Committee is proposing to make a distinction between securitized exposures and resecuritized exposures. A "resecuritization" is defined as a securitization exposure, where one or more of the underlying exposures meet the definition of a securitization exposure (e.g. collateralized debt obligation (CDO) of asset backed securities). This definition would also capture a securitization exposure where the underlying exposures consisted of hundreds of mortgage loans and a single ABS. In other words, if one underlying exposure was a securitization exposure, the securitization exposure in question would be considered a resecuritisation. Resecuritized exposures will be subject to a higher capital requirement under both the standardized and internal ratings-based (IRB) approaches. For higher rated exposures, the proposed capital requirement is more than double what is currently applied. The minimum capital required for resecuritisation exposures held in the trading book could be no less than the amount required under banking book treatment. So banks will need to consider carefully the implications of future securitization investments.

➢ *Higher capital requirements for securitization exposures and liquidity facilities* - Recent experience has highlighted a number of weaknesses in the Basel II securitization framework. The Basel Committee recommends adding language to the Basel II framework so that a bank cannot recognize ratings - either in the SA or in the IRB Approach - that are based on guarantees or similar support provided by the bank itself. In other words, the Committee recommends that banks not be allowed to recognize external ratings when those ratings are based on support provided by the same bank. For example, if a securitization exposure is rated AAA, and that

rating is based on a guarantee provided by a bank, the bank should not benefit from a lower risk weight on the securitization exposure when the bank holds that AAA-rated exposure. In this way the banks can no longer benefit from "self-guarantees". This change could result in large increases in the risk weights applied.

The proposals also recommend changes to the credit conversion factors applicable to liquidity facilities supporting securitization conduits. This has always been a difficult policy area owing to the fact that liquidity facilities are generally not rated and often have a different term to maturity to the underlying exposures. Liquidity Facilities in the Standardised Approach - The credit conversion factor (CCF) for all eligible liquidity facilities (LFs) in the SA securitization framework would be made uniform at 50%, regardless of the maturity of the LF. Currently, eligible LFs under one year receive a 20% CCF in the SA.

➢ *Introduction of minimum operational criteria for use of securitization risk-weightings* - In order to apply the Basel II treatment for securitization positions, banks will be expected to satisfy certain operational criteria, to perform their own due diligence rather than relying on ratings. Failure to meet these criteria for a given securitization exposure would result in its deduction. It is still not clear what evidence will need to be provided to demonstrate compliance with these criteria.

➢ *Extension of prudent valuation guidance to the banking book* - The Basel Committee has proposed to extend its trading book valuation guidance to all positions that are 'fair valued'. The guidance is now outside of the trading book capital framework, emphasizing the significance that regulators place on valuation. Basel Committee released guidance relating to fair value practices in November 2008.

b. Basel II: Pillar 2 new enhancements -Supervisory review process

The Basel Committee has proposed some additional guidance for institutions and supervisors relating to Pillar 2.

➢ *Relationship between liquidity and capital* - traditionally, banks have tended to manage each of liquidity and capital individually. Recent events have highlighted the interdependencies between the two. Liquidity risk can impact capital ratios, which in turn, can aggravate a bank's liquidity profile. The Basel Committee recommends that all banks consider this

interdependent relationship as part of their internal capital adequacy assessment process (ICAAP).

➢ *Disclosure of liquidity information* - banks are also encouraged to publicly disclose information on their liquidity profile and liquidity risk management framework on a regular basis. The value of the liquidity information will depend on the circumstances under which it is disclosed, as well as on its timeliness given that a bank's liquidity position can change rapidly, particularly in times of stress.

➢ *Stress testing* - The Basel Committee also highlights the importance of ensuring that stress-testing under Pillar 2 is conducted on a firm-wide basis, and forms an integral part of the overall governance and risk management culture of the organization. Stress-testing should be used in conjunction with risk management models, highlighting a bank's vulnerabilities in adverse outcomes.

Stress testing results are seen to be particularly useful as a forward looking assessment of risk feeding into capital and liquidity planning. This is seen to be especially important in times of growth when, as recent experience has shown, risk may tend to be underpriced.

The proposal draws on the Basel Committee's consultative document on stress testing issued on 6 January 2009. This document highlighted the weaknesses in current stress testing practices and made various recommendations to banks and supervisors. Key recommendations for banks include:

* he results of stress testing analyses should be impacting decision making, including strategic business decisions of the board and senior management;
* he infrastructure in place within an ADÍ should be sufficiently flexible to accommodate different and changing stress tests at an appropriate level of granularity;
* tress tests should be developed across a sufficiently board range of risks, products and business lines and also at the macro-economic, firm-wide level;
* tress events should include scenarios that could challenge the viability of the bank, for example, simultaneous impacts of funding and asset markets together with a reduction in market liquidity.

➢ *Reputational risk* - While recognized as an important risk source, reputational risk has in the past been somewhat overlooked due to the

difficulties in quantifying its impact and probability. Recent events have highlighted the catastrophic impact of reputational risk. The financial market crisis has provided several examples of banks providing financial support that exceeded their contractual obligations. In order to preserve their reputation, some banks felt compelled to provide liquidity support to their SIVs, which was beyond their contractual obligations. In other cases, banks purchased ABCP issued by vehicles they sponsored in order to maintain market liquidity. As a result, these banks assumed additional liquidity and credit risks, and also put pressure on capital ratios. Reputational risk also may affect a bank's liabilities, since market confidence and a bank's ability to fund its business are closely related to its reputation. For instance, to avoid damaging its reputation, a bank may call its liabilities even though this might negatively affect its liquidity profile. This is particularly true for liabilities that are components of regulatory capital, such as hybrid/ ubordinated debt. In such cases, a bank's capital position is likely to suffer.

Bank management should have appropriate policies in place to identify sources of reputational risk when entering new markets, products or lines of activities. In addition, a bank's stress testing procedures should take account of reputational risk so management has a firm understanding of the consequences and second round effects of reputational risk.

- *Conducting own credit analysis* - Financial institutions have relied too much on rating agencies and in response, the Basel Committee has recommended that banks reduce this reliance by conducting their own credit analysis of securitization exposures at acquisition, and on an ongoing basis. The Basel Committee suggests that a bank should be able to identify triggers, credit events and other legal provisions that may affect its positions and assess the impact of such events on its capital and liquidity. Historically, obtaining some of this information has been difficult; however, greater demands for transparency by investors and regulators should encourage the availability of this information.

c. Basel II: Pillar 3 new enhancements - Market discipline

The current Pillar 3 requirements are intended to compliment the other two Pillars of the Basel II framework (i.e. the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) by allowing market participants to assess capital adequacy of a bank through key pieces of information on the scope of application, capital, risk exposure, and risk

assessment process. This alternative approach would facilitate more flexibility, allowing additional disclosure requirements to remain relevant and responsive to market needs.

- *Trading book quantitative disclosures* - As the Basel II framework regarding the quantitative Pillar 3 securitization disclosures, has been understood by the market to apply only to banking book positions, the new enhancements extend the majority of the quantitative disclosures to the trading book.
- *Qualitative disclosures* - Currently banks are required to provide information on the nature of credit risks inherent in securitized assets. It is proposed to extend this requirement such that banks must disclose information on the nature of all risks. This includes processes used to monitor changes in the credit and market risk of the securitization exposures as well as a description of the policies governing the use of hedging and financial guarantee insurance for mitigation purposes.

Conclusion

In our contemporary world, marked by risk and uncertainty, the banking activity evolves under especially risky circumstances. Risk and uncertainty can be associated to each and every type of active and passive operations of the credit institutions, and also, they can be raced by means of the implementation of such techniques and procedures, so that the level of these ones should be enframed within manageable bounds.

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PARTICULARITIES OF LIFE INSURANCE PURCHASING PROCESS

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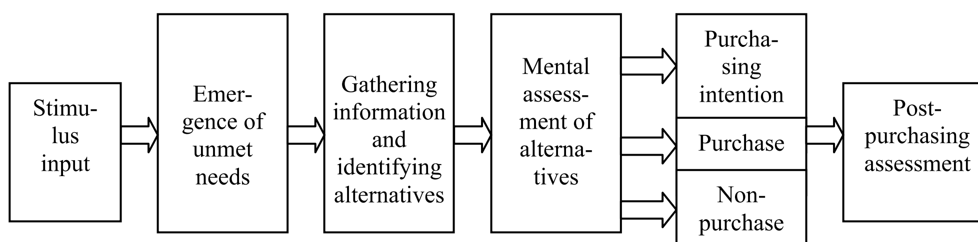
***Abstract**: The decision to buy a life insurance policy is in most of the cases a complex decision. The consumer faces many problems before the purchase and during the effective process and after the purchase.*
Keyword: life-insurance, insurance policy, situational factors, decision-making.
JEL Classification: M_{31}, G_{22}.

1. Introduction

The decision to buy a life insurance policy is in most of the cases a complex decision. The consumer faces many problems before the purchase and during the effective process and after the purchase. In the case of a life-insurance policy purchase the same traditional steps are to be followed as in the decisional purchasing process:

- emergence of unmet needs;
- gathering information and identifying alternatives;
- mental assessment of alternatives;
- result of assessment;
- post-purchasing assessment.



Source: Cătoiu, I., Teodorescu, N., 2004, p. 32

Fig. 1. Stages of the decisional purchasing process

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