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Procedia Economics and Finance 6 (2013) 668 – 674

Procedia
Economics and Finance

www.elsevier.com/locate/procedia

International Economic Conference of Sibiu 2013 Post Crisis Economy: Challenges and Opportunities, IECS 2013

Some Aspects Concerning the Measurement of Credit Risk

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Abstract

The paperwork outlines the importance of risk management within financial institutions and focuses on the credit risk, given that the statistics have revealed that the overwhelming majority of the banks' bankruptcies are caused by the credit operations. Therefore the paper concentrates on, what the author thinks to be the hub of the quantitative and qualitative models, the scoring/rating models, considered to be the common denominator of them. The risk modelling processes deployed by every entity should be continuously backed up by the rational judgements. The improvement of the risk modelling and of the framework of the rational judgements brings added value in the financial institutions operations.

Selection and peer-review under responsibility of Faculty of Economic Sciences, Lucian Blaga University of Sibiu.

Keywords: risk modelling, quantitative/qualitative models, scoring/rating systems, multilevel risks

1. Introduction

"Risk management is a core activity" (bankers, regulator authorities etc.) within the financial institutions, allowing competitive advantages. In the bank's decisions, the ability of measuring risks is an integral part of its organisational culture. Generally speaking, the risk management of the successful financial institutions should be based on the following main principles:

- A genuine commitment at all level to implement and update the data sets and the risk management models;
- A strong and independent control function in order to perform an adequate risk management, allowing flexibility to perform efficiently daily activities, yet prudent concerning the overall risk exposure;

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Selection and peer-review under responsibility of Faculty of Economic Sciences, Lucian Blaga University of Sibiu.
doi:10.1016/S2212-5671(13)00187-1

- An adequate diversification in order to implement an efficient mechanism to manage risks;
- A strong corporate governance "to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding". (Basel Committee on Banking Supervision, 2005).

To support the risk management mechanism, a financial institution should make substantial investment in Information Technology and Communications (IT&C) and in Human Resources (HR). A risk management mechanism should monitor the bank's whole portfolio, independent of the entity's business lines and to refer directly to senior management. In addition, the risk management is a proactive activity not a reactive one. The risks affect the whole entity and thus the risk management processes should be performed before engaging in risky transactions. Every available opportunity needs to be assessed in order to identify the subsequent risks.

There are different criteria for banking risk classification (financial, operational, business, conjuncture, cyclical and so on). Among financial risks one can list: balance sheet structure, revenue structure, adequacy of capital, credit, interest rates, foreign exchange, liquidity, solvability and market. Among operational risks one can list: internal system function, technological risk, poor management, frauds, lack of compliance with laws, regulations and procedures. Among business risks one can list: development level, infrastructure, systemic and not the least the unwanted effects of the monetary policies, of the taxes and of the legislation. It may include among cyclical risks: politics, contamination, and crisis, others (for instance mass-media).

2. Some faces of risks

But what is the RISK? „Risks are usually defined by the adverse impact on the profitability of several distinct sources of uncertainty." (Bessis J., 1998). The definition focuses on the uncertainty, which could be captured in some ratios as sensitivity, volatility and downside measures (stress scenarios). The idea of this definition is that a set of figures seem to clarify the level of risk.

Another very short and concentrated definition given in Guide 73 ISO 31000 is „the effect on uncertainty on objectives". This definition focuses on the events' effects upon the achievement of an entity scopes, blurring in a way the events themselves, in order to concentrate on the objectives, before identifying the subsequent risks and the methods of managing them. A good example could be the struggle of the financial institutions to offer the most innovative services, in order to increase the number of clients (especially the most sophisticated ones). Thus the main objective is to attract enough clients to cover the costs (often high as there is involved the new technology) and to get a competitive advantage. The bankers should bear in mind that in the financial industry there is not copyrights. Therefore if the project fails, there are losses and other competitors, at least for a while, would not launch similar services.

The modern financial institutions are faced with many correlated risks, multilevel risks, deriving from macro economy such as inflation, unemployment, stock market crashes and so on. The risks have been multiplying after the deregulation period, which brings new products, services and unregulated entities, bearing unknown risks (for instance derivatives), and financial institutions have developed in other business model than intermediation. The competition has erupted and the new innovations could be easily copied.

Beginning with 1988 Bank of International Settlement (BIS) has been periodically issuing a series of regulations in order to improve the processes of measuring and managing banks' risks. But anyhow the regulation framework is generic, bearing a high level of theory and, generally speaking, defines minimum standards. In some countries as in Romania, Monetary Authorities (Central Banks), parliaments, governments issue continuously laws and regulations in the respect of keeping the financial institutions on a safe track. In order to impose a better culture of risk, a new paradigm has become more and more important within banks, namely the compliance.

Nevertheless the main focus has been concentrated on financial risks, which are „related to the market movements" (Bessis J., 1998).