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Problems of Management Risk at Financial Institutions in Context of the Financial Crisis

Introduction

In all types of undertaking, risk is the potential for events and consequences that constitute opportunities for upside (benefit) or threats to downside (success). Risks are the result of unknown or uncertain factors or coefficients on goals and objectives of a business. Risks exist from the outset of an activity (Figure 1). They generally arise because either there is a lack of certainty about the activity being undertaken or that hazards exist within it. Thus, the nature of risks are identifiable in terms of: control, information, resources (i.e.: money, time, equipment) (Table 1).

Risk management is the establishment of risks followed by coordination and application of resources to optimize opportunities and reduce the occurrence of unfortunate events known as risks. Financial results in whole economy consist the earnings from the activity realize in financial sector. Banks play a crucial role in financing the economy and settling payments. Risks in every financial firm can change sharply the level of the activity or long-term strategic politics. Banks are in the business of managing risk, not avoiding it.

The paper is organized as follows: the first section discusses the overall problems connect with the risk management, the second section examines the process of the risk management in banks, the last part illustrates the possibilities of defeating the obstacles in the management the risk at the bank (Table 2).

The general aim of the paper is to study the overall problems connects with the risk management process, and create the opinion about the role of the improving by different factors the financial institution's position in the international market. The study based on literature and research effects from 2002–2012 (i.e. Poland, US, and EU countries). The author used the investigative methods: deduction, observation, questionnaire and descriptive analysis.

Risk Management process in context financial crisis

Accounting for the risk management in risk measurement is very difficult and costly task in every undertaking. However, not performing that task for an organization means that the firm's top executives are managing the company with blinders on – they see only part of the big picture they have to understand to manage effectively. Especially the problems of risk management are very important during the time, when all economists have discussed the financial crisis in the world. Risk management is a central part of any entity's strategic management. Risk management means, for example:

1) "the identification, analysis, assessment, control, and avoidance, minimization, or elimination of unacceptable risks. An organization may use risk assumption, risk avoidance, risk retention, risk transfer, or any other strategy (or combination of strategies) in proper management of future events" [Business Dictionary 2012, p. 38];
2) "the systematic application of management policies, procedures and practices to the tasks of establishing the context, identifying, analyzing, assessing, treating, monitoring and communicating" [Standard AS/NZS 4360 2004, p. 47];
3) "systematic approach to minimizing an organization's exposure to risk. A risk management system includes various policies, procedures and practices that work in unison to identify, analyze, evaluate, address and monitor risk" [Investor Glossary 2012, p. 54].

Risk covers all aspects of organizational activities and included in all management levels. The risk management is a continuous process that depends on the changes of the internal and external environment of the company. Risk management should be a continuous and developing process which runs throughout the firm's strategy and the implementation of that strategy. It should address methodically all the risks surrounding the enterprise's activities past, present and in particular, future.

The risk management process is a standard process that consists of the following steps: identification, assessment and risk treatment – of the context: means a chosen area of interest is taken into account. Risk has become one of the greatest concerns of senior management in recent years because the high expectations of the financial markets demand that companies achieve optimal mixtures of risk.

In a typical company, the role of risk management is first to assess the risks faced by the firm, communicate these risks to those who make risk-taking decisions for the firm, and finally manage and monitor those risks to make sure that the firm only bears the risks its management and board of directors want it to bear. In general, a firm will specify a risk measure that it focuses on together with additional risk metrics. When that risk measure exceeds the firm's tolerance

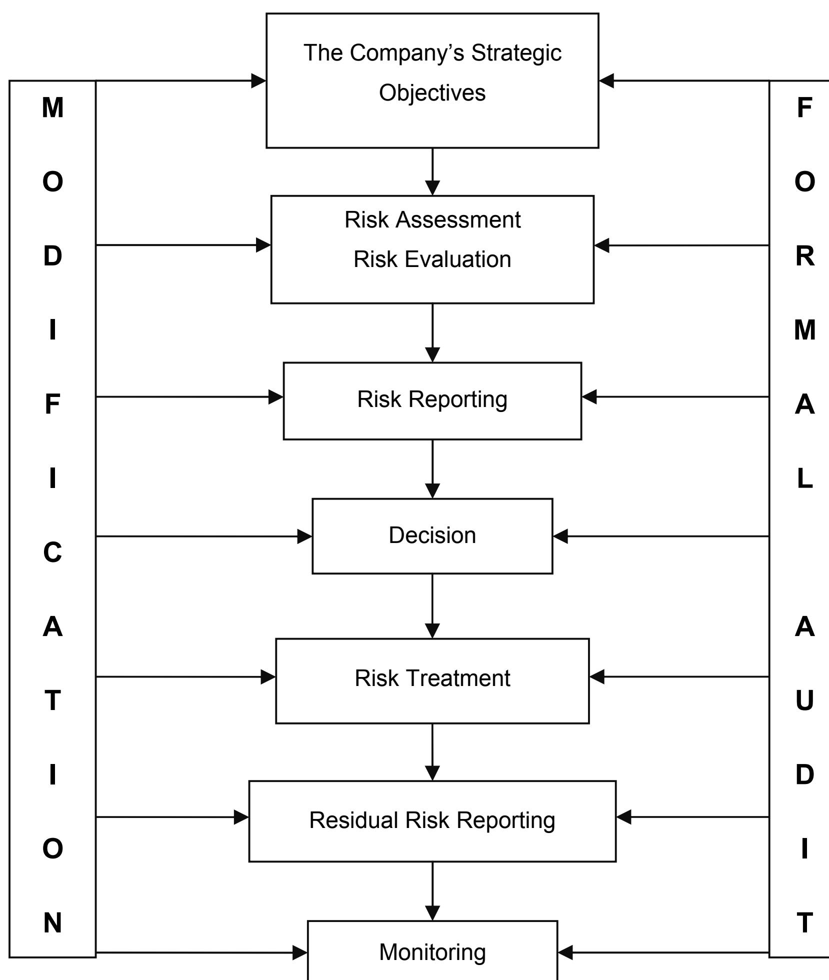

Figure 1
Risk Management Process

Source: Own based on: *A Risk Management Standard* 2002, p. 6.

for risk, risk is reduced. The activities of risk identification and qualitative assessment often progress at the same period as the necessary response. Planning and risk evaluation proceed in parallel ways. During risk management, the information gathered from risk analysis is used to make decisions on how to eliminate or mitigate the identified risks.

Risk management protects and adds value to the company and its stockholders through supporting the firm's objectives by: improving decision making, planning and prioritization by comprehensive and structured understanding of

business. The role of risk management is also: reducing volatility in the non essential areas of the business activity, volatility and project opportunity or developing and supporting people and the firm's knowledge base or protecting and enhancing assets and company image. Generally Risk Management Process includes:

a) Risk Analysis – Identifying risks, analyzing potential consequences, and setting priorities for action,
b) Risk Response – Developing and implementing an action plan to address risks.

Risk Identification (Analysis)

Every manager should remember: risk is neither bad nor good. It is simply a measure of deviation from the expected i.e.: plans, expectation coefficients or results. Risk consequences can be either bad or good. Bad risk consequences drain resources and interfere with an entity's financial stability and ability to fulfill its mission. In recent years, risk management at banks has come under increasing scrutiny. Financial institutions and their consultants have attempted to sell sophisticated credit risk management systems that can account for borrower risk, and the risk-reducing benefits (profits) of diversification across borrowers in the large portfolios. Regulators have even begun to consider using banks internal credit models to devise capital adequacy standards.

Good risk consequences produce better than expected results or unexpected opportunities. [Tchankowa 2002, p.p. 290–292]. The company that analyzes and responds to its risks protects itself against bad risk consequences, and positions itself to take advantage of opportunity. Especially during the financial crisis entities need:

a) strong involvement by upper management,
b) the organized process for risk analysis and response,
c) assignment of specific risk responsibilities and performance accountability,
d) workplace special culture where every employee understands risk and their role in addressing it.

When the financial institution realize different steps of the risk identification (during the individually risk policy) particular note the elements:

1) Secure upper management support: employees will respond if they know risk is a priority for upper management and communicate to employees about upper management's support for risk management.
2) The team leader bears primary responsibility for the risk program. A risk manager – very often as the position RMO (Risk Manager Officer) or CRO

(Chief Risk Officer) – with good organizational and communication skills and an interest in risk, would be a good candidate for this position.

3) RMO (as the team leader) defines the Risk Team's goals and the scope of its activities in writing, and distributes this document to upper management and department heads.
4) Project a preliminary measurement (matrix) of the firm's risk exposures and the potential effects of risk on the entity's resources. Each position of the measurement (cell of the matrix) represents the effect a particular risk may have on important resources.

Table 1
Steps for risk identification in financial institutions in context the financial crisis

Number of step	Activities during the step
Step 1 – Establish Risk as a Priority	Create and distribute a program mission statement that: defines risk as a priority idea, establishes a Risk Team to analyze and respond to risks.
Step 2 – Designate a Risk Team Leader	Team leader functions include i.e.: determining the scope and goals of the project, developing a framework to follow, coordinating plan development and implementation, reporting progress to upper management.
Step 3 – Define the Scope and Goals of the Risk Team's Activities	The project include: the scope of activities: whether the project is entity wide, or will be tested in a few operational areas with high risks before proceeding to an entity wide plan and what the products will be, and a risk action plan consistent with the scope of activities.
Step 4 – Create a Risk Matrix	A risk matrix must provides a structure for systematically analyzing risks, stimulates thinking about rare events, helps you assemble and assign risk responsibilities to members of a Risk Team (i.e. Altman's Z score model, J.P. Morgan credit matrix, HAZOP (Hazard & Operability Studies), BPEST (Business, Political, Economic, Social, Techno-logical) analysis).
Step 5 – Recruit Risk Team Members	The Risk Team should include people knowledgeable about the entity and the operations included in the scope of the project: team members need not be risk experts.
Step 6 – Analyze Risks	Analysis can be performed by the team as a group, individually, analysis limited to area of operational expertise or individually, analysis includes perception of risks in other operational areas.
Step 7 – Risk Response	The Risk Team should now gather to review the results and create a comprehensive action plan to address high-priority risks.

Source: Own based on: Claire Lee Reiss, J.D.: *Risk Identification and Analysis*, ARM Public Entity Risk Institute 2006, pp. 10–23.

5) The Risk Team should be small enough to function efficiently, include enough members to carry out team activities, include members who are reliable and committed to the success of the Risk Group (as Risk Team), and who have access i.e.: to research resources, such as professional organizations, colleagues in other jurisdictions, and publications.
6) Risk Analysis includes: identifying risks, assessing potential risk consequences. For each type of potential loss, estimate frequency and severity ought to be reported:
   a) frequency: how often a loss is likely to occur (i.e.: past loss records, information from employees, risk pool or insurance carriers),
   b) severity: how bad cumulative losses of that type are likely to be (either financial losses or other interference with delivery of services to customers).

While we accept the idea of creating incentives for banks to improve their risk management systems (also by the system Risk-Based Supervision), the results suggest that regulators should not expect better risk management to lead automatically to less risk. Instead, the results suggest that banks that enhance their ability to manage credit risk may operate with greater leverage and may lend more of their assets to risky borrowers.

Risk response

Every RMO (or CRO) in the bank knows and should consider the special variants of realize the risk management problems. In practice there are four general types of risk response strategies:

a) *avoid* (means – eliminate the risk producing activity entirely. Can be highly effective for some types of risk, but may not be practical for important government functions. Banks must develop a competitive Early Warning System (EWS) which combines strategic planning, competitive intelligence and management action),
b) *reduce* (as pre-event actions to reduce the frequency and or severity of losses. The element connect i.e. with the reliable and solid observation the financial liquidity their big corporate clients),
c) *control* (post event actions to keep resulting damages to a minimum, i.e. customer demands during the financial crisis periods, industry changes, foreign exchanges),
d) *transfer* (shift some of the financial burden of a loss to another party, new contracts).

Choice of the response strategies depends on the different factors, as quality of work with operational departments in the company, contacts with supervisors and staff (means whole entity's employees) or financially and organizationally ability to implement strategies. Possibility to identify the risks of loss that remain after the firm has implemented the action plan, and make plans for transferring or financing those risks. A consultant (with outside the entity as: supervisor, auditor, Treasure controller, fiscal inspector) may be helpful when RMO (or CRO) considering new options, also after detection of fraud, bribery [Chong 2011, p. 7]. The chosen strategies into a risk action plan can be endorsed by the team leader and whole team members. Next element of this activity is obtain endorsement of the plan by upper management (i.e.: department heads, board of directors, supervisory board of company). The action plan can be prepared as the special kind of spreadsheet that includes the elements: risk source, strategies selected, activities, target completion date, responsible person (RMO or Risk Team), actual date of completion, performance measures. The Risk Team (or only RMO) continues to meet as a permanent organization annually, semi-annually, quarterly or more often – to review the implementation of the action plan, and make changes (implement, monitor, evaluate and modify) as needed.

Impediments to more active use of risk information in context financial crisis

This problem is especially difficult in non-stabilization periods in the world. Different reports inform that lack of leadership interest, lack of interest from other business lines, or company culture are major barriers to greater use of risk data. [Schneider, Sheikh, Simione 2011, p. 31].

The effectiveness of risk management depends on efficient information system, computerization and networking of the branch activities. An objective and reliable database has to be built up for which bank has to analysis its own past performance data relating to loan defaults, operational losses and so on.

The study based on materials from my investigations in commercial banks in Poland from 2012. About 100 persons (from different finances and risk departments in banks) took part in the special survey about problems connect with risk information. In the respondents' opinion very often improving risk processes in general as leading risk-related priority for finance functions (52%), leading risk-followed by integration of data across the companies (about 47%) and improving the management of data relevant to risk (39%). When I asked the leading priority for their function, in my questionnaire, only about 30% of finance executives

mention something overall risk-related. The benefits of alignment (between risk and results of finance) are real. Among survey respondents, of those who rank themselves much better at alignment about 58% are much better at financial performance and 89% are above average. The equivalent figures for those who are average or worse at alignment were 7 and 31% respectively.

Table 2
What are the major barriers to better aligning the finance and risk at your institution?

Kinds of barriers	% respondents
Inconsistent focus (for example: risk is more heavily compliance focused, finance on reporting previous year's results)	56
Different cultures and customs within departments	42
The two are using inconsistent data (as: terms of accounting periods, methods of valuation assets – for internal and external reports, inconsistent assumptions)	36
Lack of resources	24
Organizational incompatibility	17
Others (i.e. non-integrated systems and functionality, KPIs* across the businesses, lack of capacity within company to share necessary information, customer service and segmentation, employee renumeration)	4

* KPIs – Key Performance Indicators

Source: Based on my research materials from 2011 realized in commercial banks (Additional information: every respondent could choose more than 1 barrier).

As with risk management in general, data management improvements are really necessary, but on their own are not sufficient. While inconsistent data are a major barrier to better alignment at 36% of financial institutions surveyed, far more widespread problems are that the primary focus of each function is not the same (56%) and more general cultural and customs differences exist (42%).

Additional, despite its benefits, alignment is less of a focus for finance than its data and process improvement efforts. Survey respondents most often cite improving risk processes in general as the leading company (55%), followed by integration of data across the organisation (about 44%) and improving the management of data relevant to risk (42%). Collaboration between the risk and finance functions comes next, cited by only 29%. Since the financial crisis, best practice in the financial sector has increasingly been defined to include a strong, independent risk function with a CRO who has direct access to the RMO and the board.

Conclusions

Individuals tend to focus on short time horizons when making their decisions. This behavior has particular significance when it comes to developing strategies for managing risks (i.e. during financial crisis) where there is a need to engage in long-term thinking. Risk management is responsible for making sure that the firm takes the risks that it wants to take and not others. As a result, risk managers must constantly monitor the risks the firm is taking. Create a preliminary matrix of the entity's risk exposures and the potential effects of risk on the entity's resources. Each cell of the measurement (matrix) represents the effect a particular risk may have on important resources. The step connect with the risk identification (and risk analysis) means treat all variants connect with the essential sources (i.e.: state and international law, contracts and legal relationships and fate events, as natural hazards). Risk Measurement (matrix) to stimulate thinking frequency and severity worksheets to record analysis of potential risks, samples are provided and are on-line and can be downloaded for free. Especially in the financial crisis firms should not forget about different benefits of risk management (i.e. widens management perspective and encourages initiative and pro-active behavior, contributes to improved organizational efficiency and effectiveness, provides an effective and systematic approach which enables management to focus on areas of risk in their operations, improves the level of accountability in the entity). Every RMO must remember about limited entity's ability to absorb losses and necessary to estimate the effect of losses on the firm's ability to continue operations in long-term future. The Risk Team and RMO should hold everything objective as possible and avoid interpersonal conflicts. They should prepare general information about the action plan (as the result of the risk management policy) for dissemination to the general employee population. Results of my research materials and study the other literature confirmed the thesis that monitoring process should provide assurance that there are appropriate controls in place for the organisation's activities and that the procedures are understood and followed. Review process should also determine whether:

1) the measures adopted resulted in what was intended,
2) the procedures adopted and information gathered for undertaking the assessment, were appropriate,
3) improved knowledge would have helped to reach better decisions and identify what lessons could be learned for future assessments and management of risks.

Additionally, banks are coming to terms with a "complexity-cost problem", and finding ways to generate substantial savings through reducing complexity in systems, processes and administration. And most of employees in banks said

about necessity to better use of risk management to provide competitive advantage (eg, improving decision-making, greater understanding of opportunities).

Financial institutions are now better prepared for financial crisis, but may not be as well prepared to deal with new or emerging risks. Leading financial companies are developing new tools to improve their ability to identify emerging risk. The bank-wide view of risk is becoming a critical part of management and staff and boards are demanding more risk information in far greater detail. But banks still should a lot of do in this field. For example although managers (as CFO, RMO, CRO) can develop the risk solutions and formulate strategies for dealing with identified risks in consultation with the other internal departments (as planning, accounting, controlling, reporting), they should understand that they are responsible for the final decisions in these areas.

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Problemy zarządzania ryzykiem w bankach w warunkach kryzysu finansowego

Streszczenie

Zarządzanie ryzykiem jest ważną dziedziną w każdej firmie. Szczególnej uwadze poddano w niniejszym opracowaniu elementy związane z zarządzaniem ryzyka w bankach w warunkach kryzysu finansowego. Omówiono elementy tworzące proces zarządzania ryzykiem, etapy identyfikacji ryzyka oraz bariery stojące na przeszkodzie minimalizacji ryzyka w instytucjach finansowych. Zwrócono uwagę na istotną rolę specjalistów zatrudnionych dla pomiaru, wykrywania i eliminacji ryzyka (CFO, RMO, CRO). Celem artykułu jest badanie stanu istniejącego oraz wydanie opinii w zakresie kierunków doskonalenia konkretnych czynników związanych z kwestią zarządzania ryzykiem w bankach. Opracowanie oparto na krajowej i zagranicznej literaturze przedmiotu z lat 2002–2012 oraz na wynikach przeprowadzonej ankiety własnej w bankach komercyjnych w 2012 r. Wykorzystano następujące metody badawcze: dedukcji, obserwacji, wywiadu i analizy opisowej.