

# OPERATIONAL BANKING RISK MANAGEMENT – RESEARCH PERFORMED AT THE ROMANIAN COMMERCIAL BANK

**Matiş Eugenia-Ana**

*Dimitrie Cantemir Christian University of Bucharest, Faculty of Economics Cluj-Napoca  
Romanian Commercial Bank, Cluj-Napoca, Str. Theodor Mihali nr. 56, Tel. 0723-205526*

*The main objective of this research is to provide a detailed perspective of the operational risk in the case of commercial bank. The research is based on the main regulations and procedures in the field of the operational banking risk, and it presents the method commercial banks use to manage operational risk. The case study presents the results of the research performed at the Romanian Commercial Bank, Cluj County Branch, with examples of operational risk management. Both from the theoretical approach and the description of operational banking risk quantification, the results of this study emphasize the importance of operational banking risk measurement and the identification of major issues that need improvement.*

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## **1. Main Objectives in Operational Risk Management**

Romania's adhesion to the European Union from the 1<sup>st</sup> of January 2007 has brought the requirements of implementing the Basel II Capital Agreement, the name of the International Convergence of Capital Measurement and Capital Standards - a Revised Framework. The purpose of this study is to provide an analysis of the operational risk management in Romanian commercial banks, presenting the main types of risks and showing some preventing and decreasing measures for the Romanian banking societies – as provided by the case study analysis at the Romanian Commercial Bank.

Romanian banks have adopted a well-defined strategy regarding Operational Risk Management. The objectives regarding the Operational Risk Management are becoming focused on the responsibilities in managing operational risk at the whole bank's level in order to maintain the risk at adequate parameters to permit the development of the bank's activity in best conditions. The strategy regarding the Operational Risk Management concentrates upon the observation of the following principles:

- The management of the operational risk is mainly realized at the level of each organizational entity in a bank.
- The integration of operational risk's management in the development of the bank's daily activity.

According to the national regulations, Romanian banking societies must have policies for the management of the operational risk. These policies must take into consideration at least the following types of events that generate operational risk:

1. Internal fraud (for example bad-faith reporting the positions, theft, concluding of transactions by employees on their own)
2. External fraud (for example robbery, fake, breaking informatics systems' codes)
3. Conditions for hiring the personnel and the safety of working place (for example compulsory demands of the personnel, not respecting the labor protection regulations, promoting discriminatory practices)
4. Deficient practices regarding the customers, products and activities (for example inadequately using the confidential information about the customers, money laundry, selling unauthorized products, wrong use of products and services regarding the electronic banking system by the clients)
5. Endangering the tangible assets (for example terrorism or vandalism acts, fires, earthquakes)

6. Interrupting the activity and defective functioning of systems (for example defections of hardware and software components, telecommunication troubles, defective projection, implementation and maintenance of the electronic banking system)
7. The treatment applied for customers and commercial counterparts, as well as the defective processing of customers' data (for example wrong recording the income data, defective management of the real guarantees, incomplete legal documentation, unauthorized access to the customers' accounts, disputes)
8. The security of the electronic banking system (for example engagements of the credit institution coming out in false pretences by fabricating the electronic money or getting extra losses or engagements by the customers in case of a defective access in the system).

## **2. The process of managing the operational risk in the Banca Comerciala Romana**

The Romanian national regulation consists of two extra categories of risk, compared to those included in the Basel II Agreement: the treatment applied for customers and commercial counterparts, as well as the defective processing of customer data, and the security of the electronic banking system. An argument in favor of the electronic banking system is the one that these systems simplify transactions and are relatively new in Romania.

The management of operational risk is continuously adjusted to the risk profile of the bank at a certain moment, to the internal risk management abilities, but also to the changes appeared in the economic, financial, political and regulatory field in which the bank develops its activity.

The process of managing the operational risk respects the following steps in the case of the Romanian Commercial Bank.

**Identification:** identifying the risks is a first step which further has to be the basis for developing the viable systems for monitoring and controlling operational risk. This process begins with the definition of the operational risk from the bank's point of view, identification of the main elements and description of the generating elements, separation of the operational risk from other risks that appear in the bank's activity.

Internal factors: bank's structure, nature of the bank's developed activities, human resources implied, organizational changes.

External factors: changes appeared in the banking system, technological progress which may have a negative impact on the achievement of the bank's strategic objectives.

The process of identifying the operational risks will be developed in the following ways: identification of the operations and activities vulnerable to the operational risk, and identification of the operational risk's manifestations meaning the impact on the bank's financial results, following those with potential impact, those efficiently remediate, preventing in this way getting losses, and those that have determined getting losses. This last process means identifying and catching the losses generated by the operational risk's development. Thus, importance is given to the identification of the type of followed losses, the persons responsible for reporting the losses, the criteria and methods of validating the registrations. After validating and insuring the information's consistency, these will be stored in a database regarding the losses from operational risk, and this will be the foundation for the future valuations of this risk. The database will contain information regarding the registered losses, and also regarding their retrieval, for example the retrieved amounts, the moment of retrieval, sources of retrieval.

**Valuation** - this step of the process of managing the operational risk is based on the information obtained in the previous category. This process will follow the next directions: in order to value operational risk, Romanian Commercial Bank will follow the registered losses through a database regarding the losses of operational risk; identifying and calculating some key ratios for risk, and also analyzing them. Also, the bank has in view to analyze the opportunity of introducing in the future self-valuating systems for the operational risk based on the experience and capacity of the implied personnel to assess this risk. Valuating the operational risk in a bank

implies a straight aggregation of individual risks, despite other risks for which the portfolio risk is lower than the sum of individual risks having in view the portfolio effect.

The valuation of operational risk focuses also on the correlations of this risk with other risks affecting the bank, as this risk may determine the development of other risks, mainly the credit risk, but also the market risk and reputation risk.

**Monitoring** – on the risk-owners' level, the risk management implies analyzing the operational risks generated by each activity, operation, transaction engaged, product, so that the decisional process to have in view aspects regarding the operational risk. After identifying and valuating the risks that affect the risk entities activity, their risk-owners must ensure the taking of appropriate measures for the activity to develop in good conditions, as well as for preventing the risk's manifestation. The risk-owners will efficiently send observations and proposals to the adequate bodies for permitting them to generalize the measures for all the entities affected by the same type of event.

**Management** - after identifying, valuating and monitoring the operational risk the bank is confronted with in its activity, the management will decide on the attitude adopted toward them. The bank may decide upon the following:

- Assuming the operational risks resulted from a certain process, activity;
- Decreasing the risks – as regards the strictness or frequency – by adequate means of control, by training the personnel or the clients;
- Transferring the risks to third parties;
- Eliminating the risks by closing the activity.

Such a decision will take into account aspects regarding the proportion between the costs of control or transfer and the impact of the respective operational risk.

The risk-owners will take the appropriate measures to maintain the risk between the desired parameters, to restrict the probability of appearance for an event or to reduce its impact. In order to transfer a part of the operational risks she is confronted with, the bank pursues to sign some insurance policies regarding some types of events generating operational risks.

Each banking society configures its own operational risk profile, identifying the activities generating operational risk events. In the case of Romanian Commercial Bank, it consists of the following:

1. The operational risk event – internal fraud, including:

- The bank's engagement in operations with clients, based on the wrong analyze of their activity and potentially loss generating for the bank;
- The deceiving of the clients, by neglecting, errors, deliberate or involuntary elision in clients' information;
- The fabrication of documents by the bank's employees or their complicity in making fake documents (credit contracts, underwriting contracts, cash documents, payment instruments)
- The performance of unauthorized banking operations, or operations that are not in the employee's responsibility;
- The registration in the bank's accountancy of operations without documents in proof;
- The information changes made in the bank's informatics applications, without necessary competence and authorization;
- Material and money theft.

2. The operational risk event – external fraud, including:

- Introducing fake banknotes or coins in the bank by clients
- Cash deposits made by clients deliberately in a smaller amount than mentioned in documents;
- Robbery at the bank;
- Unauthorized access at the bank's informatics system which leads to the bank or clients' prejudice.

3. The operational risk event - the conditions for hiring the personnel and the safety of the working place, including:

- Disciplinary diversions of the bank's employees;
- Banking activities that can be executed only by several employees, for whom had not been predicted substitutes for unavoidable casualties;
- Work assignments that overwhelm the employees' knowledge

4. The operational risk event - deficient practices regarding the customers, products and activities, including:

- Unequal, preferential, subjective and ungrounded treatments applied to clients;
- Not identifying the money laundry operations;
- Initiating and developing unauthorized banking activities with the clients or operations without contractual documents;
- Not investigating clients' data, according to the requirements for knowing the clients and the internal working regulations;
- Not respecting the internal procedures referring to the maximum limits of exposure on groups or individual clients and the proficiencies on territorial units;
- Incorrect use of the IT applications by the clients.

5. The operational risk event - endangering the tangible assets, including:

- Natural events with impact on the tangible assets;
- Unpredicted events involving third persons or bank employees, generating destructions of the bank's tangible assets

6. The operational risk event - interrupting the activity and defective functioning of systems, including:

- Problems in the functioning of informatics systems, leading to data loss;
- Viruses in the banking informatics system;

7. The operational risk event - the treatment applied for customers and commercial counterparts, as well as the defective processing of customers' data, including:

- Insufficient study of the quality of values and cash manipulated by the operative bank units;
- Incomplete or wrong contractual documentation signed with the bank's customers;
- Inadequate transportation and taking over of cash from other banking units or from the branches of the National Romanian Bank;
- Inadequate preserving, recording and processing the clients' documents and banking operations;
- Deficient knowledge of the legal and internal banking regulations regarding the clients;

8. The operational risk event - the security of the electronic banking system, including:

- Improper activities performed in the system, thus generating liabilities for the banking society or for the customers, including fabrication of electronic money.

### **Conclusions**

In conclusion, the actual stage of development regarding the banking operational risk management shows a generalized assuming of the Basel II Agreement's requirements.

In spite of the positive aspects, there are some disadvantages to be considered, too, because the banks have more responsibilities in determining the activities that generate banking operational risk. If there existed a national general valid frame, possibly enforced by legal regulations, the banks would have the possibility to configure their own management strategies for the operational risk, based on an existing frame. One cannot deny each bank's specificity or individuality in the operational risk management, but the innovation of its approach in the banking field has to be emphasized, not only on a national level, but also on international level.

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