Banks' Risk Management: From Business Function to Transversal Function.

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Abstract

Risk management, i.e. identification, assessment, and prioritization of risks, is a crucial process in a bank. The most important goal of this process is to secure the repayment of the amounts deposited and, more generally, it affects the ways in which management intends to create value and distribute it to its shareholders. The greater or lesser intensity with which the risk is managed impacts the satisfaction of some stakeholders rather than others. As recent scandals suggest, managers' selfish behaviour extracts value from other stakeholders by engaging in risky activities which jeopardize company's survival. The above mentioned pathological events have been characterized by a weak corporate governance, both internally (internal auditing) and externally (market authorities). Stakeholders' reaction has been a lack of confidence in managers, creating a "market failure" that has strongly influenced the functioning of the global economic system. Monetary authorities and governments intervention to counter such phenomena were necessary but very costly. In the absence of strategies for economic growth, the liquidity injected into the market and the increase of budget deficits of the states, have triggered fears about the adequacy of monetary and economic policies. The recent crises in the sovereign debts are the bitter response of the financial markets on the government economic policies. Given the above, responsible managers have to match risk and return with the identification, assessment, and prioritization of risks borne by coordinated and efficient allocation of resources to minimize, monitor, and control the probability and/or impact of unfortunate events. Nowadays more than ever the banking system has to engage in risk management that invests all the aspects of the bank and is not confined, as in the past, within a single organizational function.

Introduction

Each choice of enterprise is characterized, in probabilistic terms, by the possibility of success but also of failure. The decision is put into action if the first hypothesis is deemed prevalent and can offer a significant contribution to the success of entrepreneurial.

The management's ability is in the evaluation which must be thought out and in good time, in order to consider the possible effects and the impact on the process of value creation (Brunetti, 2000; Coda, 1988; Collis- Montgomery, 1999; Copeland- Koller- Murrin, 2002; Damodaran, 2001; Grant, 1994; Guatri, 1991; Porter 1987; Zanda- Lacchini- Onesti, 2001)

Actions oriented to the increase and diffusion of value, are surrounded by unknown factors of uncertainty and, hence, risk (Bertini, 1987), the relative control and containment are exercised through the activities commonly referred to as risk management.

The latter is particularly important in the management of the banks, especially in times like these, which are strongly influenced by the resurgence of the economic and financial

crisis, the instability of the market, and extreme volatility in the values of financial instruments traded in them.

The effectiveness of functional processes in the identification, measurement, management (mitigation) and risk control is conditioned by the possibility of risk influences every decision-making process affecting the modus operandi of the participants in the life of the company. Despite this, risk management activities are often associated - in simplistic terms - with a specific business function and with the team of resources involved in the implementation of these processes (Fortuna, 2005; Forestieri, 2000;. Saita, 2000; Sironi-Resti, 2008)

It is the responsibility of top management of the bank to prevent this from occurring, and this intention must be clearly manifested in the definition of the business strategy, which is essential to guide the company towards goals that are consistent in terms of tools, resources and actions which can be used to achieve adequate results with respect to the risks assumed.

The purpose of risk management in the European economic framework

All functional areas of the bank should be aware of how to achieve the objectives, the correlations among the short and medium-long term as well as the rules for the risk assessment of the economic effects on the results (Bessis, 2002; Crouhi- Galai- Mark, 2006; Damodaran, 2008; Damodaran, 2010; Froot- Scharfstein- Stein, 2005; Hull, 2008; Jorion, 2000; Schroek, 2002; Stulz, 2003).

Insufficient or lack of knowledge and consideration of such evidence, unfortunately, has emerged during the recent economic and financial crisis, pointing out that risk management has not been adequately developed - or perhaps chosen by the management to meet own interests - which inevitably affect business continuity and, in extreme cases, the functioning of the economic system.

The logic of maximizing short-term economic performance has prevailed on those related to sound and prudent management. The "race" of management to better financial performace to enhance their work, was useful only to consolidate their position and increase their power within the bank. They are made of dimensional growth policies according to levels of leverage which are difficult to sustain over time, the continuous and excessive use of derivatives and securitization originated from moral hazards by management.

This strategic behavior is not allowed and does not allow the creation of virtuous processes of value creation that, in addition to profitability and growth in size, covers the sustainability of the risks assumed. Recent events, have revealed and confirmed that very high performance can be achieved only with the assumption of an equivalent risk profile, with dangerous effects on equilibrium business.

In reference to this case it is reasonable to think that there was a significant correlation between:

- careless observation of how they were reaching more ambitious business results in the presence of weak internal control systems and weak rules of governance, insufficient for an adequate share of control over management;
- Ineffective external control systems in a free market.

Both phenomena that characterize the behavior of management in modern large enterprises, were possible in the presence of hidden information both internal and external.

The management, in fact, often did not allow other stakeholders in the company to understand the contribution of different areas for the achievement of performance targets and risk units, providing organizational systems in which each one was a specialist in operations, in the absence of information flows able to make the knowledge on how the bank was pursuing its own institutional purposes transversal.

About esternal information and the related rules of communication (Campedelli,2003; Molteni, 2000; Salvioni 2003; Terzani, 2002), we can say that there has not been a total lack of disclosure by management, but there has been a shortage in its quality, establishing a poor intelligibility.

The action of the regulators, in this context, is not without criticism. They were lacking in their tasks of monitoring the quality of the information content of various documents (financial and otherwise) that each broker must disclose to the market.

The same arrangement of stress tests by EBA, theoretically useful for dissemination of reliable information on the soundness of the banking system and the relative resilience in adverse situations, has been the subject of debate with regard to both for the technical contents and for the contents with which its realization was announced.

In this context, intervention by the monetary authorities were indispensable – in order to enter the necessary liquidity in the system and not to affect the functioning of financial markets and the values they express - and for governments to bail out banks, considering what happened after the failure of the Lehman Brothers.

The monetary and economic policies undertaken were very expensive and, in an economic system that shows no signs of recovery and not always viable in the long run .

The absence of government institutions together with the difficulty of Supervisors to infuse the effectiveness of their actions, has given rise to a spiral of mistrust on the validity of the choices made and, above all, on how to plan the remedy the situation.
The current crisis of "sovereign debt" and the related dynamics of financial markets make the need to control and limit the risks generated by operations ever more urgent.

The relations between risk management and corporate governance

A system of government can be considered valid if it is able to balance its operating rules of different interests of stakeholders that, "for various reasons", are involved in the life of the company. The fundamental "moment" to fulfill these intentions, as noted above, can be identified in the definition of business strategy and related planning options, to give rise to a process of value creation through the establishment of performance targets and risk capital consistent with the expectations of the various categories of stakeholders. The ways in which this intention is fulfilled in the short and medium-long term are an expression of the possibility of converging the different perspectives of those involved in the business project. These issues, typically related to the study of corporate governance (Collin, 2007; Jensen-Meckling, 1986;. Fama, 1983; Freeman- Evan, 1990;. Bertini, 2009; Fortuna, 2001; Fortuna 2010; Zattoni, 2006) are also typical of the banks.

In banks, the aspects of governance take on characteristics due to the particular nature of the business. The management and risk control, in this sense, are crucial, for top management. In fact, deciding how intensely the economic effects of risk on the company's life pervade is equivalent to giving greater or lesser importance to some objectives rather than others.

The recent economic and financial crisis has shown how the work of managers has been oriented more towards opportunistic choices rather than short-term actions focused on the principles of sound and prudent management.

In banks, in fact, any choice of allocation of capital (Benston- Irvine- Rosenfeld-Sinkey Jr, 2000; Ho, 1999; Matten, 2000;. Perold, 1999.) must first consider the need to ensure the repayment to depositors on demand through the mobilization of highly liquid assets and through the use of its own resources. Only in the presence of conditions that guarantee the fulfillment of this primary need, can one think of strategies to profit from the use of available capital.

It is essential, to take into consideration the adequacy of corporate governance models used by banks and their ability to balance the different interests that converge in the economy of the company.

These elements, in fact, greatly affect the portfolio choices of management strategies that are an expression of the bank and its willingness to implement them in line with the capital available resources and with the ability to remunerate adequately to the risks assumed and the analysis of the latter. In fact, the bank should guide decisions regarding market sectors in which to invest and increase their business. Only careful attention to the management and risk control, can allow the achievement of partial results from adequate levels of effectiveness and efficiency arising from specific competitive strategies. Their joint occurrence can implement a virtuous and unified process of value creation that constitutes the harmonious synthesis. The management, between high performance and higher capital requirements against the risks, has often been directed towards the first solution to secure economic incentives and reputational growth against shareholders. This resulted in the banks exposure to a risk of such a high level of risk which compromised, in some cases, their survival. The above suggests that the context of corporate governance issues tend to widen, expanding the audience of stakeholders to all protagonists of the market economy, but at the same time maintaining the category of depositors at the top of the stakeholders hierarchy. In any case, management must be shared with the entire company the strategy behind the process of value creation that will be put in place and the associated risk levels. In order to fulfill this the firm must acquire human and technical resources involved in understanding, analyzing, and disseminating information related to the "business strategy". The difficulty to configure an organizational, technical and patrimonial that is in line with the profit objectives of the bank and its exposure to risk can be mitigated by the desire to provide for an adequate system of internal controls.

Risk management and internal control

The internal control system is the integrated set of processes that can ensure the conditions necessary for the evaluation of the effectiveness and efficiency of its organization and operation. It can also ensure the monitoring and risk control in relation to the resources available and expected results (Anthony-Dearden, 1976; Comoli, 2002; Lorange, 1980; Newmann, 1981; Terzani, 1999) .

This system, if properly built, allows for a responsible management with the effect of favoring the achievement of the objectives in respect of corporate assets and in compliance with internal and external dynamics of risk that affect the production processes typical to the bank.

It is through the system of internal controls, moreover, that management tends to:

-Implement the policies of risk management, by monitoring the process of generating value created by all business areas;

- Monitoring the achievements of corporate objectives, and those of various stakeholders, with a view to good corporate governance.

Recent events, however, have shown behavior which arises from a state of superiority and abuse of management with respect to the control system, and from the awareness of the risks incurred in the performance of the bank. This has critical elements as in companies more involved in crisis, the management is the almost exclusive holder of strategic choices. The internal control systems have revealed shortcomings and limitations in controlling and responsibility in addressing their work. The situation described is acquired despite the existence of supervisory rules govern the action of the management which place limits on

risk. In fact, it is measured in terms of levels of solvency and liquidity of intermediaries, such as to ensure the soundness of the financial system as a whole.

The rules of supervision and control activities carried out by the competent authorities, unfortunately, have not been sufficient to prevent the proliferation of operations and financial products which have been poorly regulated and disclosed to the market in their risk profiles, according to schemes and methods in terms of deficit transparency and comprehensibility. This has occurred because of the regulator's difficulty in controlling operational areas whose size and complexity are difficult to standardize in well-defined rules, except the use of practices which are widespread and entrenched.

This last aspect has been a strong point of supervisory rules laid down in "Basel 2", bringing the logic that guides management decisions towards the regulatory provisions. the latter, in fact, prior to the formulation, were considered too distant from the reality that characterized the banks and, therefore, was a poor support for management decisions.

The regulation in question, however, showed the limits and shortcomings in the prediction and measurement of risk phenomena during the financial crisis, requiring intensive work.

The new version of the supervisory regulations, commonly referred to as "Basel 3", imposes more stringent requirements.

The effectiveness of these rules, however, is closely linked to the ability of the supervisory authorities to capture the importance of the management and the willingness of the latter to:

-Implement the broader control system of the operational processes;

- Consider them for the choice of an adequate structure of the governance model.

In Italy the primary and secondary legislation for banks is focused on the need to define roles and functions delegated to planning, management and control of risk.

Corporate functions of "strategic oversight", "management" and "control" are assigned the tasks aimed at delimiting the risk profile of sustainable relation to the objectives and balances of the bank.

The success of the risk management and, indirectly, the policies of corporate governance depends on the effectiveness of each functions.

In particular, the bodies with strategic supervision have, among others, the following responsibilities attributed to them:

- The selection and periodic review of the strategies and policies of risk management;
- The ways in which the risks are detected and measured;
- The allocation of tasks and responsibilities carried out within the company and, not least, the powers granted in this area;
- The effectiveness of technical and operational functions in charge of risk control, ensuring its independence in making judgments;
- The accuracy, completeness and timeliness of information flows related to the management and risk control.

In order to make risk control efficient manufacturing operations are particularly important:

- The adaptation of the control system to the internal dynamics and external companies;
- The allocation of responsibilities between the different corporate structures, avoiding conflicts of interest,
- Provision of information flows for the direction.

The important verification of the adequacy of the control system of risk compared to the choices made by the company are attributed to the body with control functions which, to

this end, has its own information flows and sends them to management and to other internal organs.

Despite the fact that supervisory regulations have been well articulated in there formal elements, the modus operandi of the banks and the recent financial crisis, have prompted further efforts to regulate:

- Relations between related parties in corporate life through specific rules on conflicts of interest;
- The principles of defining mechanisms for remuneration and incentive.

On this last point the activities carried out by the Financial Stability Forum were particularly important. They are the identification of guidelines with which to define rules on compensation management.

In the European environment the activities carried out by CEBS and the Basel Committee (FSB, FSF 2009; FSB, 2010; CEBS, 2010; CEBS, 2009; Comitato di Basilea, 2010; Comitato di Basilea, 2011) were particularly important.

The debate was extensive and the contrast between the supervisory authorities and institutions category was strong. In spite of everything and considering the cost that the community has endured for the intervention of the national authorities and international related to the "rescue" of banks, the new rules have been issued and are essential for the management to regain confidence in the economic system in its development and management company.

Discussion

The risk management activities, although of great importance, have not always been adequately considered in the choice of strategies put in place by banks.

In recent years, the management and control of risks have increased its influence in the processes of value creation but the management does not pay enough attention to this.

The events that have occurred, have confirmed the role of absolute centrality in order to maintain and, if possible, strengthen the reached positions of equilibrium.

This activity is often associated with a specific business function, and this decreases its importance.

The limits of this situation have been evident during the economic and financial crisis which

has made the top banks understand that the traditional risk management function are no longer sufficient to stem the negative effects generated by the phenomena of risk.

It is essential to spread the belief that the culture of risk within the bank, should be strengthened and designed using a very essential and innovative approach.

The difficulty of management to set up an organizational, technical and patrimonial aspect can be mitigated by its desire to provide for an adequate system of internal controls .

It is through this system that management tends to verify the achievement of corporate objectives, made possible by effective risk management policies and the use of a suitable model of corporate governance. Recent events and the failure to overcome them, however, showed behavior arising from a state of superiority and abuse of management with respect to the control system, on the awareness of the risks taken in the performance of the bank. This aspect presents more critical elements considering that in companies more involved in the crisis, management is the holder, almost exclusive, of the strategic choices and internal control systems have revealed shortcomings and limitations in carrying out the functions reserved to them. This was the case also for security activities more anchored to the definition of principles and rules rather than efficacious and effective action to contain the work of management. The interventions by the monetary authorities and governments results as,

however, important which were necessarily aimed to minimize the effects of the instability of the financial markets on the real economy and push the market to restore confidence in management.

It 'important to regain lost ground and contribute to the economic recovery that is hard to achieve, taking the lessons that the economic and financial crisis has given into due account of.

Among them, there is a clear need for banks to adopt an aware management. This awareness means that no results can be considered consistent and compatible with the policies of creation value, if not properly assessed against the risks assumed and resources available for addressing the resulting possible negative economic effects.

The most important think, therefore, is that of a vision of risk management that invests all-round management of the bank and that is not confined, as could have happenned in other times, within a single business function.

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