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Risk, the Element of Any Economic Activity

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Abstract: The financial risks have appeared since the beginnings of trade relations. While the step up where they were recognized, limited and checked differed greatly. Financial losses endured by internationally famous companies, due to inadequate Risk Management activities and especially highly publicized, have raised awareness by managers of growing importance to risk management. In the economic and financial life, the risk is an element of any activity, being exposed in the agenda of company managers. Unforeseeable changes in the interest rate development, the cost of a good or of the exchange rate affects not only the financial effects of an enterprise, but can cause its bankruptcy as well. Financial decisions are made depending on cash flows of contracts foreseen to come, that through excellence are unsafe.

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The financial risks

The risk is thus an uncertain component of financial decisions. It is not at all astonishing that a significant task of the financial system is the allocation of interest rate risk combined with the development, the cost of shares, the rates or the cost of replacing certain products. Risk management is a multilateral activity, and proposes completion of stages in any process of management.

These steps may be consecutive or simultaneous, showing the following specific stages:

- recognition of all types of risk;
- characterization of the Risk Management Policy;
- estimate of the risk
- each type of risk perception;
- producing risk limits;
- checking the risks;

The capital market proposes instruments both for the branching of many risks, and for reallocating those risks that cannot be branched in a business field by sharing them between many companies. In Romania, the Risk Management activity is approximately insufficiently evolved. Risk is defined as the exposure to a great replacement or the likelihood of an opposing deflection for the circumstance foreseen. Knowledge of risk is a versatile and individual action, therefore the analysis of global,

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aggregate idea is important. Extreme risk events proposes a succession of attributes that require adjustment of methods, procedures and instruments that replicate the appropriation of low possibility - extreme impact - governments have checked various solving both for the case of natural hazards and for the events caused by human action (biological or technologic accidents , international terrorism).

Risk models are:

- risk of market;
- risk of insolvency;
- credit risk;
- operational risk;
- liquidity risk;
- other types of risk;
- risks associated with derivative instruments.

Market Risk

The risk rises from the opposite modification of price or volatility of assets of an enterprise's portfolio. It is differentiated by the market deepening of a firm, which symbolizes the current importance of the financial instruments of the enterprise concerned. The market risk corresponds to the possible property damaged as a consequence of changing costs or the assets volatility. An enterprise has to estimate the market risks resulting from the portfolio owned. Enterprises that have an extremely active portfolio must assess daily market description, while the ones with low and not very active portfolios may perform it more rarely. Market risk includes the interest rate risk and currency risk (exposure contract, accounting the exposure and economic exposure). Contract exposure refers to a collection / payment in currency specified in a certainly future understanding or exists in performing process. This can be observed in the moment of closing a contractual relationship or receiving the remuneration which comprises currency, or the remuneration is made in lei, but the cost of the goods is shown in foreign currency. The economic exposure relates to the changing position of goods/ enterprise in the market quota and thanks to changes in replacement rates between the currencies.

The accountancy exposure exists because of the influence of foreign exchange enrollment of shares in the accounting records or payments / receipts currency spread over for a period. The market risk can be assessed as profit or the possible damage corresponding to a whole portfolio, positions or fellowship with a change of cost or an opportunity time in a known -time horizon - the VaR approach (Value at Risk). The calculation method shows a significant judgment which is taken most of the time by the steering committee of a company. The senior management must establish the key parameters which will be used in calculating the VaR. They can be analyzed and reflect the duration horizon or the safety period - part of the portfolio which is taken into account when calculating the VaR. The parameters mentioned above should be part of any relationship of market risk, as they are required for the outcome of the calculation analysis.

For example, a figure of 10 million USD daily VaR at a 95% the safety period, can be understood as it follows: the company may lose / win up to \$ 10 million in 19 of 20 trading days. A VaR daily number of \$ 10 million at 99% the safety period symbolizes the company may lose / win up to \$ 10 million in 99 of the 100 days. Intuitively, the company with daily VaR of \$ 10 million at 99% has an insufficiently risky portfolio than that with VaR \$ 10 million with 95% safety period.

The Risk of Insolvency

The risk of insolvency or not paying on time, turns out when the bank clients fail to pay the loan contracts and has as consequence either a final loss of capital or regain partially / delayed, as legal procedure against borrowers is done.

Studies in the field have highlighted the determinants of insolvency. The risk of insolvency is directly proportional to the mass of credits granted and is inversely proportional to the supply of credit. Concomitantly with development of aggregate lending, insolvency situations is larger, because, among the mass of borrowers there appear more and more potentially bankrupt people.

The bank itself being sensitive to the risk of bankruptcy, it imposes a threshold beyond which it will not lend, regardless of the profitable terms arising from high interest rates. Thus, it is created an area of inflexibility in the relation demand - loan supply.

Each bank promotes a certain restraint in the lending strategy, taking a series of security measures.

These regulations, known under the name of prudential norms relate to the following:

- duty of the banks to form a minimum reserve capital;
- the provision of a certain rate to hide risks, determined as a ratio between the amount of own funds and of credits granted;
- establish a division rate risk, which limits the size of loans that can be given to a single customer, so that the bankruptcy of a small group of clients do not considerably affect the bank's liquidity status.

The risk of insolvency is closely related to the performance at the microeconomic level. The degree of risk is different depending on the nature of the customer (if company or individual) and depending on the type of loan. By their nature, loans granted to individuals have a greater degree of assurance.

Real estate credits secured by mortgage are subject to less risk. In the same conjuncture there are the consumer credits, whereas the designated borrower is subject to the refund rates in the pledge to the creditor. These loans and borrowings granted to employees is under the mandatory domicile except income in bank accounts.

For economic agents, the investigation of financial and operational terms ample knowledge is a great way to alert the risk of insolvency.

Customer solvency analysis requires detailed knowledge of all his activities:

- increasing trend;
- development of profit;
- conjunctural developments;
- the solvency and the liquidity indicators evolution;
- characteristics of the enterprise;
- the evolution of the level of indebtedness;
- business development factors;
- evolution and perspective of the marketing of goods;
- the evolution of the working capital;
- evolution availabilities in bank accounts.

Wanting to reduce the risk of bankruptcy, banks have a tendency to help current lending to activity and especially commercial lending cycle.

The Credit Risk

The risk arising from doubt capacity, the skill of or interest partners desire to fulfill contractual obligations.

Examples:

- on forward foreign exchange contract term because of time zone differences, there is a time difference to the bank pay dollars so the risk that the bank cannot pay is a risk of the counterparty for the enterprise;
- bank that is lending a company is subject to counterparty risk;
- on a swap on interest rate between two companies, there was a risk of failure of the obligation or counterparty risk.

Issues:

- counterparty risk is very common;
- method of calculation, evaluation: the derivatives counterparty risk is evaluated based on the sum of current expenditures changing positions, plus an evaluation of the company's future exposure due to market movements;
- risk on derivatives is different because their value depends on an underlying asset, their exposure value not being equal to the underlying asset; if the counterparty fails to perform the contract it is deemed to cost change.

Operational Risk

This type of risk can be depicted by the deficiencies occurring in our system of internal checks or business enterprise. The operational risk can be compared with human error, system loss or misapplication of procedures. By its nature, this risk is difficult to quantify.

In the 90s, financial units have started to focus their interest on the risks associated with back office actions, which would call themselves operational risk. Being already interested in the market risk and counterparty risk, many units have included in the operational risk all other risks except premiums. Others have characterized much more limited operational risk, associating it with.

For extra clarity, I would recommend a few examples of operational risk:

- back office of a bank does not notice a mismatch between the reference to a transaction and its proof by the partner. In this case, the transaction may be the subject of a dispute, which may also cause financial harm;
- a trader performs a hedging operation, its damage being of 10 mil. USD;
- instead of communicating the operation performed, the trader enters the computer system of the institution and hides the wrong hedging. Then, he enters a speculative position, waiting to recover from the incurred loss;

The Liquidity Risk

Most of the institutions meet two types of liquidity risk degrees. The first one relates to the depth of the market and refers to characteristic traded goods, and the second relates to funding the activists of the trading. Deciding the judgment limits for different risk types related with the traded products, senior management should take into account the size, depth and liquidity of these markets because

those goods market liquidity may affect the company's or institution's ability to modify risk profile, flexibly, quickly and cost effectively.

The liquidity risk occurs when a company cannot fix a big deal in a certain period of time or when that company is fit to receive funds to honour its projected cash flow. In the case of extreme risk events, the amounts to be mobilized quickly are huge and the classical solutions are often difficult or even impossible. Risk management must therefore find innovative solutions, better adapted in terms of dynamic, effective, workable and robust.

An example is the case of Barings bank financial system where lack of liquidity has led to the collapse of the famous British banks with a length of over 200 years. This case is more than convincing, being the proof for damaging consequences of the global liquidity crisis and especially by the absence of a policy to hide liquidity risk that may lead to rapid destruction of even a solid enterprise.

Other Types of Risk

The variety of activities in a company requires a lot of other risks in addition to those expressed above and especially the legal risk, the country risk, the regulatory risk, the risk of accounting transposition, the model risk, the systemic risk, etc.

Legal risk mainly aims at risk that a particular contract is not recognized by the Contracting Party and, consequently, his contractual obligations are not met.

The risk of taxation aims at analyzing the legislation concerning the hedging taxation or the lack of legalization on hedging's taxation, such as Romania's case.

The regulating risk aims at the probability of financial market regulations to handle unexpected change. Therefore, certain types of business can become illegal.

The systemic risk presents an unfavorable shock on the economic chain. A convincing example is the financial bankruptcy of the US in October 1987, when the stock market suffered huge losses and participants were panicked. The crash of financial institutions can lead to the collapse of many other financial institutions, leading to a financial bankruptcy. Systemic risk is that circumstance as the financial bankruptcy, that extends in all economic sectors and negatively affects the entire economy.

The financial risk is common and is established by differences in accounting legalizations of different countries, especially in the case of multinational companies.

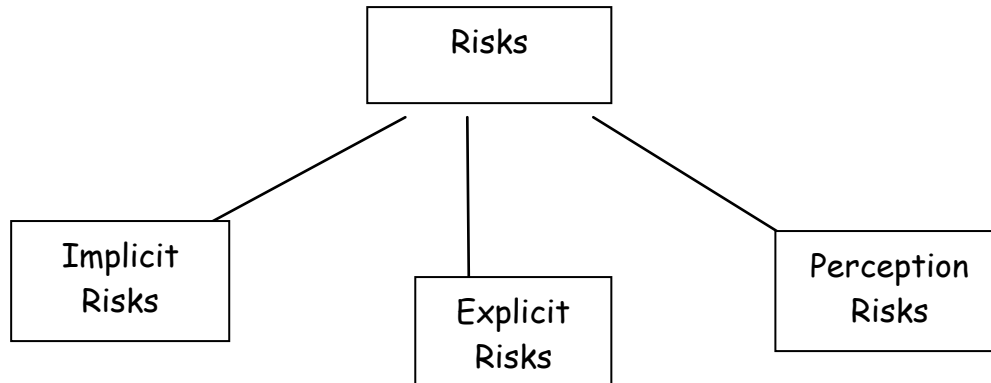
The specific risks with extreme events are hard to predict and evaluated because of its specific characteristics. Analyzing them is done with special methods which are adapted to the specific characteristics and mechanisms of the analyzed of events.

Risks Associated with Derivative Instruments

The risks mentioned above may be partially or totally hidden and managed by the application of derivatives (forwards, futures, options contracts). But exactly the use of these instruments induces more risk at the enterprise level. In recent years, the worry of banks, regulatory fora and other market institutions was held particularly on qualitative recognition and measurement such risks. More specifically, there is a very strained relationship between the economic indicators and the fickleness

unchanged capacity development of derivatives trading, sets out both of changing the financial and the detention of goods, and the growth of the OTC market.

Analysis of chain that connects derivative goods of its past users due to their functions within an economy:



The variety of explicit risks includes the exposure of the usual market risks, both the derivatives market, and the market of the underlying asset. The variety default of risks includes risks concerning the use of derivatives in a certain economic circle and within determined circumstances of market. Counterparty risk of derivative transactions is a common model of such a risk. For example, a contract traded on the OTC market choices express evolved counterparty risk towards a contract traded on the market like CBOE (Chicago Board Options Exchange). This risk will be comprised in the importance of the first elections, which will be more reduced to the OTC market and higher on stipendista market.

Besides the counterparty risk, other types of risks are liquidity risk, operational risk, legal risk. What must be specified in this context is that not the derived goods represent such risks, but the shape/structure of the market where they are traded. What I called earlier perception risks are those risks owed to disagreements or wrong agreements upon ideas about derivatives, the irregularities of the market regarding the legal framework and that of self-regulation.

Three conditions can generate or develop these risks, namely:

- the lack of transparency on the information market;
- lack of education and knowledge about derivatives;
- the wrong use of these tools and due to incorrect measurement risks in a company.

Thus, it can be clearly inferred that awareness and education on derivative financial instruments causing significant exposure to the associated risks.

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