

ANALYSIS OF THE TRIPLE CORRELATION: COMMERCE - SUSTAINABLE DEVELOPMENT - RISK MANAGEMENT

IOANA Adrian

University POLITEHNICA of Bucharest, Romania

E-mail: adyioana@gmail.com

Keywords: Commerce, Sustainable Development, Risk Management.

Abstract: The paper presents the main types of the triple correlation: Commerce – Sustainable Development – Risk Management. This triple correlation highlights the Sustainable Development priority. In this correlation the commerce must ensure the balance between the Sustainable Development and the Risk Management.

The concept of Sustainable Development would include the critical analysis of a quantitative measure of the Gross Domestic Product (GDP), and a different vision of the qualitative transformation. Harmonization of the economic, social and environmental target is included among the goals of sustainable development.

1. Introduction

Sustainable Development involves achieving the current need without compromising the ability of future generations to meet their own needs.

The standard theory of economic development involves both quantitative change (increase in Gross Domestic Product) and qualitative change (shift from pre-capitalist economy based on agriculture to industrial capitalist economy) [1, 3].

The theory of sustainable development involves both a critique of quantitative measure of GDP and a different vision of qualitative transformation. The goals of sustainable development include the harmonization of the economic, social and environmental targets. The concept of sustainable development was born 37 years ago, as a response to the emergence of environmental and natural resources crisis, especially those related to energy. The Conference on the Environment in Stockholm in 1972 marks the moment when it is recognized for the first time that human activities contribute to environmental deterioration, which threatens the future of the planet [7].

Sustainable development has become an objective of the European Union since 1997, when it was included in the Maastricht Treaty, and in 2001, the Summit at Goteborg adopted the Strategy for Sustainable Development of the European Union, which was added an external dimension at Barcelona in 2002.

Risk management in banking designates the entire set of risk management processes and models allowing banks to implement risk based policies and practices. They cover all techniques and management tools required for measuring, monitoring and controlling risks. The spectrum of models and processes extends to all risks: credit risk, market risk, interest rate risk, liquidity risk, operational risk and country risk.

2. The commerce, nonperforming loans and elements of risk management

The nonperforming loans (NPL) are those loans for which principal or interest is due and left unpaid for 90 days or more (this period may vary by jurisdiction). The NPL portfolio, along with the bank's collection ratio and the level of provisions recorded illustrate the quality of the entire portfolio and the overall credit policy of the bank. [1, 2, 4].

There are various reasons why the quality of bank loan portfolios deteriorate and research reveals that most reasons relate to the nature of the bank's credit culture. Below are listed the most usual drivers of loan portfolio deterioration:

- *Self – dealing* refers to an overextension of credits to directors and large shareholders, while compromising sound credit principles under the pressure from related parties.
- *Compromise of credit principles* refer to the granting with full knowledge of loans under unsatisfactory risk terms.
- *Anxiety over income* outweighs the soundness of lending decisions, underscored by the hope that the risk will not materialize.
- *Incomplete credit information* concerns loans granted without proper appraisal or borrower creditworthiness.
- *Complacency* is typically manifested in a lack of adequate supervision of old, familiar borrowers, based on an optimistic interpretation of known credit weaknesses because of survival in distressed situations in the past.
- *Technical incompetence and poor selection of risks* include a lack of ability among credit officers to analyze financial statements and obtain and evaluate pertinent credit information.

Measures to counteract credit risks normally comprise clearly defined policies that express the bank's credit risk management philosophy and the parameters within which credit risk is to be controlled.

Among the policies targeted at limiting the credit risk can be mentioned: policies on concentration and large exposures, adequate diversification, lending to connected parties or over-exposures.

Bank regulators have paid close attention to risk concentration by banks, the objective being to prevent banks from relying excessively on a large borrower or group of borrowers. Modern prudential regulations usually stipulate that a bank should not make investments, grant large loans, or extend other credit facilities to any individual entity or related group of entities in excess of an amount that represents a prescribed percentage of the bank's capital and reserves.

According to international practice, a single client is an individual, a legal person or a connected group to which a bank is exposed. Single clients are mutually associated or control (directly or indirectly) other clients, usually through a voting right of at least 15-20 percent, a dominant shareholding or the capacity to exercise a controlling influence on policy making and management. These clients' cumulative exposure may represent a singular risk to a bank if financial interdependence exists and their expected source of repayment is the same.

The second set of credit risk policies consist of the asset classification method, which employs a periodic evaluation of the collectability of the loan portfolio. The general rule is that all assets for which a bank is taking a risk should be classified, including loans and advances, accounts receivable, investments, equity participations and contingent liabilities. Asset classification, by means of which assets are classified at the time of origination and then reviewed and reclassified as necessary (according to the degree of credit risk) a few times per year, is a key risk management tool. The periodical review considers loan service performance and the borrower's financial condition. Assets classified as "standard" or "specially mentioned" are typically reviewed twice per year, while critical assets are reviewed at least each quarter.

Banks determine classifications by themselves, but follow standards that are normally set by regulatory authorities. Standard rules for asset classification that are currently used are listed below:

- *Standard (pass)* are loans for which the debt service capacity is considered to be beyond any doubt. In general, fully secured loans by cash or cash substitutes (bank deposits, certificates, treasury bills etc) are usually classified in this category.

- *Specially mentioned (watch)* are assets with potential weaknesses that may, if not checked or corrected, to weaken the asset as a whole or jeopardize the borrower's repayment capacity in the future. In this category are included, for example, credits given through inadequate loan agreements, lack of control over the collateral, lack of proper documentation. Loans to borrowers operating under economic or market conditions that may negatively affect the borrower in the future are also included in this category.
- *Substandard* regard well defined credit weaknesses that jeopardize debt service capacity, in particular when the primary sources for repayment are insufficient and the bank must look to secondary sources for repayment, such as collateral, the sale of a fixed asset or refinancing. In this category can be included term credits to borrowers whose cash flow may not be enough to meet currently maturing debts, as well as short term loans and advances to borrowers for which the inventory-to-cash cycle is insufficient to repay the debt at maturity.
- *Doubtful* are assets having the same weaknesses as substandard assets, but their collection in full is questionable on the basis of existing facts. The possibility of loss is present, but certain factors that may strengthen the asset exist as well.
- *Loss* regard assets that are considered uncollectible and of such little value that the continued definition as bankable assets is not warranted. The inclusion in this category does not mean that the asset has absolutely no recovery or salvage value, but rather that it is neither practical nor desirable to defer the process of writing it off, even though partial recovery may be possible in the future.

The third set of credit risk management policies are policies regarding loss provisioning, by means of which allowances are set up at an adequate level as to absorb anticipated loss. Asset classification is the one providing a basis for determining an adequate level of provisions for possible loan losses. The aggregate level of provisions, together with general loss reserves, indicates the capacity of a bank to effectively accommodate credit risk.

In determining an adequate reserve, all significant factors that affect the collectability of the loan portfolio should be considered. These factors include the quality of credit policies and procedures, prior loss experiences loan growth, quality of management in the lending area, loan collection and recovery practices, changes in national and local economic and business conditions, and general economic trends. Assessments of asset value should be performed systematically, consistently over time and in conformity with objective criteria. Policies on loan-loss provisioning range from mandated to discretionary, depending on the banking system. In many countries, in particular those with fragile economies, regulators have established mandatory levels of provisions which are related to asset classification.

3. Triple correlation: Commerce - Sustainable Development - Risk Management

Trade, Sustainable Development and Risk Management are (and should always be) correlated. The optimization of this triple correlation must be performed by any good manager [5, 6].

The main types of correlations Commerce (C) - Sustainable Development (SD) - Risk Management (RM) are presented below (figure no. 1, a1), a2), b1), b2), c1), c2)).

The review of the correlations Commerce - Sustainable Development - Risk Management involves three successive levels:

- a) Level a), where Sustainable Development (SD) has the leading position; it has two subcomponents, a1) and a2);
- b) Level b), where Commerce (C) has the leading position; it has two subcomponents, b1) and b2);

c) Level c), where Risk Management (RM) has the leading position; it has two subcomponents too, c1) and c2);

Of the 3 levels of correlation (a, b, c) and 6 subcomponents (a1, a2, b1, b2, c1, c2) correlation a1) is the most interesting – in consists of:

- Putting the concept of Sustainable Development (SD) on the leading position.
- Direct correlation between Commerce (C) and Sustainable Development (DD), for the purpose of developing an “organic” commerce, to ensure achievement of Sustainable Development
- Having Risk Management (RM) as a link to balance Sustainable Development (SD) and Trade (C).

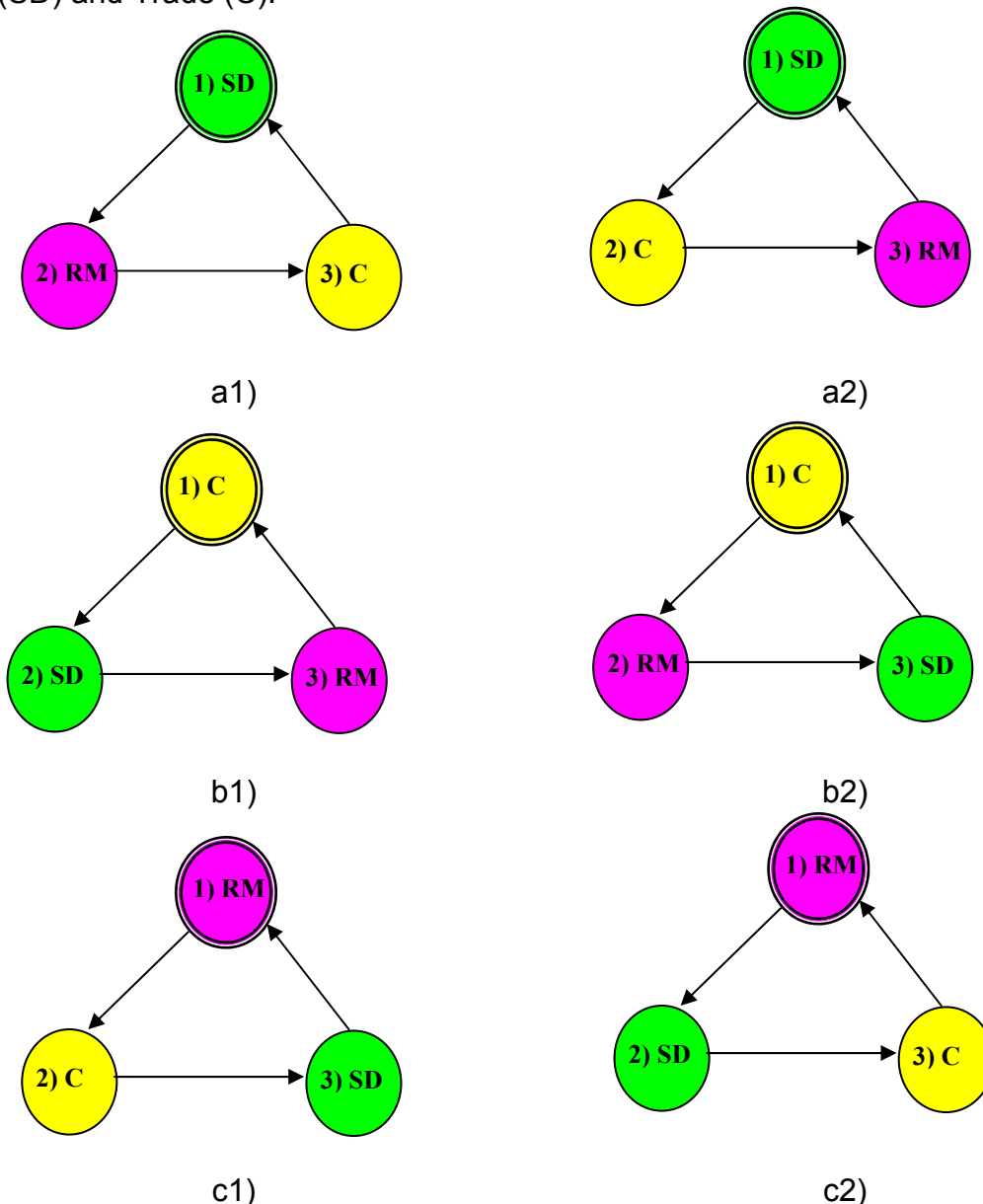


Figure no. 1. The types of correlations Commerce - Sustainable Development - Risk Management
SD – Sustainable Development; C – Commerce; RM – Risk Management

4. Conclusions

The satisfaction of human needs and aspirations is the major objective of development. The essential needs of a large number of people in developing countries (for food, clothing, shelter, jobs) are not being met yet, and beyond their basic needs these people have legitimate aspirations for an improved quality of life. A world in which poverty and inequity are endemic will always be prone to ecological and other crises. Sustainable development requires meeting the basic needs of all people and extending to everybody the opportunity to satisfy their aspirations for a better life.

The level of commerce depends on the specific credit resource. There are three sets of policies specific to credit risk management: policies aimed at limiting or reducing the credit risk, policies of asset classification and policies concerning loss provisioning.

In determining an adequate reserve, all significant factors that affect the collectability of the loan portfolio should be considered. These factors include the quality of credit policies and procedures, prior loss experiences loan growth, quality of management in the lending area, loan collection and recovery practices, changes in national and local economic and business conditions, and general economic trends. Assessments of asset value should be performed systematically, consistently over time and in conformity with objective criteria.

The main types of the triple correlation Commerce – Sustainable Development – Risk Management reflect the leading position of Sustainable Development concept. In this context, Commerce must realize the balance between the requirements of Sustainable Development and Risk Management.

References

1. Ammann, M., *Credit Risk Valuation: methods, models and application*, Springer Publishing House, Berlin, 2002.
2. Cerban, N., Ioana, A., ș.a., *Ingineria Materialelor Metalice Prețioase în Contur Financiar – Bancar*, Ed. Fair Partners, București, ISBN 973-99985-5-0, 207 pg., 2002.
3. Ioana, A., Mirea, V., Bălescu, C., *Analysis of Service Quality Management in the Materials Industry Using the BCG Matrix Method*, Amphitheater Economic Review, Vol. XI, Nr. 26, June, Bucharest, 2009.
4. Ioana, A., *Managementul producției în industria materialelor metalice. Teorie și aplicații.*, Editura PRINTECH București, ISBN 978-973-758-1232, 232 pg., 2007.
5. Ioana, A., *Marketing Elements Mix in the Materials' Industry*, Proceedings of the International Conference "European Integration - New Challenges for the Romanian Economy", 4th Edition, May, 30-31.2008, Oradea, 2008.
6. Ioana, A., *The Electric Arc Furnaces (EAF) Functional and Technological Performances with the Preheating of the Load and Powder Blowing Optimization for the High Quality Steel Processing*, PhD Thesis, University "Politehnica" of Bucharest, 1998.
7. <http://www.earthpolicy.com>