FACTORS THAT MAY DETERMINE THE RECOVERY RATE OF FINANCIAL RISK DAMAGES

Nicoleta Diana Rosioru
Spiru Haret University of Bucharest, Romania

The information about the performance of a company, especially about its profitability, are useful to the consideration of potential changes of the economic resources, which the company might further control and the forecast of the ability to generate treasury flows by the existent resources. Also, based on the performance, judgments are expressed, aiming the efficiency whereof the company may use new resources. The performance of company may be influenced by its financial risk. The financial risk is defined as "variability of result indicators, under the incidence of financial structure of the company"[50]. It is established by "the financing policy of the company, by equity or loans". The financial risk results by the structure of the company shareholding or by the use method of financial instruments. The financial risks result by different sources, including changes of the interest rate, currency trades, expansions of lending operations, issuance of shares, as well as the use of derived financial instruments (IFD).

Key words: administration, cost, risk, risk management, strategic management of risk, ensurance, risk exposure, risk financing, payment of losses, risk assignment

1. Introduction

The increase of vulnerability of the companies, their size, focus of assets, high technological impact, inter-dependence and strong worldwide competition, as well as the interest in the environment are only several factors that coerce us to focus on the issue of risks and their management.

We have to stress that the concerns regarding risk management progressed very fast in one direction, namely: insurances. But the insurances especially aim the "pure" risks, which are not resulted by the managers' activity, but by causes independent to them. Therefore, the risk management was focused for a long period of time on the insurance spectrum. Actually, besides the pure risks, we notice the speculative risks generated by the management act.

Returning to the vulnerability of companies, more and more specialists consider that the administration and its cost are one of the most stringent issues of industrial society. This is the function of focus, size, inter-dependence, technology, as well as social progress.

Independently of the area where the managers are acting, the risk is an invariable notion of their concerns. Therefore, the trading staff faces the aging risk of products, the competition risk or the price risk, the financial staff – the bankruptcy, foreign currency, payment incapacity risks etc., the social area staff – conflict, epidemics risk etc., and the manufacturing area staff – damage, fire, quality risks, etc.

2. Risk – a constancy of international economic activity

According to the Explicative dictionary of Romanian language[51], the word "risk" comes from the French word "risque" and means a possible danger, a possible inconvenient or the probability of a damage. The Dictionary of Finance and Banking[52] defines, too, the risk, as the possibility of suffering something, a loss or damage on trades. The risk means "the potential prejudice, whereto the patrimony, interests and activity of the economic agent are subjected." [53] By a synthetic point of view, the risk is defined as "the probability of an event with adverse consequences to the subject". [54] Other authors present risk as a "potential adverse deviation from the expected results".

[50] Mihai Toma, Felicia Alexandru, Finanțe și gestiunea financiară de întreprindere, Ed. Economică, București,2003
[51] Academia Română, Institutul de Lingvistică „Iorgu Iordan-Al. Rosetti", Dicționar explicativ al limbii Române, Ed. Universul Enciclopedic Gold, 2009, pag. 957
[52] Oxford , A Dictionary of Finance and Banking, Ed. Oxford University Press, 1997, pag. 309
[53] I. Mihai, Tehnica și managementul operațiunilor bancare, Ed. Expert, București, 2003, pag.151
[54] I. Trenca, Simona Mutu, Managementul riscurilor bancare - Soluții econometrice -, Ed. Casa Cărții de Știință, 2012, pag.10

The bases of classic decision theories, relying on the certainty assumption, are more and more weathered by the real situations that don't comply with the full and correct knowledge requirements of all the conditions and effects of an event. As a direct consequence of it, it is not operating nowadays with absolute certainties, with certain forecasts of progress of a certain element or phenomenon, but the deciders turn more and more to probable, doubtful forecasts, to risk and/or uncertainty notions, the incomplete knowledge of one or several "variables" being a constancy of economic activity and a cause that explain in a lower or wider extent the differences between the profitability of different business projects.

Acceptations of the risk concept

The risk is subject to several acceptations, such as:

- „the risk represents the variability of the possible result function of an uncertain, unsure event".
-„the risk is the uncertainty with respect to a loss".
-„the risk can be defined as a possibility that the losses are greater than expected".
-„the risk represents the uncertainty with respect to the occurrence of damage".
-„risk is that situation in which there is a possibility of a deviation which is adversary to the expected result".

Analyzing all these definitions, several common characteristics and certain criteria for defining the risk can be notice. In the first stage, it can be said that the risk derives from uncertainty: the adoption of the decision takes place in present, and the implementation and the generated results will occur in the future; the uncertainty due to incognizance of which event out of the identified ones will occur and at what moment, what will the real effects be and what will the amplitude of this effect will be. In the second stage, the risk implies the idea of potential loss (of any type), generated by an evolution of a factor opposed to the outcome expected by the decision maker.

3. Risk management

The risk management is a systematic process, a continuous and rigorous process which contains the processes related to the identification, analysis, planning, control and resolution of risks, having as objective the transformation of risks in opportunities.

In a free market economy, characterized by a honest competitiveness, the frequent oscillation of prices due to the offer and demand, the level of sales and undertakings, etc. are only few elements which would bring uncertainty and risks, even if the most opportune forecasts are being performed and irrespective of the undertakers' level of prudence.

Although it does not contribute directly and obviously to the company's economic growth, the risk management constitutes one of the main components of the company's management. And this is due to the fact that the ignoring of certain situations which imply risks can lead even to the disappearance of the company. The main objectives of the risk management are the following:

- the company's survival
-low costs with the risk management and consequently the generation of high profits
-obtaining stable earnings
- short-term interruptions or the absence of interruptions in the company's activity – continuous increase
-the company's satisfaction with respect to its social responsibilities and its good trade mark image.

These objectives might differ function of the company's purposes, the environment in which it develops its activity and the attributes which are particular to each and every organization.

The risk management imposes a discipline which is necessary for the fundament of each business. All risk managers take risky decisions either related to the launching of a new product or a publicity campaign.

The risk, however, is not an isolated event. In a world which is highly dependent and strongly technologized as the one in which we are currently living, an event can have catastrophic consequences determining the transfer of risk from one place of the world to another.

3.1. Strategic administration of risk

Insuring is not the only method of treating risk; for this reason, we will present you below a strategic manner for approaching risk.

A program for risk administration which is well implemented will help the minimization of the risk exposure and will reduce costs. In order to ensure the effectiveness of the expenses which are necessary for risk management, we propose a strategic approach, according to the figure below.

Strategy, Measurement, Treatment and Monitoring

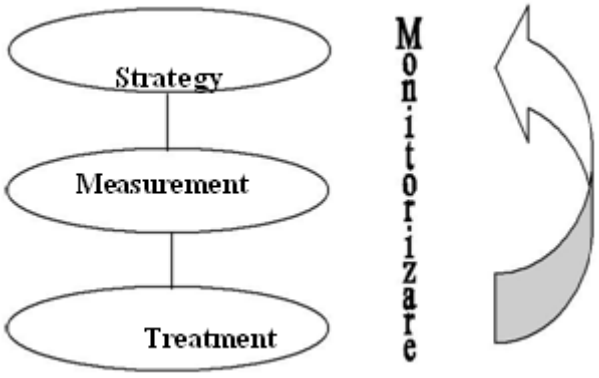

Figure no. 1. The components of the strategic risk administration system

The components of the strategic risk administration system - Strategy, Measurement, Treatment and Monitoring.

Strategy

We consider that in order to be successful, the risk management programme, must be part of a general plan, and must be structured function of the company's purposes. We will present in a comparative manner the main impediments in fulfilling the objectives thorough interviews at managerial level.

This information will provide the base for the development of a strategy for the administration of a company's risk, which will allow the identification and assessment of risks, in the same time supporting the company's objectives.

Measurement

A continuous programme for the definition and measurement of risk is an important element for the approach of the strategic administration of risk.

Once they are identified, the risks are assessed in conformance with the frequency of losses, their gravity and aggravation and amelioration factors. Also, priorities related to the measures for the loss control can be established. The risks are assessed not only function of the company's capacity to support them, but also function of one another.

The risk profile of a company is formed of credible losses scenarios; their gravity and frequency determines limitations and restraints of the optimum programme.

The description of the risk profile represents a chapter within the implementation plan. This represents a key component of the risk management stage.

Treatment

This implies the development of a tactical action plan, which prescribes a treatment for each and every risk in one or several of the three forms of transfer:

Physic control – for example: detection with a high degree of safety, measures for prevention of fires and/or rehabilitation from disasters.

Risk financing – for example, through retaining the risk on its own expenses and development of a loss fund. Development of a campaign for captive insurances represents a good example for risk management.

Transfer of risk – for example, through the contractual transfer or through the conclusion of insurance policies.

Monitoring

During the continuous evolution of the company, its risk profile and priorities can be modified. Any change must be monitored, and the risk management programme must be adapted to the company's structure and activities and to its future objectives.

3.2. Risk financing

After the identification, measurement and treatment of risk by means of the most adequate methods, except for the case in which the risk is completely eliminated most of the times a residual risk will remain which will be undertaken by the organization.

Possibilities:

- To pay the losses from the current budget without making any special financial provisions;

- A fund to be constituted for covering the costs of the losses;
- Loans to be made for the coverage of the losses;
- The transfer of the financial consequences through insurance should be used.

1. Payment of losses upon their occurrence

This is the simplest method for risk financing, because it does not imply any special effort or administrative arrangement. But this method cannot be applied for very restraint losses, which have the following characteristics:

- Reduced gravity. Obviously, if the loss is significant, it is possible that there are no enough funds for the cover of these losses;
- Very predictable, because they appear very frequently;
- The loss would occur when the organization records significant earnings.

The advantages of the method:

- The money remain at the disposal of the organization until it is necessary to cover the loss. No advance payment is necessary as the case for the insured risk;
- Only the loss is paid with no type of additional payment.
- There is a certain incentive for the limitation of the losses because of the fact that their cost is included in the budget, and the abnormal levels of the losses will be identified as any other variation of the budget.

Disadvantages of the method

- It is difficult to establish a reporting system for the losses financed in this manner, so that the information which could indicate a modification in nature or size of the risk will not be put at the disposal of the risk manager.
- Credits are rarely granted for the unspent budgets, so that there is no incentive to reduce the losses below the level included in the budget;
- This method tends to imply that each profit center will cover its own losses in its budget. Through this method, the size of the loss which can be financed in this manner is more diminished, because without a certain centralization or additional support between the units of the organization the support of the risk can be reduced to the lowest budget.

2. The funds which are constituted especially for the coverage of the damages

The more serious losses can be financed by means of constituting a special fund:

- By putting apart a sufficient amount of money;
- By means of periodical installments as internal insurance premiums against risks;
- By means of a combined method.

Such a fund can provide the possibility to divide the costs of the losses on a period of several years due to the fact that the amounts which are not used immediately can be retained for the cover of the future losses.

Advantages

- The funds are at the disposal of the organization and can be used for short term investments until the date at which the payment is made.
- Only the payment is paid with no other type of addition as in the case of financing from the company's own budget.
- The amount of the installments can be varied function of the company's situation. Big amounts can be allocated when the company's situation is favorable and small amounts can be allocated when the company's situation is not favorable. This flexibility is not possible when the financing of the losses is performed by means of insurance.
- The organization can decide which of the losses would be sustained from the created fund.

Disadvantages

- Internal retaining, as compared to the insurance premiums are not deductible from a fiscal point of view.
- The retained amounts cannot be kept for several years without paying the related tax.
- There can be alternatives which can generate profits for the retained funds in order to cover future losses;
- The funds must be available anytime for the payment of losses so that they cannot be invested in order to obtain maximum profit;
- For the initial establishment of the fund big amounts of money are needed in order to cover the first loses;
- The stopping of the protective actions against loses with the purpose of saving for the creation of the fund is not recommended.

3. Loan after the occurrence of the loss

This method is used when funds are necessary for covering the losses or for covering the funds which were especially created, when they are not sufficient.

Advantages

- This is a very flexible method. No action is undertaken until the loss appears and until the necessary amount to be taken as loan for covering the damage is established. (estimated values are not used).

Disadvantages

- The moment of the loss occurrence cannot be controlled and consequently the crediting conditions are not known. If the imposed interest is too high or the reimbursement term is too short it could be impossible to obtain the loan. In addition, the loss could destroy significant assets so that the organization will hardly obtain the necessary credit.

3.3. Factors which can influence the decision to retain or to assume the risk

The company's degree of aversion towards risk

- the degree of aversion depends both on the decision maker as well as on the company's objectives. The family organizations with long term objectives have an increased aversion towards risk.
- the big companies which have a good financial situation will be capable to retain many more risky projects as compared to a company which is in a more difficult situation

Nature and size of the risk.

In general the reduced losses will be retained as compared to the financial situation of the organization as well as the very predictable ones.

External incentives or the lack of incentives:

- The insurance requirements can make some of the risks as being impossible to be retained;
- The interest of the necessary credits to cover the losses
- The taxation system upon the amounts retained for covering the risks etc.

4. Conclusions

The Financial Supervising Authority acts for the development of an integrated framework for the effective operation and supervision of markets and operations related to the three sectors of activities: insurances, capital market and private pensions respectively.

The need to approach the supervision also at integrated level is generated by the manifestation of the systemic and operational risks, as a consequence of the permanent evolution of information technology and of criminality for the purpose of preventing the economic and macroeconomic crisis.

The control points, the risk indicators, the impact assessments, identification and collection of incidents, regulation of the risk areas, of the outsourced activities, new auditing concepts, have become a European priority. Among the measures undertaken by the European macroeconomic supervision organisms, also the stress testing and active structures is counted on the financial markets in the financial markets of the EU member states.

The integrated supervision provides a unitary approach for the prevention and answer to crisis, including the stress testing of entities and structures.

At national level the integration with the actions of the macro-prudential stability committees is necessary, through cooperation with the national Bank of Romania and with the other specialized organisms.

From a macro-prudential point of view, the common risk elements related to the three markets supervised by Financial Supervising Authority, the one related to insurances, financial investments and private pensions, are approached at an integrated level in order to have a global perspective upon them. Their integration must be both on the vertical of the sector as well as intra-sector, horizontally. In this manner, The macro-prudentiality covers the risks related to financial groups and conglomerates.

In the Guide proposed by The Economist Books[55], it is mentioned that: „for the assumed risks, the investors obtain an earning" and, in general „the higher the risk is, the more substantial the earnings will be". Consequently, the risk must not necessarily be avoided but in the first step should be

[55] T. Hindle (coordonator), Finante. Ghid propus de The Economist Books, Ed. Nemira, Bucureşti, 1998, pag.163

identified and assessed with the purpose of transforming the possible negative results in opportunities.

Acknowledgment

The work benefitted of a financial support by the project named "SOCERT. Knowledge company, dynamism by research", agreement identity number POSDRU/159/1.5/S/132406. The project is co-financed by the European Social Fund, through the Sector Operational Program of Human Resource Development 2007-2013.

References

1. *Academia Română, Institutul de Lingvistică „Iorgu Iordan-Al. Rosetti", Dicţionar explicativ al limbii Române, Ed. Universul Enciclopedic Gold, 2009, pag. 957 ;*
2. *Ciurel, Violeta, Asigurări şi reasigurări: abordări teoretice şi practici internaţionale, Editura ALL BECK, Bucureşti, 2000;*
3. *Colecţia Revistei de asigurări "Primm" 2005, 2006,2007;*
4. *Eduard Ionescu, Ion Viorel Matei, Laura Ungureanu – Monetary and financial politics: a dynamical model approach – World Review of Entrepreneurship, Management and Sustainable Development, Vol II, Nos. 2/3, 2015;*
5. *Mihai, Tehnica şi managementul operaţiunilor bancare, Ed. Expert, Bucureşti, 2003, pag.151;*
6. *Trenca, Simona Mutu, Managementul riscurilor bancare - Soluţii econometrice -, Ed. Casa Cărţii de Ştiinţă, 2012, pag.10*
7. *Kuritzkes, T. Schuermann, What we know, dont know and cant know about bank risk: a view from the trenches, Ed. Princeton University Press, 2007, pag.3*
8. *T. Hindle (coordonator), Finante. Ghid propus de The Economist Books, Ed. Nemira, Bucureşti, 1998, pag.163*
9. *Oxford , A Dictionary of Finance and Banking, Ed. Oxford University Press, 1997, pag. 309*
10. *Bătrâncea, coord. A.Mosviciov, M. Bătrâncea, L.Bătrâncea, A. Popa, A. Nichita, Analiza financiară în bănci, Cluj Napoca, Ed. Risoprint, 2010*
11. *P. Prunea, Riscul în activitatea economică, Ed. Economică, Bucureşti, 2003,*
12. *www.xprimm.ro;*
13. *www.Wall-Street.ro;*
14. *www.1asig.ro*