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### **RISK-ORIENTED MANAGEMENT IN THE BANK**

**Abstract.** Risk-oriented management is defined as the scientific and methodological concept of banking management, aimed at identifying and assessing the totality of bank risks through special techniques and methods in order to create conditions for reliable and stable functioning of the bank, maximizing its own capital, meeting the needs of clients and partners of the bank, ensuring profitability of banking activity. The introduction of new principles for building a risk management system aims at increasing the level of corporate governance in banks, strengthening and more detailed requirements for the risk management process, strengthening the responsibility of the bank's management bodies for the risks taken and the financial stability of the bank. Creating an effective risk culture requires Boards and senior management to focus on the bank's written rules that clearly define risk management objectives and priorities and by taking a hard, honest look at any informal rules, protocols, the way workflows are performed, how decisions are made, and the link to the bank's compensation practices. The risk management system in the bank covers all its structural levels — from the top management of the bank (board and board) to the level at which the risk is directly taken or generated. A feature of the risk-oriented management of the bank is the creation of three lines of protection against risks. The degree of complexity of the banking risk management system should correspond to the degree of riskiness of the environment in which the bank operates. The policy on operational risk management also involves the development of technological schemes (maps) of products and services of the bank, which are maintained in a constantly updated state. Accordingly, the requirements for management of the main types of bank risks are defined. Improving banking risk management systems requires a transitional period for the implementation of specific requirements, as well as the need for additional staff costs and IT technology.

**Keywords:** bank, risk-oriented management, financial management, risk categories, line of protection.

**JEL Classification** G21

Formulas: 0; fig.: 2; tabl.: 1; bibl.: 10.

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### **РИЗИК-ОРІЄНТОВАНЕ УПРАВЛІННЯ БАНКОМ**

**Анотація.** Орієнтований на ризик менеджмент визначається як науково-методологічна концепція банківського менеджменту, спрямована на виявлення та оцінку сукупності банківських ризиків за допомогою спеціальних методів і методів для створення умов для надійного та стабільного функціонування банку, максимізації власного капіталу,

задоволення потреб клієнтів і партнерів банку, забезпечення прибутковості банківської діяльності. Упровадження нових принципів побудови системи управління ризиками спрямоване на підвищення рівня корпоративного управління в банках, зміцнення та більш детальні вимоги до процесу управління ризиками, посилення відповідальності органів управління банку за ризику і фінансову стабільність банку. Створення ефективної культури ризику вимагає від правління і вищого керівництва зосереджуватись на письмових правилах банку, які чітко визначають цілі та пріоритети управління ризиками, а також чітко та чесно визначаються на будь-які неформальні правила, протоколи, способи виконання робочих процесів, способи ухвалення рішень, а також посилення на практику компенсації банку. Система управління ризиками в банку охоплює всі її структурні рівні — від топ-менеджменту банку до рівня, на якому ризик безпосередньо приймається або створюється. Особливістю ризик-орієнтованого управління банком є створення трьох ліній захисту від ризиків. Ступінь складності системи управління банківським ризиками повинна відповідати ступеню ризикованості середовища, в якому працює банк. Політика управління операційним ризиком також передбачає розроблення технологічних схем (карт) продуктів і послуг банку, які підтримуються в постійно оновлюваному стані. Відповідно визначаються вимоги щодо управління основними видами банківських ризиків. Удосконалення систем управління банківським ризиками вимагає перехідного періоду для виконання конкретних вимог, а також необхідності додаткових витрат на персонал та ІТ-технологій.

**Ключові слова:** банк, ризик-орієнтоване управління, фінансовий менеджмент, категорії ризиків, лінії захисту.

Формул: 0; рис.: 2; табл.: 1; бібл.: 10.

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## **РИСК-ОРИЕНТИРОВАННОЕ УПРАВЛЕНИЯ БАНКОМ**

**Аннотация.** Риск-ориентированное управление определяется как научно-методологическая концепция банковского менеджмента, направленная на выявление и оценку совокупности банковских рисков. Особенностью риск-ориентированного управления банком является создание трех линий защиты от рисков. В соответствии с этим определены требования к управлению основными видами банковских рисков. Совершенствование банковских систем риск-менеджмента требует переходного периода для внедрения отдельных требований, а также связана с необходимостью дополнительных затрат на персонал и ИТ-технологии

**Ключевые слова:** банк, риск-ориентированное управление, финансовый менеджмент, категории рисков, линии защиты.

Формул: 0; рис.: 2; табл.: 1; библи.: 10.

**Introduction.** The banking sector is characterized by high risk. The global financial crisis of 2007—2009 revealed the inefficiency of existing risk management system in banks, the weakness of corporate governance and the inability of banks to solve the problem. That is why international regulators in the post-crisis period pay special attention to measures aimed at strengthening the role of risk management in the management of banks. The introduction of new principles for building a

risk management system aims at increasing the level of corporate governance in banks, strengthening and more detailed requirements for the risk management process, strengthening the responsibility of the bank's management bodies for the risks taken and the financial stability of the bank. Building a high-quality risk management system in banks is an integral part of the new requirements for corporate governance. An effective risk culture implies that the Board, senior management, and employees understand the bank's approach to risks and take personal responsibility to manage risks in everything they do and encourage others to follow their example. A bank should encourage the Board, senior management, and employees to make the right risk-related decisions and exhibit appropriate risk management behavior by aligning its management systems and behavioral norms.

Creating an effective risk culture requires Boards and senior management to focus on the bank's written rules that clearly define risk management objectives and priorities and by taking a hard, honest look at any informal rules, protocols, the way workflows are performed, how decisions are made, and the link to the bank's compensation practices. Often, it is these informal rules, practices and procedures that are strong influences in guiding people's behavior. In doing this, Board members and senior management are responsible for setting the right tone at the top and for cultivating bank's awareness of risks that fosters risk intelligent behavior at all levels of the bank.

**Analysis of research and problem statement.** Risk management system in banks is in process of transformation during ongoing decade. The Basel Committee adopted new improved Core Principles acknowledges the need for a Risk-Based Supervision (RBS) approach in which more time and resources are devoted to larger, more complex or riskier banks.

The Core Principles also give particular consideration to macro prudential issues and systemic risks. Specifically, in the application of a RBS approach or framework, supervisors are expected to assess risk in a broader context than that of the balance sheet of individual banks. This includes consideration of: the prevailing macroeconomic environment, business trends, and the build-up and concentration of risk across the banking sector.

The definition of risk assessment then follows as the identification, evaluation and estimation of the levels of risks involved in a situation, their comparison against benchmarks or standards, and determination of an acceptable level of risk [1]. Risk management answer the five questions: what can go wrong, how can it go wrong? what is the potential harm, what can be done about it, how can we stop it from happening again? Banks are often exposed to risky sectors, they are usually set apart from foreign subsidiaries, and thus need risk models that foreign-based banks do not address [2].

Foreign banks subsidiaries, in contrast to domestic banks, shun risky sectors. They adopt preconceived target markets definitions, risk acceptance criteria, and standardized risk models targeted at structured and riskless sectors with which their well-honed exotic risk models fit in [3]. Financial institutions must take risk, but they must do so consciously [4]. The most significant risk is prepayment risk that may impact return on loans, return on equity and real estate loans to total loans ratios of various commercial banks [5]. Bank risks are corresponding to bank's environment, including macroeconomic and policy concerns [6].

**Research results.** Existing banking risk management practices have proved ineffective in overcoming the current global challenges. This led to the objective need to strengthen the requirements of regulators to build a risk management system in banks. The risk management system is an integral part of the bank's business model and ensures maximization of profitability within the limits of adequately estimated opportunities of the bank to take risks. With the help of the risk management system, the management of the bank will be able to identify, assess, locate and control one or another risk.

In 2018, the National Bank of Ukraine approved the "Regulation on the organization of a risk management system in banks of Ukraine" [7], which is based on the recommendations of the Basel Committee on Banking Supervision, the experience of the EVA and other regulators, while taking into account the specifics of the local market. The transition to risk-oriented management of the bank is aimed at increasing the manageability and transparency of risk management systems in

banks, creating a coherent culture of risk management that penetrates all aspects of the banking management system [8].

Risk-oriented management is defined as the scientific and methodological concept of banking management, aimed at identifying and assessing the totality of bank risks through special techniques and methods in order to create conditions for reliable and stable functioning of the bank, maximizing its own capital, meeting the needs of clients and partners of the bank, ensuring profitability of banking activity.

The risk management system should be comprehensive in order to provide a reliable process for identifying, assessing, monitoring and monitoring all types of risk at all levels of the banking institution, including taking into account the mutual influence of different categories of risks. Risk management is aimed at resolving the conflict between maximizing income and minimizing risks. Therefore, the purpose of bank risk management should be determined by the management of the bank in the context of the overall management strategy.

The degree of complexity of the banking risk management system should correspond to the degree of riskiness of the environment in which the bank operates. To diagnose the risk management system in the bank, Deloitte proposes to use a scale that reflects its level of development (Fig. 1). At the lower level of the pyramid is the state of the system, in which the bank detects and reflects the operations carried out by it, but does not carry out an assessment of risks. The upper sixth level reflects the state of the system, in which the bank carries out calculations of economic capital, its distribution between divisions and assessment of their efficiency, taking into account the level of risk.

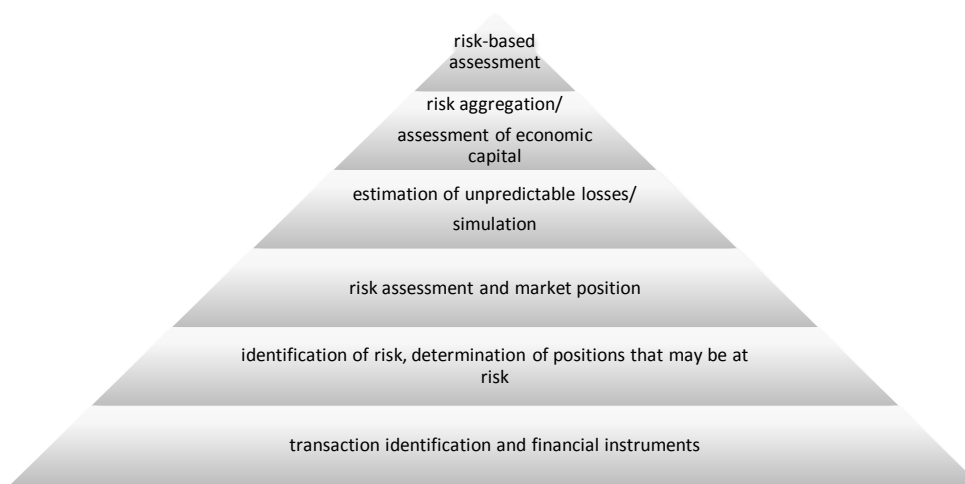


Fig. 1. Scale of development of the risk management system in the bank, developed by Deloitte [9]

An effective risk management system focuses not only on risk assessment and control, but also combines risk analysis with forecasting the impact of risks on the bank's profitability, determining whether or not it compensates for the expected return on risk taken by the bank. Such systems should be created in advance, as losses due to their absence can significantly exceed the expenses of the bank for their development and implementation. The risk management process covers all activities of the bank that affect the parameters of its risks. This is a continuous process of analyzing the situation and the environment in which there are risks, as well as making managerial decisions about the impact on the risks themselves or the level of vulnerability of the bank to such risks.

The risk management system in the bank covers all its structural levels — from the top management of the bank (board and board) to the level at which the risk is directly taken or generated. Accordingly, organizational and hierarchical structure of the system consists of the governing bodies of the bank and their committees, executive bodies and their committees, and also includes three levels of protection against risks (Fig. 2).

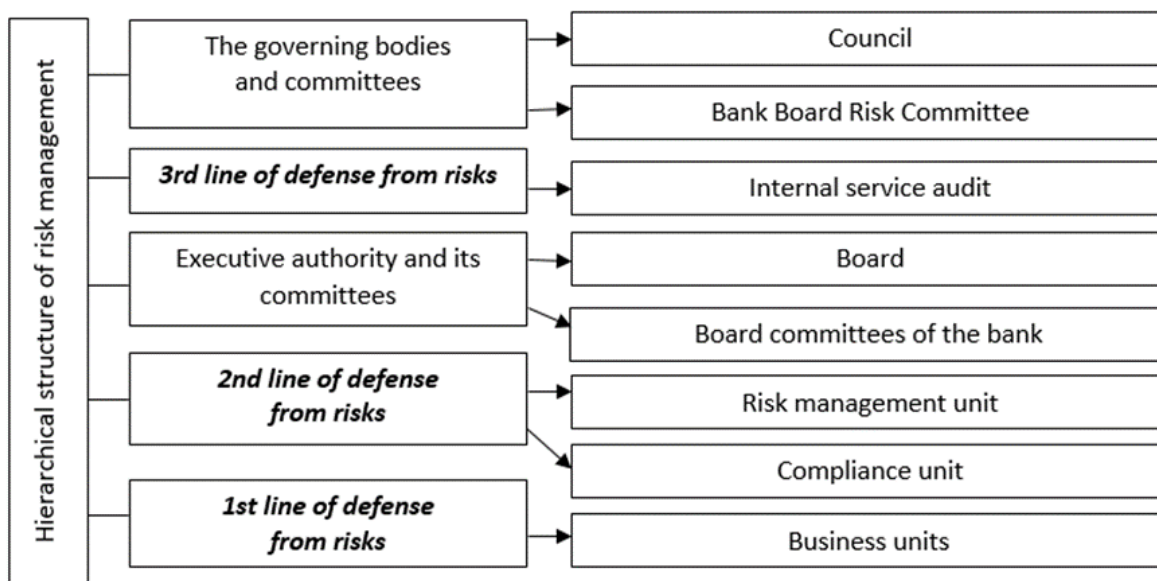


Fig. 2. Organizational-hierarchical structure of the risk management system in the bank

Source: Developed by authors

A feature of the risk-oriented management of the bank is the creation of three lines of protection against risks:

- 1 line of protection — a set of business units that manage and control current risks, provide information on risks to the relevant structural units of the bank;
- 2 protection lines — includes two divisions:
  - Risk Management Unit, which develops, implements and performs procedures for evaluating, forecasting and substantiating risk reduction methods;
  - Compliance unit, which monitors compliance with the established level of risk tolerance and risk limits;
- 3 line of protection is an internal audit service that checks the availability and evaluation of the effectiveness of the risk management system and determines whether this system is adequate to the level of risk that the bank is exposed to. The first line of protection against risks is created by such structural units of the bank, as front offices, mid-offices, back-offices.

The main principles of the operation of units located on the second line of protection against risks (the department of risk management and subordination compliance,) is independence, authority, competence. These principles are the basis for the division of functions, powers and responsibilities of these divisions. Sections of the second line of defense are provided with resources for an adequate balance of positions in the processes and decision-making systems of the bank. Organizationally these divisions are separated from business units and audit units.

The Risk Management Unit performs functions of direct risk management of a particular bank. The main requirement for this unit is its complete independence (structural and financial) from those divisions of the bank that take first risks (front offices) and units that record the fact of taking risks and control its magnitude (MIDL offices and back offices).

Creating a compliance unit is relatively new to domestic banking practice, and its main function is:

- control of compliance by the bank with the requirements of international and national legislation, as well as market standards;
- prevention of cases that may lead to the use of sanctions and / or other measures of influence on the bank by supervisors;
- monitoring compliance with the regulatory requirements of the bank's internal documents, standards and procedures that could lead to significant financial losses;
- control over the level of risk of loss of reputation of the bank;

- control over compliance with the requirements of self-regulatory organizations (if such standards or rules are mandatory for banks).

The Compliance Unit is accountable to the Board and the Risk Board. It should be emphasized that the compliance of the heads of the risk management unit and the subdivision is vetoed on the decisions of the management board and the board of directors of the bank if implementation of such decisions may lead to the adoption of significant risks by the bank that could lead to violations of approved risk limits and established levels of risk tolerance, would threaten the interests of shareholders, depositors, other bank lenders or impede the proper conduct of banking activities.

On the third line of protection against risks is the internal audit service of the bank. The internal audit unit is an operational control body that oversees compliance with the established norms, principles and rules of risk management in a bank, makes conclusions about their adequacy and effectiveness, and also assesses the efficiency of the operation of the bank's risk management system. This unit is subject only to the supreme governing body — the council of the bank. The internal audit unit does not directly participate in the risk management process, its role in this process is to assess the adequacy of risk management systems for the needs of the bank. The most important thing is to ensure the independence of this unit from any other executive body involved in the risk management process. In accordance with the requirements of international corporate governance practice, the Bank's internal audit service is independent, subject only to the Supervisory Board (or Audit Committee of the Board), and does not allow any interference in its work by the executive body of the bank and the specialized committees established by the bank's board.

The system of three lines of protection thus constructed has the purpose of not avoiding risks, but avoiding the situation of overcoming acceptable risks in catastrophic, threatening the very existence of the bank. Accordingly, the requirements for management of the main types of bank risks are defined.

Some risk areas of the bank's activities in addition to the policy of managing these types of risks may be regulated by the provisions. In particular, for the proper and efficient management of credit risk, the bank develops a provision on lending, which regulates: the methods of accounting for both the balance sheet and off-balance sheet operations of the bank; the types and conditions of loans and other operations that are accompanied by credit risk are regulated; account is taken of the nature of the markets and sectors to which loans will be provided; adequately takes into account the concentration of credit risk and associated potential risks; other issues related to lending, in particular, the procedure and procedures for determining the interest rate on a loan and the required collateral.

In order to increase liquidity risk management, a plan is developed in the event of a crisis situation regarding liquidity and financing, and the introduction of a regular refinement order of this plan. In addition to the policy on market risk management, provisions are being developed regarding types of financial instruments, both balance and off balance sheet, for which the bank is ready to conduct trading operations or take positions, as well as provisions regarding the limits of risk by types of financial instruments or other assets.

The policy on operational risk management also involves the development of technological schemes (maps) of products and services of the bank, which are maintained in a constantly updated state. Regulatory documents of collegial bodies, functional and territorial divisions, job descriptions, limits and powers are developed with the purpose of regulating the activity of individual committees of the council and the board, departments of the bank and their employees and brought to the notice for implementation in accordance with the practice of corporate governance in the bank. The adequacy and efficiency of the risk management system is determined by the results of the achievement of the planned values of the main indicators of riskiness of the activity, which include four: the ability to accept the risk; level of bank's tolerance to risk (risk-appetite); risk limits; risk profile [10]. The level (quantitative values) of these indicators of riskiness of activity is determined individually by the bank individually, taking into account the preferences of the shareholders (owners) and the overall strategy of management of the bank (Table 1).

Table 1

## Indicators of risk of activity of the bank

Indicators	Context
Ability to take risks	the maximum level of risk the bank is able to take on the basis of: capital adequacy requirements; effectiveness of the risk management system
Bank's risk tolerance level (risk appetite)	the aggregate size and types of risks that the bank is prepared to take in accordance with the business model and strategic objectives. Recognized in the declaration of predisposition to risk
Risk limits	quantitative limitation to control the size of the risks that the bank faces during its activities
Risk profile	the actual value of the total risk accepted by the bank, calculated at a certain time point

Source: Composed on [7].

**Conclusions.** The rethinking of the approaches to building a risk management system in the bank was carried out in view of: raising the level of responsibility of the board and beneficiaries, transforming the operating model of the bank, changing the corporate culture and creating a coherent culture of risk management that penetrates all the levels of the organizational structure of the bank. Improving banking risk management systems requires a transitional period for the implementation of specific requirements, as well as the need for additional staff costs and IT technology. The introduction of better quality risk management systems will increase the level of reliability of both individual banks and the banking system as a whole. Bankers should realize that a qualitative and adequate risk management system is the main competitive advantage of the bank.

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Стаття рекомендована до друку 14.05.2019

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The article is recommended for printing 14.05.2019 © Prymostka L. O., Prymostka O. O.