

What are the advantages and disadvantages of financial risk management? essay sam...

[Business](#), [Management](#)



1. What are the advantages and disadvantages of financial risk management?

Financial risk management is the practice of creating economic value in a firm by using financial instruments to manage exposure to risk. Similar to general risk management, financial risk management requires identifying its sources, measuring it, and plans to address them.

Financial risk includes various categories such as credit risk, market risk, liquidity risk, operation risk and reputation risk. These are risks that can ruin a company as well as harm investors' benefits. Finance theory prescribes that a firm should take on a project when it increases shareholder's value and to create value for shareholders using financial risk management. Thus, adopting financial risk management offers advantages associated to protection of companies and the shareholders. Of course, many other negative effects brought by financial risk can be minimized.

To begin with, financial risk management reduces the probability of financial failure of firms. For example, market risk can bring uncertainty of future earnings resulting from changes in market conditions. If market situation becomes bad, firms finance may be seriously affected and greatly reduce investors' gain. However, with financial risk management which involves measurement of market sensitivities, analysis of cash flow and VaR measurement of loss, market's adverse influences to firm can be controlled. Shareholder will be protected and their probability of suffering huge loss can be diminished.

Of equal importance is that financial risk management increases job security and employment. Staff of a company is an essential stakeholder so that their security should also be concerned. Financial crisis always result in large-scale unemployment and job market instability. Take the financial downturn in Asia in 1997 as an example, the unemployment rate of Hong Kong was at an all-time peak 6%. This was resulted from the bankruptcy and collapse of many firms. Given that financial crisis could cause enormous unemployment, financial risk management is necessary. It monitors the financial performance within a firm and makes sure it goes on right track.

As long as the finance of the company is kept well, it can operate normally without the need of cost cut. Then its staff can have their job secured.

Generally speaking, employment of society will also be protected.

Apart from the above, social security is maintained with aid of financial risk management. It is obvious when looking at the past that financial crisis brings great impacts to the society. The large extent of social unrest triggered by European financial crisis in 2011 is a case in point. Mass protest was all over Europe. Crimes such as robbery and destructions were widely seen in countries like Greece and Spain. This showed the connections between financial condition and social order. Therefore, risks have to be under serious control by the establishment of financial risk management. Risks such as operation risk and credit risk must be carefully assessed and managed so that companies would not fall and create chain effect to other firms. This is highly relying to risk control and discreet financial planning

carried out by the risk management team. Only with it can the society be stable.

Besides of social security, mantle and family problems will less likely to be created. From the experiences of pass financial crisis, hundreds of cases of mental problems were seen afterwards. This phenomenon was due to huge loss of investors. They are often put in debt and huge financial pressure followed by. Financial failure of companies can cause serious depression to general public. Not only is that the society's atmosphere turns doom, citizen may develop mental disorder and even tendency of committing suicide because of stress related to money. Again use the financial crisis in Europe two years ago as example, the suicide rate in Greece rose dramatically, for more than three times. It is also common that family affairs will arise.

Because of unemployment, high debt and financial pressure, problems within family such as abuse and divorce are likely to happen. Therefore, avoiding financial failure is necessary for protecting the public. Financial risk management is particularly useful in sense of its monitoring and planning work over financial operations in firms. Since it protect the company from credit risk and liquidity risk which can lead to severe failure, the public can be secured from the harm of mantle and family problem.

Last but not least, financial risk management reduces poverty and adverse changes of life style. For society as a whole, financial stability plays an important part. Every time when there is financial crisis, there is a great impingement on countries' economy. During financial downturn in 2008, public deficit of France reached 3. 4% of GDP. Many people will fall into debt

and poverty generally increases. To avoid this situation, proper financial risk management must be adopted. Carefully manage all potential risk related to finance is protecting public's interest. There will be able to enjoy living quality without change in lifestyle.

Although there are a lot of benefits brought by financial risk management as mentioned above, there are also come disadvantages.

Firstly, the presence of financial risk management may make public careless about their investment. Knowing that there is risk management in firm, people may be overconfident in it. They may misunderstand that all financial risks can be avoid and companies will not suffer losses at all. People in society may have faith and invest because of the trust in risk management. In fact, risk management does not necessarily avoid all risks. Moreover, financial situation varies frequently and are difficult to handle properly. Sometimes, people really ignore the possibility of management failure and an actual financial downside. Being overconfident and do investment in haste will finally lead people to loss.

Secondly, there is a definite cost in carrying out financial risk management. Indeed, the cost of supporting risk management can be quite high. In terms of resources allocation, this reduces the amount of investment in other areas, which may offer a higher return. To every company, developing risk management software is very costly, not to mention maintenance and updating cost, especially when financial situation always changes.

Requirement in capital is particularly a problem for middle and small firms.

Sometimes, it is even true that the outcome of financial risk management is not prominent when compared to the money input. Furthermore, the return of such investment is uncertain. The chain effect of financial crisis proves that one firm's own risk management is not able to resist macro financial failure. Therefore, there is certain cost but uncertain return for risk management.

Thirdly, considerable amount of training and time are required. Financial risk management is a professional job, even if educated workers are provided, the software can be very difficult to understand and operate. Extra time and resources for training can be a burden. Some interfaces can be very complex, with tools that employees are not used to. Training reduces the time available for implementation of financial decisions. In addition, the time required for complete risk management is an obstacle to firms' swift actions. There are usually months of suspension to any decisions before their actual implementation. Therefore, financial risk management can be a very inconvenient procedure for companies.

All in all, financial risk management offers a lot of advantages but also comes with shortcomings. On one hand, it has the ability to protect different stakeholder, one the other hand, it requires plenty of cost and time. Therefore, it should always be carefully and cautiously adopted.