Why risk management is important for global financial institutions

Business, Risk Management

Because taking risk is an integral part of the banking business, it is not surprising that banks have been practicing risk management ever since there have been banks – the industry could not have survived without it. The only real change is the degree of sophistication now required to reflect the more complex and fast-paced environment.

The Asian financial crisis of 1997 illustrates that ignoring basic risk management can also contribute to economy-wide difficulties. The long period of remarkable economic growth and prosperity in Asia masked weaknesses in risk management at many financial institutions. Many Asian banks did not assess risk or conduct a cash flow analysis before extending a loan, but rather lent on the basis of their relationship with the borrower and the availability of collateral – despite the fact that collateral was often hard to seize in the event of default. The result was that loans – including, loans by foreign banks – expanded faster than the ability of the borrowers to repay. Additionally, because many banks did not have or did not abide by limits on concentrations of lending to individual firms or business sectors, loans to overextended borrowers were often large relative to bank capital, so that when economic conditions worsened, these banks were weakened the most.

Although avoiding failure is a principal reason for managing risk, global financial institutions also have the broader objective of maximizing their risk-adjusted rate of return on capital, or RAROC. This means not just avoiding excessive risk exposures, but measuring and managing risks relative to returns and to capital. By focusing on risk-adjusted returns on capital, global institutions avoid putting too much emphasis on activities and investments that have high expected returns but equally high or higher risk. This has led to better management decisions and more efficient allocation of capital and other resources. Indeed, bank shareholders and creditors expect to receive an appropriate risk-adjusted rate of return, with the result that banks that do not focus on risk-adjusted returns will not be rewarded by the market.

A point too often overlooked, however, is that, by focusing on risk-adjusted returns, risk management also contributes to the strength and efficiency of the economy. It does so by providing a mechanism that is designed to allocate resources, initially financial resources but ultimately real resources to their most efficient use. Projects with the highest risk adjusted expected profitability is the most likely to be financed and to succeed. The result is more rapid economic growth. The ultimate gain from risk management is higher economic growth. Without sound risk management, no economy can grow to its potential. Stability and greater economic growth, in turn, lead to greater private saving, greater retention of that saving, greater capital imports and more real investment. Without it, not only do we lose these gains, but we also incur the considerable costs of bank disruptions and failures that follow from unexpected, undesired and unmanaged risk-taking.