FINANCIAL RISK MANAGEMENT – INFLUENCE FACTORS AND NEW TRENDS

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Abstract: Financial or corporate risk management is a part of the firm risk management with which deal with the financial risks, such as market risk, liquidity risk and credit risk. In the context of international financial crisis, a variety of factors are influencing the development of corporate risk management: the increased volatility and deregulation of financial markets; developments in information and communications technology; the complexity of financial products and so on. The objective of risk management for most corporates is to reduce the influence of external financial variables on the company's earnings volatility, in the short term. This article describes the developments in financial risk management, presents the influence factors and underlines the recent trends in this field.

JEL classification: G01, G32

Key words: corporate risk, management, crisis, factors, trends

1. INTRODUCTION

Risk management can be defined as identification, assesment, analysis of internal and external risks that prevent the company from achieving its business goals and financial objectives. Therefore, the risk management means also coordination and economical use of resources in order to minimize, monitor, and control the probability or impact of unfortunate events o none hand, or to maximize the realization of opportunities, on the other hand.

Financial or corporate risks can directly or indirectly influence the value of a company. In the last years, combination of effects of financial crisis, a greater deregulation, international competition, interest rates and foreign exchange rate volatility, together with commodity price discontinuities heightened corporate concerns, which have resulted in the increased importance of financial risk management.

The firms recognizes that the effective management of business risk is critical to the success of the company. Business risk is strategic in nature and embraces all forms of risk.

Management should identify and evaluate the risk to achievement of business objectives. This would include the regular assessment of both the significance and the probability of occurrence the risks arising.

A variety of factors are driving corporate risk management developments, such as the increased volatility and deregulation of financial markets, developments in information and communications technology, increased use of derivatives, the complexity of financial products, imperfection of financial markets (information asymmetries, agency costs, transaction costs and taxes) and the financial crisis. These factors have increased the number as well as the complexity of risks a company should face.

An integrated, proactive and quantitative approach to risk management is the latest trend in the financial markets. Increasingly, companies make use of systems to quantify the market risks their companies face and use this information for decision-making at a strategic level.

2. OBJECTIVES

Financial risk management is only one part of enterprise risk management with a focus on financial risks, such as market risk, liquidity risk and credit risk. Figure 1 below presents a classification of corporate risks:

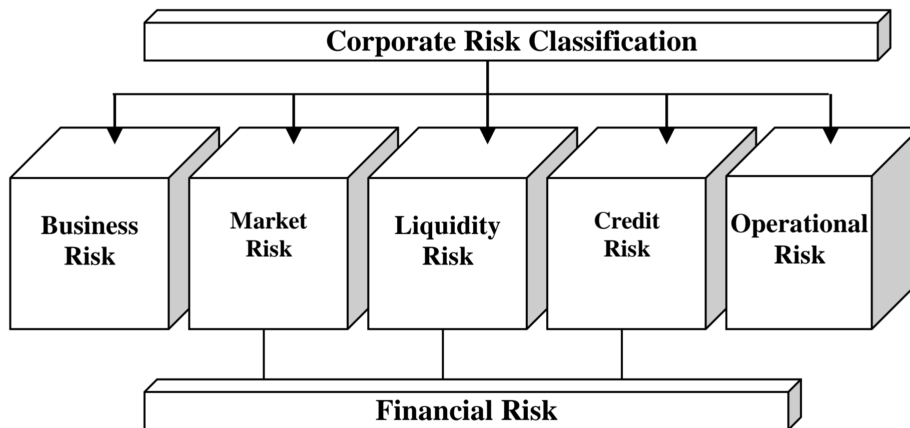

Figure 1: Corporate Risk Classification

Business risks result from the core competencies of the corporate and involve to make strategic business decisions. The role of the manager is to support this process by analyzing the investment proposal or the execution of financial transactions. Business risks are important to manage as investors need to estimate the unlevered beta and to estimate the credit rating to determine the required rate of return on debt.

Financial risks is generally not the core competence of a corporate but managing it is of vital importance, and this is the responsibility of the financial manager and corporate treasurer. Financial risks can be seen as a collateral effect due to the fact that the company is taking on business risks. They can be subdivided into market risk, liquidity risk and credit risk:

Market risk is created by the values of financial variables, such as earnings and cash flow. The value of a firm changes, due to changes in market variables including foreign exchange rates, interest rates, commodity and equity prices.

Liquidity risk is an important financial risk for a corporate, which is split into funding and price risk. Funding risk is the risk that a company is unable to fund itself due to its financial or market position. Price risk is the risk that interest rates increase or that the companies credit spread increases.

Credit risk occurs when a counterparty is unable to honors its (full) contractual obligations. It is managed by using proper limit control for external counterparties and via negotiation of contracts and documentation, such as the ISDA agreements.

Operational risks are often procedure and internal control related issues. The corporate treasurer can act as an internal consultant for the business and also has a responsibility to minimize operational risks for its own organization and processes.

Organizations that rigorously interpret the results of the risk assessment process set a foundation for establishing an effective enterprise risk management program and are better positioned to capitalize on opportunities that can arise. In the long run, this capability will support steer a business toward measurable, lasting success in today's ever-changing business environment

3. METHODOLOGY

Corporates need a more advanced risk management approach in order to benefit by a competitive advantage from strategic risk management. They should manage risks proactively via an integrated approach with a focus on measurable financial risks.

The framework is a systematic, integrated approach with a focus on managing financial risks to enhance shareholder value. The corporate risk management framework could have a five-step approach (figure 2):

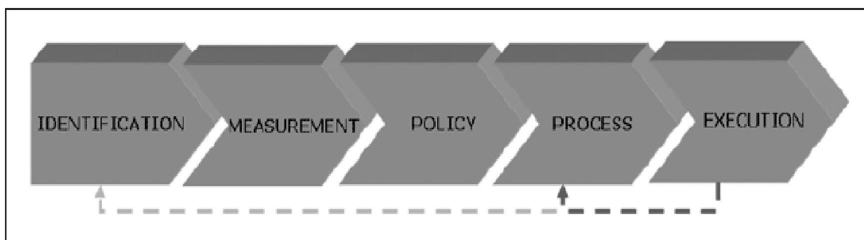

Figure 2: Corporate Risk Management Framework

a) Identification. The first step of the framework is the identification of risks. Key risks are identified by using impact analysis and estimating the impact of each exposure on the variability in earnings or cash flow.

b) Measurement. The second step uses cash flow-at-risk and earnings-at-risk techniques to quantify the key exposures. Simply adding up exposures or using scenario analysis or sensitivity analysis will not meet the requirements of a truly integrated corporate risk management approach.

c) Policy. The third step is the definition of a risk policy and strategy. Executive management needs to define the objective and risk appetite of the company in line with corporate strategy and operations.

d) Process. The fourth step is about implementing risk management within the organization using the risk policy as a guideline. The right enablers need to be used to guarantee that risks are owned at different levels within the organization by the people who are able to influence it.

e) Execution. The last step in the framework is execution and tactics, which relates to the tactical decisions that need to be made within the boundaries set by the risk policy, such as the optimal combination of hedging instruments. It also deals with the execution of operational procedures and control.

Managing risks is a recurring process and needs to be reviewed by the managers periodically. Some techniques, such as cash flow-at-risk and earnings-at-risk, are necessary to look at the combined effect of risks on the formulated business objectives. To achieve this, the corporates need to embed risk management across the organization because this will allow them to optimize their risk and reward balance by reducing earnings and cash flow volatility, which ultimately increases shareholder value.

4. INFLUENCE FACTORS AND TRENDS FOR CORPORATE RISK MANAGEMENT

A variety of factors are driving corporate risk management developments, such as:

- the increased volatility and deregulation of financial markets;
- developments in information and communications technology;
- increased use of derivatives;
- the complexity of financial products.

These factors have increased the number of risks, as well as the complexity of the risks, a company has to face. At the same time, risk awareness has intensified among board members as their responsibility and accountability increased caused by the growing pressure from external regulators. The result is an increased focus on risk management forcing companies to pay more attention and disclose more details of their risk.

Risk management is becoming an area in which a company can differentiate itself from competition and it is therefore a topic of strategic importance. There are a few trends in corporate risk management that will help address these challenges:

- the scope of risk management is becoming broader and extending from market risks to enterprise risks (including operational risks);
- risks are increasingly managed through an integrated approach. A truly integrated approach takes into consideration the risk contribution of each risk type present in the business portfolio with respect to the overall objective of risk management;
- in order to effectively implement a corporate risk management framework requires that risk management to be embedded across the whole organization. This starts with the commitment of executive management when they need to define the objective and risk level of the company, in line with corporate strategy and operations, and elaborate a risk policy. The policy is used internally as a guideline to define the risk management approach to all levels within the organization. It can also be used as a guideline for disclosure and communication of the company's risk to external stakeholders.

At present, risk management keep the attention of most company's boards, but they are still trying to determine the best way to address the array of exposures they face to risk.

More and more the companies recognize that corporate risk is broadening all aspects of their business including reputation, property, liability risks, intellectual property, supply-chain management, environmental and social risks. As a result, managing the organization's risks involves greater cooperation among its various departments, including finance, legal, human resources, production, distribution and information technology.

Also, since corporate governance has become an issue, boards have taken a serious interest in risk and insurance. In general, there is a policy of the companies that global corporate risks should be assessed on an annual basis and that the Board of Directors is responsible for overseeing the risk management strategic activities of the company.

Some companies are installing a chief risk officer to oversee the management of all the company's risks, while others are setting up risk committees, with senior representatives from most departments reporting on risk to the board.

The risk managers could have a variety of backgrounds, such as: law, auditing or engineering as much as insurance. Therefore, the risk management requires a knowledge that also embraces business continuity, project management, corporate governance and many other disciplines. Risk management is a field that has come together through a number of different professions coming at risk from different aspects.

At present, more European companies adopt a structured and enterprisewide approach to risk management, setting up risk committees. That group seeks to identify, monitor and manage the company's risks. There is a raised awareness of corporate and operational risk.

Recently was introduced a new technique for identifying risks that are hinder progress to corporate goals: Business Confidence Management. Instead of asking managers directly about risk, they are asked about confidence in achieving results (a positive approach). Thus, lack of confidence is translated into risk.

This technique could be a solution to some high profile events which exposed errors of judgment of both executive and non-executive directors, senior management and external professional advisors.

Business Confidence Management analyses the confidence of staff in meeting agreed targets, key performance indicators and management objectives. These tasks can be achieved when there are cross-functional responsibilities for delivering a particular target. The answers may expose unidentified high impact risks while results are anonymous, without attribution to individuals. This generally generates direct responses from interviewees, creating an opportunity to raise concerns. In this circumstances, there are needed confidence bar charts highlight areas of low confidence, which are then translated into risk and brief report comments and therefore, the managers can work together better in order to reduce risk.

Business Confidence Management has been successfully implemented in a number of large organizations. It has highlighted areas of low confidence and promoted more balanced corporate reporting.

5. CONCLUSIONS

In the context of globalization, the companies have to face more and more the challenges and risks which could occur. Therefore the risk management is a key tool that all general managers should have to take into consideration as a priority. The Corporate Risk Management is a part of risk management with a focus on financial risks (market risk, liquidity risk and credit risk).

At present, a variety of factors are driving corporate risk management developments, such as: the increased volatility and deregulation of financial markets; developments in information and communications technology; increased use of derivatives; the complexity of financial products, etc.

At the same time, risk awareness has intensified among board members as their responsibility and accountability increased as a result of growing pressure from external regulators. The result is an increased focus on risk management which forces companies to pay more attention of their risk and reward ratio.

All these challenging factors have increased the number of risks, as well as the complexity of the risks, a company has to face. As result, the companies recognize that the effective management of business risk is critical to the success of the company. Therefore a company's approach to risk management should follow the principles:

• Risk management will be embedded in all management systems and business processes and will be an integral part of the company's internal control processes;

• The identification of and management of risk is not limited to just the Board of Directors, but includes all managers and staff of the company;

• A key objective of risk management is the development of a comprehensive risk management framework to ensure that risks are being managed in an efficient, effective, and economic manner. The framework will include risk management standards and risk assessment criteria.

• the Board of Directors will review the effectiveness of risk management systems and internal controls regularly.

In conclusion, the executives in all fields need to acquire a greater understanding of risk management. Risk management is becoming an area in which a company can differentiate itself from competition and it is therefore a topic of strategic importance.

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