American Journal of Engineering Research (AJER)
e-ISSN: 2320-0847 p-ISSN : 2320-0936
Volume-6, Issue-4, pp-34-39
www.ajer.org
Research Paper Open Access

Risk Management Problems: Risk Management Challenges in the Financial Institutions

Abdulhameed Atif Jastaniyah
609 Atlantic St Bridgeport CT 8572047823 University of Bridgeport

I. INTRODUCTION

Risk management has become a key organization practice; it is among the issues that have consistently been in the spotlight. Every organization is striving to develop risk management policies that will enable it to handle issues better and to develop a competitive advantage in their respective industries. Business is all about risk taking; poor management of the risk would imply adverse losses for an organization. The prime goal of a risk management program or policy is to minimize risk and to set it to acceptable levels.

Risk management is practiced as a professional discipline in the finance sector by many financial institutions. The prime goal of risk management in financial institutions is to improve the quality of their institutions' decision-making at various levels of their organizations with an eye set at increasing shareholder value. Risk management is all about handling the business' risk exposures- that is, identifying and managing all activities and practices that expose the company to risks. This implies that the firm, in the execution of the risk management practices and strategies, will identify the sources of the risk and find the best means of mitigating those risks. This process is not always smooth and has led to the realization that risk management does not guarantee that the organization will not incur losses.

In that sense, this research paper will be analyzing the challenges of risk management in the financial institutions and give recommendations as to what may be done to handle these challenges. Risk and risk management will be defined and discussed in more detail in the sections that follow.

II. LITERATURE REVIEW

This section aims at discussing the literature that has been made available about the topic of risk management in the financial institutions. It will also define the terms risk and risk management. Various sources will be analyzed to give a foundation for this research paper. The term risk is used to suggest to uncertainties about the future, the possibility of outcomes other than the expected (Berg, 2010). Various authors have given varied definitions to the term, but it all depends on the profession. For example, the term risk is used to describe the possibility of loss, or an event that leads to a loss. However, the term is used in insurance in general to refer to the possibility of unexpected outcomes or the outcomes that deviate from the expected. From this definition, it follows that risk management entails activities that integrate the recognition of risk, assessment of risk, develop risk management strategies, and mitigate the risks using various managerial resources (Berg, 2010).

There will be a brief overview of the risk exposures for the banks and other financial institutions. There are various types of risks that face an organization.. Jorion (2009) classifies the risks into three: 'known knows', 'known unknowns', and 'unknown unknowns.' The first classification implies those risks that are known and measurable meaning they can be quantified in regards to their probabilities and their distributions. The second category pertains to those risks that are known, but cannot be measured accurately (mostly due to lack of adequate information). Lastly, the third category refers to those risks that are both unknown and immeasurable. This is a general categorization of risks.

In the banking industry, there are six common risks: credit, market, liquidity, operational, strategic and compliance risks (Deloitte Touche Tohmatsu, 2009). Credit risk arises from an incident where an obligor is unwilling or unable to perform an obligation (Sabau, 2013). This will ultimately result in a loss on the part of the institution. Liquidity risks are the potential losses for an institution due to its inability to meet obligations when they are due. The liquidity risk may also arise as a result of the institution's failure to address or recognize condition changes in market condition that affect its ability to liquidate assets quickly with minimal loss in value. Market risks are the result of adverse fluctuations in the market's prices, for example, interest rates, forex rates, commodity prices and equity prices all can fluctuate. Operational risks arise from the internal processes, systems, people, or from external sources. They are the potential loss of revenue and capital arising out of the above factors. Strategic risk is both the current and the prospective impact on capital, revenue, and reputation that arise from poor business decisions, lack of response to industries, or improper implementation of decisions. Lastly, compliance risks arise from non-compliance with laws, agreements, rules, regulations, or ethical standards; earnings, these affect earnings, reputations, and capitals. As mentioned above, risk management entails mitigation of risks. The main risk mitigation practices include elimination or avoidance, risk transfer, or actively managing the risk at the firm level (Ordfield & Santomero, 1997).

It has been established that risk management is a challenging task for institutions, especially the financial ones (Feridun, 2006). Banks and other financial orgnizations are faced with the need to continually develop and improve both operational and technical practices. It is also a fact that management of credit risk is assuming a greater significance in the modern environment. There is a trend within the banking industry towards a quantitative evaluation of their loan portfolios risk. Previously, it is market risks that had gained prominence in terms of quantitative risk management, but this has been gradually overtaken by credit risk management. Quantitative risk management has posed several challenges, as well as opportunities for personnel. These challenges include both quantitative problems modeling and change management issues (Feridun, 2006).

Liquidity risk management challenges facing the financial institutions became clearer during and after the financial crisis (Bank of Japan, 2010). First, the institutions have to gauge their liquidity risk profiles, considering the characteristics of things such as their business and the funding measures. More so, these institutions need to establish a risk management system that is institution-specific. This ought to be accorded priority especially for the institutions with no stable funding. Secondly, the institutions are needed to strengthen their resilience or flexibility in a liquidity stress phase. Thirdly, there are financial institutions that operate around the world, they are faced with a particular challenge of managing risks both locally and internationally. These institutions are required to enhance their management system of liquidity risk on a global basis.

Another challenges explored about the financial institutions is the fact that the institutions are facing an increased exposure to risk. This arises from the willingness of said institutions to take on greater risks (SAS, 2011). These institutions are growing in complexity, and managing this complexity is becoming a big challenge for the firms. It is a fact that complexity exposes them to greater risk. Management boards paying excess attention to risk are yet another challenge; this can be seen to undermine the other operations of these firms. The risk management function finds it hard to increase its authority, which is a real challenge; the lesser the authority, the lesser the effectiveness of the risk management personnel and departments. Sabau (2013) explores new challenges facing the risk management in the financial institutions and highlights some challenges (like globalization and its association with the banks' exposure to risk). Batlin and Schachter (2000) come up with several challenges that affect risk management. They categorize them into three: application of risk management, risk types, and risk measurement implementation issues.

III. RESEARCH METHODOLOGY

The research is qualitative, focusing on information available from both primary and secondary sources. This entails researching literature in the library, on the internet, and in databases for information about the challenges facing risk management in financial institutions. This study will be a review of previous studies that have researched risk or a related topic. The data gathered will, then be presented in the findings section below, with a brief discussion will following to clarify the findings.

IV. FINDINGS

Risk management in financial institutions is often subject to monetary constraints

Risk management has been defined as a process of identifying risk exposures, quantifying them or assessing their impact on the profitability of the institution. The risk management is an unique function that requires financing. However, many organizations find it difficult to provide adequate funds for their risk management program. In that case, it follows that the level of risk management will rely on the amounts of funding available. There are often trade-off between financing and risk management (Rampini, Viswanathan, & Vuillemey, 2010).

Financial institutions are faced with increasing exposure to risk

As mentioned previously, the financial institutions have been taking on more risk- that is, they are investing in more risky ventures (SAS, 2011). For example, the banks are extending credit to low-income earners whose creditworthiness is not always guaranteed. While this may be having positive impacts in terms of profitability, there is the impact of greater risk that might jeopardize the future of said profitability.

The financial institutions are increasing in complexity and this increases challenges in risk management

The complexity implies an increase in the size of the institution to encompass an increase in the number of operations, people, equipment, and, (most importantly), products (SAS, 2011). The increase in complexity is directly proportional to the increase in risk exposure. Risk management activities have become more and more coupled with restrictions in risk financing; the risk managers are really having a hard time.

The growth and thus the increase in complexity is not proportional to the strengthening and revamping of risk management

The growth of a financial institution is supposed to go hand in hand with the development of the risk management function. However, this has not been the case; in some instances, the revamping has indeed slowed down. This is in part due to the unwillingness of top management to recognize the role of risk management and the need to adequately finance this function. Another challenge with the risk management in the financial institutions is situation in which the management boards are obsessed with RM. This adversely affects the other operations of the firm.

It is possible for the firm to experience retarded growth In such a case, especially where the managers employ risk mitigation practices that hinder investment decisions. For example, the management may consider not investing in certain areas because of perceived risk and; they use avoidance as a way of managing risk. The risk management practices will then be a barrier to the growth of the firm.

The risk management function and personnel are given little say in the organization (SAS, 2011). Just like in other organizations, the common situation has the risk management has inadequate authority and it follows that the personnel are not motivated. They are rarely recognized and viewed as extra cost to the firm. In such a case, their performance will be compromised and the risk management programs may not bear he expected fruits.

GLOBALIZATION

As discussed earlier on, globalization has posed another challenge to the risk management field in financial management. This is because the firms have had to increase in size thus exposing itself to more risks. The risk levels also vary across the countries, and firms are forced to establish a comprehensive risk management program that will cater for both the local and international markets (Sabau, 2013).

Legal problems and the changing role of the risk manager

Since the occurrence of the 2008-2009 Global Financial Crisis, there has been a trend of new rules and regulations that are aimed at preventing another occurrence. These rules sometimes focus on customer protection, and they have forced the institutions to talk in a more holistic view of the risk management. These rules also raise compliance issues, and this has become an added responsibility for the risk manager- that is, to handle compliance risks. This is to imply that the risk managers are becoming increasingly responsible for a broader range of risks and the roles bare or more strategic significance (Advisen Insurance Intelligence, 2014).

Choice of risk-related models

The financial institutions also have the challenge of choosing an ideal risk-related model. In some instances, the financial institutions have been seen to apply models used by non-financial organizations. The danger with this choice is that the non-financial organizations adopt corporate models that are long-term in most cases. For the banks, however, most risks are short-term in nature meaning that the choice of which risk model is the key to the success of the risk management program. Credit risk and liquidity risks, for example, cannot be handled perfectly using long-term models. The regulations have, as such, been encouraging the financial institutions to independently validate their models for risk management since this will enable them to assess risk reliably and decide on the actions to take. Indeed, this sounds like the ideal solution to the challenge of risk models.

V. DISCUSSION

Business is all about risk taking, and all organizations are faced with various risk exposures depending on the nature of business. The financial institutions present a special case because they are faced with greater risk. The financial institutions are faced with several risks as mentioned earlier, and this includes market risk, credit risk, liquidity risk, operational risk, strategic risk, and compliance risks. For the non-financial institutions, these risks may either be uncommon or impact the organization at a smaller margins that they do with the financial institutions. As such, the financial institutions face several challenges that arise due to the specific nature of the risks that they handle. As illustrated ion the findings presented above, the banks and other financial institutions have not fully developed in terms of risk management functions. This can be seen from the fact that the financial management programs are not as comprehensive as they should be.

More so, the findings also show evidence that the developments facing the financial institutions come with various challenges. For example, the aspect of globalization has not only availed opportunities for growth and profitability but also has availed new challenges in terms of risk management. The organization, by going

global, has diversified its investment portfolio similarly diversifying its risks. Investing in global markets implies also taking on risks from those markets. As mentioned earlier on, every market has its characteristic risks, sometimes they are similar to those seen in other markets. As such, the firm will have to develop its risk management program so that it can cater for both local and international risks. This is a real challenge.
The issue of globalization goes hand in hand with the issue of growth of the firms and the corresponding increase in complexity. It is also discussed in the literature review and the findings sections that the increase in complexity also makes the risk management more complex. This is because the complexity of the institution is often in terms of the products, operations, personnel and this due to the scope of risk management programs needs to be expanded.

All these challenges are interrelated, and one challenge sheds light to another. For example, the increase in complexity and the aspect of globalization are related to the expanded scope of risk management practices. The new rules and regulations also expand the scope of risk management programs as well as the responsibilities of the risk manager. As such, the risk manager is faced with this challenge of evolving roles, and this is coupled with the reluctance of the firms to give adequate recognition and authority to the risk management function. Inadequate recognition may be related to the financial constraints and financing of the risk management institutions.

VI. CONCLUSION

This research paper has discussed the various challenges affecting risk management in the financial institutions. The terms risk and risk management have been defined in the literature review section. The scope of risk management has also been outlined where various aspects of risk management like risk mitigation methods have been highlighted. More so, the various risks that face the financial institution have been briefly discussed, and these include market, operation, strategic, compliance, credit, and liquidity risks.

The most important part of this paper is the issue of the challenges facing the risk management field in the financial institutions, and the various challenges have been highlighted in the findings section. These risks include the issue of globalization which forces firms to develop comprehensive risk management programs. The increase in complexity has also been mentioned where the firms tend to expose themselves to more risk. The increase in exposure is itself defined as a challenge where the firms take on more risks in an attempt to gain profitability through diversification. Another key challenge is the issue of the choice of which risk management model to use. It is seen that the financial institutions are faced with unique sets of risks meaning their models too should be unique. However, their adoptions of models from other non-financial institutions have become a problem because of the differences in scope and timeframe in question. It is also mentioned that financial institutions need to manage risks mostly in the short-term while other corporate models often focus on the long term. Apart from these challenges, this paper also contains some recommendations for the situation presented, and also, some lessons learned. These two sections will come below this conclusion section.

VII. RECOMMENDATIONS

The following is a set of recommendations for the financial institutions on how they can handle the various challenges in the risk management. The recommendations are a combination of the actions that the firms might take, as well as the actions that might be taken by other players like the government. The recommendations are as follows. A full integration of risk management functions throughout the firms may help the financial institutions to better manage the challenges of risk management. The risk management function should be given more authority and say in the decision-making processes of the financial institutions. This will make the personnel feel relevant, and this will motivate them to be more productive.

Training programs for the risk management personnel are paramount. This is to say that the institutions should continuously seek to develop the risk management personnel as the field of risk management is becoming more dynamic and diversified. Training and development programs will help them cope with this challenge. The financial institutions should make sure that their rate of growth takes into consideration the risk management factors such that the function develops at the same rate. This way, the increasing complexity of the financial institutions will not pose many challenges to the risk management function.

The financial institutions should endeavor to develop their own risk management model owing to the fact that their risk management needs differ from those of non-financial institutions, and also across the financial institutions. risk management needs of a firm depend on the market situation and also on the size and also the extent of complexity of these firms. In that case, each institution will be better if it develops a customized model tailored at meeting the specific needs of the firm. The financial institutions should also monitor their globalization strategies in a bid to effectively handle the risk management challenges arising from globalization. Globalization should be strategic in the sense that it takes into consideration the nature of the markets that will help the firms to invest in markets that are similar in terms of the risk exposures. Such a strategy will ensure that the risk management instituations will not find it difficult to deal with markets that have distinct characteristics that require distinct risk management approaches. Government regulation should also ensure that the financial institutions take the risk management issues seriously. The government, in an attempt to protect the consumers or the general economy, should ensure that firms do incorporate risk management programs in their operations. The government should also have a say in the scope and extent or risk management practices in financial institutions as it would be the case with other institutions. The management should refrain from becoming extremely obsessed with risk management to the extent that risk management becomes the primary goal of an organization. The primary goal should remain the maximization of shareholder value, and risk management should not become a practice that works to the contrary. Obsession with risk management hinders investment issues, and the management should balance between risk management and investment issues.

Lastly, the financial institutions should increase the finances allocated to the risk management function. Underfunded functions cannot perform to standard. Risk management function cannot be expected to bear positive results if it is faced with extreme financial constraints.

LESSONS LEARNED

This paper presents several issues and lessons that one can learn from. There are lessons for a student, regulators, the government, and lessons for the financial risk managers.

Lessons for the student

The student learns that the risk management issues in financial institutions differ from those of other non-financial organizations. As argued above, the financial risk exposure of the financial institutions are mostly short-term in nature, and so the firms cannot afford to adopt models that cater for long term risk management goal without considering the short term goals first. The second lesson for students is pertinence to the types of risks influencing ‘financial institutions. Which is different from non-financial institution, the financial institutions are affected by a wider range or risks thus risk management ought to be more comprehensive in the financial institutions. As such, it becomes an issue when the financial institutions seem to become relaxed on the risk management practices.

Another lesson for the student pertains to the effect of globalization on organizations. In general, globalization is seen as a way of gaining competitive strategy by forms, and also as a way of increasing market share. Globalization is seen as an opportunity to increase market share. However, globalization in the financial institutions can be seen as a risk taking venture where the firms take on more risk by venturing into foreign markets. It can be seen as a way of increasing the complexity of the firm and consequently the scope and challenges of the risk management department.

Lessons for regulators/government

This paper has also provided insight that the government also has a role to play in the risk management issues in financial institutions. The regulators need to learn that the organizations sometimes need to be pushed to do things, and that financial institutions need to be encouraged to take risk management issues more seriously. The regulators also need to learn that they affect the risk management issues of the financial institutions when they make new policies. As mentioned above, the modern laws and regulations have impacted on the scope of risk management and the responsibilities of the risk managers. The regulators create more risks through regulation- that is, compliance risks.

Lessons for the financial institutions

Financial institutions have a lot to learn. Basically, they need to learn that they are faced with risk management challenges that need to be handled effectively. As outlined in this paper, the challenges are many and they have a significant effect on the operations and profitability of the firms. The challenges arise from the nature of business of the financial institutions and the fact that they have not fully integrated the risk management function into the overall management function of the firms. The second most important lesson for the financial institutions is the fact that too much obsession with the risk management function will hinder profitability, and the firm needs to be balanced. In the case where they are not obsessed, they do not give it considerable recognition as an important function in the institution. In that case, issues will arise including under financing. Another lesson for the financial institutions is that they need to monitor and regulate their growth in consideration of the risk management requirements. For example, venturing into new markets should also consider the risk management needs of those markets to see if they align with those already being dealt with by the firm. This is to ensure that they do not invest in a place where they have no control of the risk exposures. Lastly, the financial institutions need to learn that there is a need for the development of risk management models customized for the needs of their organizations. These models ought to consider the nature of business, risk exposure, and the complexity and size of the business. That way, the firm will effectively manage its risks factors.

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