What are the major risks that financial intermediaries face and how do they manage them?

A financial intermediary is an establishment or an institution which acts as a third party between investors and firms in trying to obtain funding. A general explanation would be the instance of a saver who has extra money and a borrower who needs this extra capital. A typical example of a financial intermediary is a bank, but there are more such as life insurance companies and building societies. This essay will assess the risks which financial intermediaries face and how they manage them.

It is important to note that financial intermediaries do not use their own money instead they use the money of its depositors. To give a simple example of how a bank would act as a financial intermediary. Banks receive funds for depositors and while they keep a percentage in of this cash in reserve in case they want it back they lend a large percentage of it out or purchase bonds.

Financial intermediaries generally provide four important services. The first one is expert advice; they can provide the best information for investing customer funds and alternative methods of obtaining finance. The second service is that they provide expertise in channelling funds; they can provide specialist advice on areas to channel funds to yield high results. The third service is maturity information this is where the banks who have many depositors borrow small amounts from each one so they are able to provide long term loans. The final area which this essay will pick up on is the risk transformation. This service provides the know how of how to allocate loans and money to other money at the least possible risk to the institution.

Risk is a major factor in any financial market and in particular to institutions which are borrowing money from there depositors or customers. This essay will now look at the potential risks involved through financial intermediaries.

Financial intermediaries should be concerned with risk because it can make its capital volatile and in most cases when financial intermediaries are faced with these types of problems the most probable outcome is that they can go into severe financial distress or this could lead to bankruptcy.

The risks come when the financial intermediaries do not correctly regulate their own techniques and staff. There are many examples where financial intermediaries such as Baring’s bank and BCCI (Bank of Credit & Commerce International) were forced to declare bankruptcy due the inappropriate actions as they themselves played as financial intermediaries.

To take Barings bank as an example a trader with the name of Nick Leeson was able to use large cash reserves which the bank held which belonged to the banks depositors, to implicate the bank in a serious of rogue deals which ended up causing the bank to file bankruptcy. The management of Barings broke a cardinal rule of any trading operation - they effectively let Leeson settle his own trades by putting him in charge of both the dealing desk and the back office. This is tantamount to allowing the person who works a cash-till to bank in the day's takings without an independent third party checking whether the amount banked it at the end of the day reconciles with the

till receipts. After this incident financial intermediaries have placed strict working practises on its staff and they manage these by following regulatory standards.

Another risk which financial intermediaries face is that of the interest rate risks. For example if the financial intermediaries were able to negotiate 10 million pounds for a rate of interest at 8% on a 1 year loan, but it lends the money for two years. It charges 9% interest and expects profit on that 1%. However in the second year it will need to refinance the loan and it may be able to get the cost of funds at 8% over the 2nd year but this is not guaranteed. Say in this time interests have gone up and they can only secure it at 10% they will then make a 1% loss over the time. Hence one can clearly see the risk involved in refinancing. This will be the same for reinvestment risk where the liabilities are longer then the assets taken out. A way of managing this type of risk is by taking a position in the Futures market. For example take the following model highlighting the earlier example:

In this instance the financial intermediary takes a short position in 10 euro dollars contracts at 1 million dollars each, at the price of $91.2 reflecting a yield of 8.1%. Suppose after one year the interest rises to 8.6%, we can now offset the 10 contracts to yield $12,500. Now we can borrow at the rate of 8.6% but the profit yielded in futures contract will make the new rate of 8.1%. This is now fixed through hedging the risks.

Another risk which can be discussed is that of market risks which are closely linked with interest rates, equity return and foreign exchange. Going back to the Barings bank example Nick Leeson gambled the sum of 1.2 billion dollars on believing that the Nikkei would increase in strength and value. But what actually happened due to global economics and the Kobe earthquake the Nikkei actually fell in value. This meant that Barings bank the oldest merchant bank around went insolvent because its losses on the Futures market exceeded the banks own equity capital.

It can therefore be said that market risk can be greatly induced if a financial intermediary takes open or unhedged bets in foreign exchange, equities and bonds as the prices or rates can change in undesired directions.

Another risk which must be considered is the credit risk. This is where the expected cash flows and payments which have been borrowed out by the financial intermediaries have not been paid back. In the trade this is called bad debts, and it accounts for large changes in a companies balance sheets to show a lower profit and hence if they are a publicly limited company a drop in the share prices. An example of this can be seen by the trading reports of Lloyds TSB in 2001 when they issued their accounts and market players could not tolerate the levels of bad debts, which almost immediately was reflected in its share price. A way that this is avoided and managed is through screening and monitoring loan applications so that this percentage of bad debt is actually reduced.

Another type of risk is technological and operational. A firm definition has been placed on this type of risk by the Bank for International Settlement “The risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems or from external events” (McGraw & Hill, 1997). This can be further broken down by saying that the technological risk is when the financial intermediary enforces

a new system to reduce costs by saving through economies of scales and when this new technology does not serve this purpose and when red tape or bureaucracy or disorganisation adds to this problem then the risks mount up. Hence it is of up most importance that any system being implemented in a financial intermediary is actually beneficial to the company.

Operational risks are when the technology support systems may malfunction or breakdown. This means where financial intermediaries were trading using real time technology to manage liabilities and buy assets and investments as well as trading in futures and options will not be able to happen due to this breakdown of services which is a real concern and a huge risk to the financial intermediary. To manage these risks financial intermediaries outsource their technological sections to allow for minimal disruptions. Also backups of data and emergency overrides are in place to allow for such situations. Also the financial intermediaries keep updating and reconfiguring their software and hardware abilities to make sure that they are ahead of the game and up to date.

We have discussed the potential risks that financial intermediaries face on a daily basis; this essay will now discuss the ways that they take to control these risks. Financial intermediaries have to establish controls to limit positions taken by traders as well as to develop models to measure the market risk exposure of a financial intermediary on a day to day basis. There are five reasons why it's really important to measure market risks by financial intermediary the first one is management information. This is when the management of the financial intermediaries take a look at the way its traders deal on a daily basis and the amounts of risks which there traders were taking. In this way the management can keep tabs on the amount of risks being taken and comparing it to there capital resources. If this form of management had been active at Barings bank then the management would have realised the gravity of the trades being made and could have stopped any further transactions.

The second way of managing risk is by setting individual limits on traders so they do not have access to more money then they should have which may jeopardise the financial integrity of the intermediary.

The resource allocation is the third way of managing risk; this is done by analysing the market and looking at the areas which yield higher returns. After doing this resources can then be allocated into areas where there is a high yield and less risk and some of the resources can be allocated to areas where there is a high risk and high return. But hedging all your resources in one area and losing it all like was done in Barings without the consent of management.

Performance evaluation is the fourth way of reducing risk. This is when the management reviews the trading of particular traders and realises the return to risk ratio of those particular traders. Depending on how they have faired they can increase there associated risk with that trader but still being cautious on how they are regulated. Also by introducing a higher bonus or compensation scheme allowing the trader to be motivated in making calculated risks rather then instinctive ones like Nick Leeson. This form of risk management is purely for the management to assess who is capable of getting returns with higher amounts of risk.

The final risk management procedure is regulation. Regulators are only concerned with the social costs of failure and therefore allow for strict more conservative models to be implemented in a financial intermediary. Therefore by being constantly regulated they will have to account for there actions, this may seem like a good way of managing the risk but this was no help to when ENRON went bust and they were hiding losses for years and showing that the company was worth more then it actually was.

In conclusion the financial intermediaries learn from past examples, Barings sent shock waves around all financial institutions as well as regulatory bodies. The same can be said for ENRON. But as the world is being introduced to the likes of global terrorism and the heinous attacks of the worlds largest financial capital on September 11th there was an increased reason to protect themselves form risks from insider factors and now new deadly outsider factors. When you are in a high risk market playing with large amounts of other people's money to make a financial system work there can never be no risk. As the financial world gets to grips with new threats and risks it makes sure that it has some ways of protecting itself. I would like to end this essay with a quote "Take calculated risks. That is quite different from being rash. Do not fear risk. All exploration, all growth is calculated. Without challenge people cannot reach their higher selves. Only if we are willing to walk over the edge can we become winners."