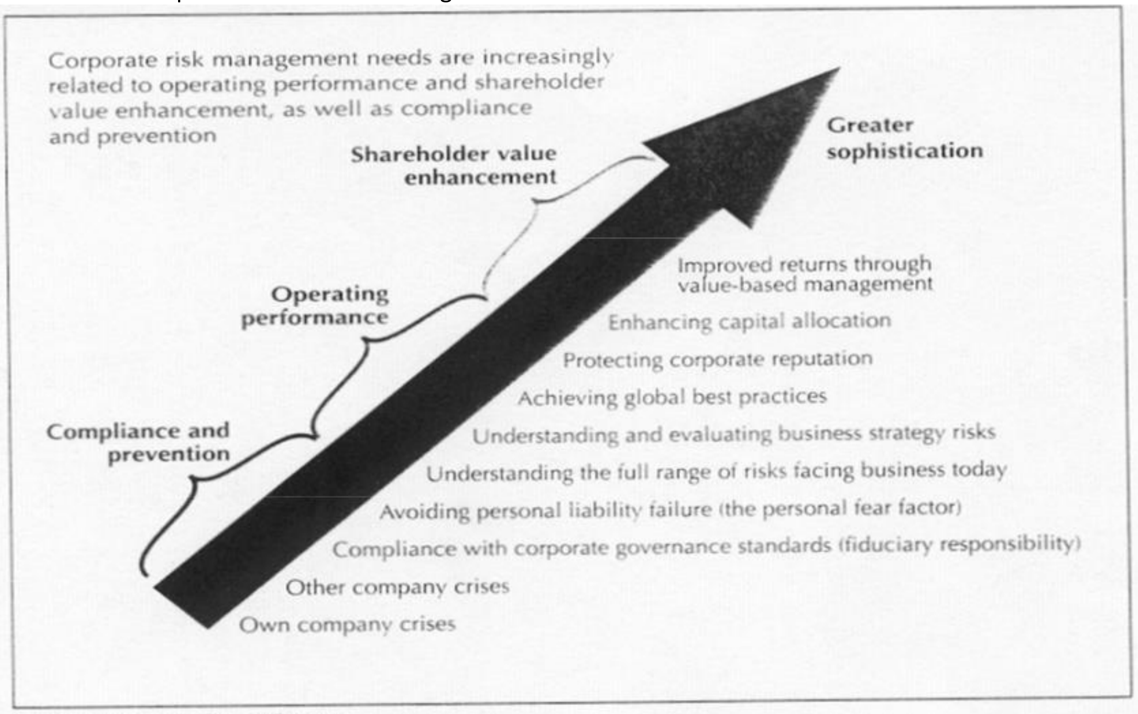
FINC3018 Bank Financial Management
Topic 1: Overview of the Financial System and the Role of Banks

<u>Risk and Financial Institutions</u>

Importance of Risk Management

- The primary role of financial institutions (FIs) is to intermediate and manage risk. Such risks arise from the financing role that FIs play in the economy, including credit, market, liquidity and operational risks.
- The inherent difficulty in risk management is that risks evolve over time.
- Risk management is about the creation of value, which arises from either:
  - Raising returns for a given level of risk.
  - Lowering risk for a given return.
- Greater sophistication in risk management is shown below:



Source: PricewaterhouseCoopers

- Risk may be defined as a condition in which there is a possibility of an adverse deviation form a desired outcome that is expected or hoped for.
  - Risk measurement therefore involves an estimation of the possibility of the risk occurring and the likely impact of the event if it did occur.
- Financial risk may be defined as a measure of the potential changes in the value that will e experienced by a portfolio as a result of differences in the environment between now and some future point.
- Key risks faced by financial institutions are as follows:
  - Market risk, which is the risk incurred from assets and liabilities in a FIs trading book due to changes in interest rates, exchange rates and other prices. Market risk incorporates the following subsets:
    - Interest rate risk, or the risk incurred by a FI when the maturities of its assets and liabilities are mismatched.
    - Foreign exchange risk, which is the risk that exchange rate changes will adversely affect the value of a FIs assets and liabilities denominated in non-domestic currencies.
    - Equity risk (not discussed in the course).
    - Commodity risk (not discussed in the course).
  - Credit risk, which is the risk that promised cash flows from loans and securities held by FIs may not be paid in full.