MODULE 11 – Risk Management

Introduction

In this Module, we will undertake a comprehensive examination of all the risks associated with the operation of the IB system. We will examine several banking crises and their implications in the contemporaries and modern times. We will briefly discuss the economic and political consequences of emerging global terrorism, money laundering and financial crime which prompted enactment of the USA PATRIOT Act. The roles of the World Trade Organization (WTO), World Bank (WB) and International Monetary Fund (IMF) will be touched upon, including anti-sentiment for the said organizations.

Objectives

Upon successful completion of this module, the student should be able to:

• Articulate all the risks associated with the operation of the IB system.
• Elaborate upon some of the banking crises (debt crises) of the 1990’s.
• Discuss the USA PATRIOT Act and the anti-money laundering aspect of it.
• Examine the roles of the WTO, World Bank and IMF, and their monetary policy ramifications.

Like every other financial and economic entity, the operations of international banks are exposed to a series of risks when conducting business in an environment of economic uncertainties, cultural diversity, sovereignty and regulatory issues. Globalization of the economic and financial systems has led to an increase in interdependencies amongst nations of the globe for goods and services, coupled with specialization and comparative advantage. This process brought a relative degree of economic prosperity for everyone, and international banks were a catalyst in the streamlining of the above activities. At the same time, it posed a greater risk for the IB system. It is known and understood in financial and economic forums that no business enterprise can predict a risk posed by certain externalities outside of their control, but they can utilize tools and means to ensure the risk is either eliminated or reduced within their operation.

Investors in the financial market operate under the assumption that the system is efficient and perfect. This assumption can be realized when there is no asymmetric information in the financial market. Two important factors that are responsible agents for the existence of such anomalies are adverse selection and moral hazard. Both of these anomalies pose serious risks to the operation of IB. In order for the banking system to prevent exposure to these types of risks, banks need to have certain checks and balances in place for obtaining proper information so they can protect the value of the securities in their portfolios.

International banks underwrite large-scale capital and financial projects. Therefore, it is imperative that a risk analysis be conducted to ensure the project is completed without any possibility of being compromised by forces outside of the control of the project manager. In order to shield themselves from unpredictable risk caused by circumstances outside of their control, international banks should have strategies and efficient structures in place to confront uncontrollable externalities. Their strategies should cover the
objectives of their risk management program, such as who will execute it, the degree of risk, and which risk should be dealt with first. Therefore, banks are required to have effective checks and balances in place to confront financial and economic uncertainties. The examination of variables, such as the cost of being exposed to risk, failure to correctly measure it, possibility of exposure to risk, and the duration of exposure to risk, is essential for any bank in order to avoid the financial consequences of exposure to risk. 

For further information, please see Footnote #1 and #2.

It is imperative that we examine the various risks to which the banking system is exposed. According to the Federal Reserve, there are several types of risk to which banks may be exposed:

Credit – For further information, please see Footnote #3.
Market – For further information, please see Footnote #4.
Liquidity – For further information, please see Footnote #5.
Operational – For further information, please see Footnote #6.
Legal/Reputational – For further information, please see Footnote #7.
Country – For further information, please see Footnote #8.

As mentioned before, sound and prudent operation of international banks is essential for the growth associated with their activity in many parts of the globe. This becomes more apparent with globalization and the role that the Internet plays in connecting everyone, regardless of geographical boundaries. Any deviations (risk taking) by international banks may result in a domino effect and may cause macroeconomic variables not to function at the equilibrium level. The result could be an interruption in international trade and the foreign exchange market, price stability, and the unemployment rate, consequently prolonging the duration of the business cycle. The cumulative forces of such a deviation of the above leading economic indicators may result in a negative multiplier throughout the economic and financial sectors.

The underlying reason for the economic slowdown, due to the housing market, that started in late 2005 and has continued through 2008 is directly related to reckless loan packaging by the banking system. The contemporary banking crises all point to the same culprit: risks taken by banks.

If we study a major banking crisis of the contemporaries and modern times, we will find through empirical evidences that every banking crisis resulted from a series of mischievous activities and risks taken by a major banking system. Even though summaries of some of the banking crises have been mentioned in different modules, students should further research and study the following banking crises in-depth:

• The Asian banking crisis – For further information, please see Footnote #9.
• The Tequila crisis – For further information, please see Footnote #10.
• The banking crisis in the U.S. (Savings & Loan Association) – For further information, please see Footnote #11.

• The Argentine banking problems and Argentina’s confrontation with international monetary authorities such as the IMF and World Bank concerning sovereignty, and the economic austerity program imposed by the IMF. – For further information, please see Footnote #12.

With the enactment of the USA PATRIOT Act of 2001 (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism), the US banking system created a shield against money laundering activity perpetrated by international drug cartels and illegal financing of terrorist organizations. This Act brought a certain level of financial soundness to the US banking system. There are also guidelines that have been put in place by the European Union to prevent criminal financial activity. For further information, please see Footnote #13.

There is a direct relationship between the operation of international banks and international trading activities. The World Trade Organization (WTO) is an international organization that ensures and safeguards international trade agreements among member nations. Like the IMF and World Bank, the WTO is known to allegedly promote and safeguard the welfare of the wealthy members of this organization. Whether this is true or not, this organization replaced the General Agreement on Tariff and Trade (GATT) which lacked enforcement, and violations were made blatantly by many member nations. Under the auspices of the WTO, the violations have been drastically reduced. For further information, please see Footnote #14.

It is ironic that whenever the following three entities meet – the WTO, World Bank and IMF – there are cries of humanity to protest the policies of the above economic and banking cartel. There are serious issues concerning the overall policies of the said organizations. The rumors are that they are solely protecting the economic and political welfare of the major industrial nations of the west. For further information, please see Footnotes #15 and #16.

Conclusion

In this module, you have learned about all the risks associate with the operation of the IB system. Further, you should have an understanding of the PATRIOT Act and money laundering issues in relation to terrorism and its implications on the banking system. You have learned about the roles of the WTO, World Bank and IMF and their policies, and global anti-sentiment toward them.
FOOTNOTES


