

Risk management, Profitability & Tax factors

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Enterprise Risk Management (ERM) is a relatively new concept in Pakistan. Rather than looking at risks in isolation ERM evaluates the overall financial strength of an institution based on an integrated framework. The framework evaluates exposure to credit, market and operational risk, translates that exposure into a tangible measure of loss and then compares this measure of loss to capital at hand. The last step – comparing expected loss to capital at hand – determines the capital adequacy ratio. If we get hit by a market shock or major default will we have sufficient capital to survive? ERM frameworks found a ready audience within the financial services sector mainly because aggressive risk taking behavior in this sector, if not hidden, takes only a few quarters to translate into bottom line and balance sheet impact. In addition financial and credit risk could be measured objectively and can be priced based on trading and market information. This article discusses the impact of the new risk management paradigm on profitability and tax factors in the region.

There is a complex relationship between risk, capital, profitability and tax factors. It will help if we examine it piece by piece. Capital by itself can be broken down into operational, economic and signaling components. Operational Capital is what we need to run our businesses on a day to day basis and includes very little provision for variances and contingencies. When we add provisions for uncertainty, we add risk capital which combined with the operational requirements serves as economic capital. For internal purposes these two components are generally sufficient. External partners however demand an additional measure of comfort that we provide by adding signaling capital. The difference between an A rated and a AAA rated institution is the additional signaling capital that indicates that the firm in question is sufficiently committed to make available an additional layer of security and comfort for clients, stakeholders and employees¹.

¹ Integrated Risk Management, Parakash Shimpi, TexRe, New York, 2002

Capital, however, is not free. It has a real cost that needs to be paid to contributors to compensate them for forgoing alternate investment opportunities. Financial institutions then need to maintain a balance between risk taking behavior, capital requirements and the cost of contributed capital. Left to market forces, this gets reflected in credit spreads and ratings on individual transactions. At a collective organizational and institutional level the need is filled in by regulatory capital requirements. The objective at a regulatory level is to control risk taking behavior by imposing higher capital requirements in the hope that the increased cost of capital would help an institution find the appropriate balance between risk exposure and cost of capital without direct intervention. It is also understood that the mechanism is not fail safe which leads to reporting and monitoring of capital adequacy ratios by state regulators on a regular basis². When institutions drop below capital adequacy thresholds and fail to fix adequacy ratios they quickly find themselves under regulatory control.

Traditionally perception of risks was limited to credit portfolios. This was especially true in emerging markets with protected economies, stable treasury and currency exchange rates. But the arrival of economic growth and trade surpluses led to substantial increases in national wealth and capital stock, limited opportunities for investments, open economies, volatile currency and treasury markets and regional asset bubbles. Extreme and frequent swings in asset prices also highlighted control weaknesses and operational problems that allowed individuals to sink centuries old institutions. At a regulatory level it became important to not just quantify credit exposure but also assess and control market and operational bets, intentionally or unintentionally, being made by senior management and ownership. The desire was to retain the single capital adequacy ratio approach which in one number would tell ownership, investors, clients, counter parties and regulators how secure and protected an institution was to future challenges in credit, treasury, currency, equity and human capital markets.

² Contemporary Financial Intermediation, Greenbaum and Thakor, Dryden Press, 1995.

It was not that the cost of doing business as a financial institution had suddenly gone up because of increased volatility and the resulting additional capital requirements. Additional investments in systems and compliance, combined with higher capital requirements generally lead to dire predictions and protests of depressed Return on Invested Capital (ROIC). All that changing macro economic factors and high profile failures had done was to demonstrate that our assessment of exposures and capital adequacy needed an urgent overhaul to estimate the capital required to support risks that had already been underwritten on the operational and investment side. That in essence became the case for ERM, amendments to the Basel Capital Accord and the arrival of Basel II standard. Risk management emerged as a valuable tool to measure, monitor and manage capital adequacy for stakeholders and regulators.

To understand the linkage between risk management, capital requirements and taxation regimes we need to take a step back. At a regional level it is still rare to see a large enough bank being allowed to fail. At a cultural level given the relatively³ high savings rate in our societies, a bank failure has too much of an emotional, financial and human cost attached to it. More commonly, we see regulator sponsored take overs, mergers, turnarounds and outright sales. Given this mindset, ultimately the cost of a bank failure, frequent or rare, is borne by tax payers. Irrespective of the amount in question, from a few hundred million dollars to a few billion dollars, when central banks pump in equity, the check is underwritten by the tax base. Where the impact is not visible through higher taxes, it can be seen hidden behind the subtleties of higher reserves requirements, higher fiscal deficits, higher interest rates and higher inflation. Labeled differently, economically speaking, all four are forms of indirect taxes that only differ in timing, target segments and mechanism of collection.

Higher capital adequacy ratios and better risk management systems theoretically speaking should lead to a more stable and balanced banking systems reducing the overall financial institution failure rate. When such failures do occur, the monitoring system would allow regulators to move in and limit impact of capital loss. Lower failure rates and lower claims on the central bank should lead to lower burden of indirect taxes on the financial system,

savers and borrowers. Risk management and capital adequacy ratios are not about increasing the cost of doing business. Rather just like a good accounting standard, they are about spreading and recognizing the cost of bad bets over the base responsible for generating them rather than deferring such costs indefinitely for future generations to bear.

³ Relative to North American and European economies.