CONSIDERATIONS REGARDING THE FINANCIAL RISKS AND THE NECESSITY OF THEIR MANAGEMENT

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Abstract: *Broadly speaking, risk is defined as the probability for the occurrence of certain events with negative repercussions on a business or an activity (chance of loss). In the technical sense, the risk represents the potentiality that the real results are better or worse than the ones expected; in this sense, the risk is equivalent with the variability of results possible to obtain.*

Another definition of risk, just as famous, is that a person takes an economic risk anytime there is the chance than an unfavorable (favorable) event reduces (increases) the value of an asset that he/she has. From the probabilistic point of view, risk represents the "profit variability compared to the profitability average in the last years".

In this manner, the risk is defined starting from the profit dispersion compared to the profit average registered in the last years. In finances, risk is defined by some authors as the probability of obtaining an investment profitability different from the expected profitability.

The management of financial risks is imposed at the level of a company because both the managers and the shareholders (employees, suppliers, clients etc.) have an aversion towards the risk. The management of financial risks determines the reduction of the future cash-flow volatility of the company, which improves the company planning capacity and thus allows carrying out investments or activities which otherwise would not be taken into account. At the same time, risk management can reduce the costs generated by the financial difficulties.

Key words: *financial risks, risk management*

JEL Classification: *G32*

The term "risk" has known ***different approaches in the specialty literature.*** Some authors offer definitions of risks afferent to the activities of some sectors- the economists, the specialists in behavioral sciences, the risk theoreticians, and statisticians have their own definitions of the risk concept, and others propose general acceptations. We ascertain there is no universal definition of the risk notion and a consensus regarding its criteria of classification.

The word risk comes from the Latin term "risicare" that means "to dare".[1] In French, the term "risquer" is used in 1661, but with the graphics "risk" in 1741[2]. The explicative dictionary of Romanian defines risk as being "a possibility of ending up in danger, of having to confront a sorrow or damage"[3].

Broadly speaking, risk is defined as the probability for the occurrence of certain events with negative repercussions on a business or an activity (chance of loss). In this approach we take into account those events that, in case of occurrence, would cause losses, economical and financial damage, additional unpredicted expenses, partial or total loss of expected profit.

In the technical sense, risk represents the potentiality that real results are better or weaker than the expected ones; in this sense, risk is equivalent with the variability of results possible to obtain. Another definition just as famous of risk is that a person takes an economic risk anytime there is the chance than an unfavorable (favorable) event reduces (increases) the value of an asset that he/she has. The degree of risk refers to the extent to which a result is uncertain, unsure. Thus, risk refers to a set of knowledge of a certain action that can be assigned probabilities of occurrence.

Uncertainty, on the other hand refers to the situation that the complete identification of future results of an action or the assignation of probabilities/ chances of their occurrence, is not possible. The economist Frank Knight (1921) was one of the first authors who made the distinction between risk and uncertainty in his book *Risk, Uncertainty, and Profit*.

From the probabilistic point of view, risk represents the "profit variability compared to the profitability average in the last years". [4] In this manner, the risk is defined starting from the profit dispersion

[1] După unele surse, termenul latin pentru risc era ***riscum*** şi se referea atât la probabilitatea de pierdere, cât şi la şansa de câştig. Cuvântul latin *riscum* a reținut însă unele conotații pozitive cel puțin până în evul mediu.
[2] Lungu, N. C. - *Bazele asigurărilor*, Editura Sedcom Libris, Iaşi, 2006, p. 49.
[3] *** - *Dicționarul explicativ al limbii române*, Ediția a II-a, Editura Univers Enciclopedic, Bucureşti, 1996, p. 929.

compared to the average profit registered in the last years. This definition emphasizes the real results of the company, which can be better or worse than the ones expected. In the case there are future profits smaller than the average level, considered as reference level in establishing decision, there can occur crisis situations which might negatively affect the respective economic activity[5].

In finances, risk is defined by some authors as the probability of obtaining an investment profitability different from the expected profitability[6]. Similarly, an **investment risk** is defined by Ion Stancu as "the possibility of occurrence of profitability deviations from the expected average, as a result of the anticipated or unanticipated variation of economical-financial phenomena determining it”[7].

In the specialty literature, there are different definitions of risk , aiming at finding new valences and significations regarding the investment activity [8]: risk represents the variability of the possible result according to a an unsure, uncertain event" ; "risk can be defined as the possibility that the losses are greater than expected"; "risk represents uncertainty as regards the production of a damage” or “risk is now that situation when there is the possibility of a deviation applicable to the hoped result."

The entire financial theory is based on a fundamental theory of the rationality of operators involved in the investment processes on the financial markets. This rationality is characterized through the permanent preoccupation of investors of maximizing their utility function (practically of maximizing the investment profitability at an assumed risk level or the opposite, of minimizing the risk at an expected profitability level). Despite their rationality, the investors have however a different perception of the risk they are confronted with, the assuming of risk having an important psychological dimension. The greatest majority of investors manifest a motivated aversion to risk, however on the financial markets we can encounter, even if theoretically, indifferent investors or with preference to the risk.

The investors’ attitude to the risk is different and is influence by a series of objective and subjective factors. Through its direct impact on the risk premium, the aversion to risk influences the evolution of assets’ prices from the international financial markets. Even if aversion to risk is characteristic to the majority of investors, the indifference to risk and the preference to risks cannot be considered as irrational investment behaviors, the investors from this category aiming at maximizing the utilities of expected returns. Although initially it was considered that the aversion degree can be measured objectively through the form of the utility function, the studies subsequently resulted have proven the presence of relative (subjective) aversion and partial aversion, more difficult to analyze, through the fact that it implies an analysis of the individual’s psychological profile, where a series of socio-demographic aspects acquire meaning.

According to the ***diversification degree,*** there are two major types of risks that form together the total risk of an investment:

- *Systematic risk – non-diversifiable, general or market risk* (*systemic risk*);
- *Non-systematic risk* – specific, diversifiable or the company risk (*firm-specific risk*).

The difference between the two types of risks is established according to the factors that determine their production. The systematic risk is determined by economic general and political factors (such as : inflation, fiscal politics, modification of exchange rates, variability of the interest rate or the political torments) , that influence the totality of activities within an economy. A non-anticipated increase of the inflation rate, for example, affects salaries, the cost of raw materials bought, the value of assets held by the company and the price at which the produced goods are sold. The systematic risk is non-differentiated and cannot be eliminated, it influences the results of the majority of companies. In this category we mention: the country risk, the exchange rate risk, the interest rate risk, the inflation risk and other fundamental risks. For the management of certain systematic risks we use in the last decades derived financial instruments.

The non-systematic risk is that part of the risk of a security or an economic activity, which can be eliminated by diversification. This type of risk is the result of those risk factors that directly depend on the internal conditions of the company, such as: new inventions, actions in justice, strikes, success or failure of marketing programs, winning or losing some major contracts etc[9]. All these factors influence either negatively the results of a single company, but do not affect the entire national economy. Moreover, the specific risk can be decomposed in specific risk belonging to the company (issuing company) and specific risk due to the characteristics of the sector or industry in which the company is activating.

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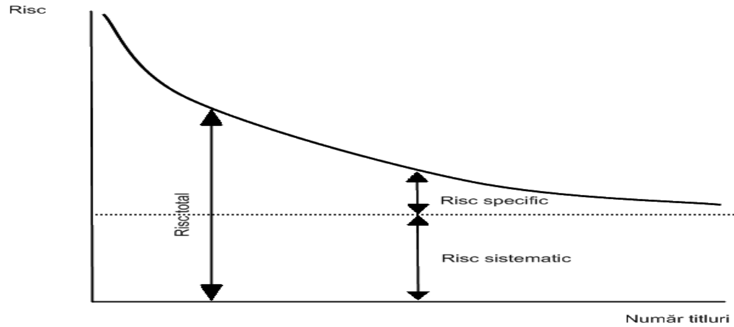
[4] Ibidem, p.117.
[5] Păun, C. - *Aspecte financiare ale relaţiilor economice internaţionale*, Editura Luceafărul, Bucureşti, 2003, p. 117.
[6] Ibidem, p.117.
[7] Damodoran, A. - *Strategic Risk Taking: A Framework for Risk Management*, Wharton School Publishing, New Jersey, 2008, p.5.
[8] Stancu, I. - *Finanţe,* Ediţia a 4-a, Editura Economică, Bucureşti, 2007, p. 249.
[9] Horobeţ, A. - *op.cit.*, p. 23.

FIGURE 1. THE IMPACT OF PORTFOLIO DIVERSIFICATION ON THE SYSTEMATIC RISK AND SPECIFIC RISK



Source: Horobeț, A. – *Risk Management in International Investments,* All Beck Publishing House Bucharest, 2005, p.29.

For the investors in the portfolio, the non-systematic risk can be covered by diversifying the securities portfolio. As we can notice from figure 1.2, while the portfolio diversification degree increases, the dispersion (risk) of the portfolio decreases because of the specific risk diversification. No matter how much the number of securities (assets) of the portfolio increases, a part of the total risk is maintained as a result of exposing all assets to the market factor. The principle of diversification has important implications: in the decision of investing in an asset, a diversified investor is only interested in the asset systematic risk.

Some authors speak also about risks belonging to an intermediary category according to the assets that are exposed to a certain risk. For example, the appreciation of the American dollar compared to other currencies, has a significant impact on the portfolio and values of the company which achieved international operations. In the case that most of the companies carry out important international operations, this risk can be catalogued as market risk. However, if only a few companies carry out international operations, the risk is considered as being a firm-specific risk.

CONCLUSIONS

Because of the complexity of economic and social life, risk currently represents a daily reality, and the management of economic risks represents a key function of modern companies. The economic and social activity is carried out in the conditions of more or less serious risks, more or less known, easier or more difficult to avoid. In order for a company to be able to survive and prosper, it must know the risks it is exposed to, evaluate them correctly and protect itself appropriately against them.

In the last twenty years, we notice an ***increase of the role plaid by the financial risks management*** in the multinational companies under the impact of the following factors:

- Deregulation from the international financial markers which forced the financial institutions to be more competitive and become aware of the need to cover the financial risks;
- The financial globalization has determined the companies to really recognize the global dimension of competition;
- The increasing demand for the financial products and the financial innovation process;
- Increased volatility from the international financial markets, together with the publicity of bankruptcies and regulatory actions of the International Regulations Bank.
- Considerable increase of the volume of transactions with shares and bonds which led to the complexity of the world financial system;
- Development of international trade;
- More and more important role of financial instruments (especially derived financial instruments) in the process of financial intermediation;
- Creating a few diversified portfolios to which a multitude of risks are associated;
- Theoretical developments in the finances field (models of evaluation of the financial assets price)

The management of financial risks is imposed at the level of a company because the **managers, the stakeholders and the shareholders** (employees, suppliers, clients etc.) have **an aversion to risk.** The financial risks management determined the reduction of the company's *future cash-flows volatility*, which improves the company's planning capacity and thus allows carrying out some investments or activities which would not have been taken into account otherwise. At the same time, the risk management can reduce the costs determined by the financial difficulties.

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