Chapter II

Risk Management in Banking: A Review of Principles and Strategies

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Abstract

Banks play an important role in the financial system contributing to efficient and well-functioning transfers of capital and risk between those in excess (savers) and those in need (borrowers) of money. Traditionally, financial risks, like interest rate, foreign exchange and credit risks, have been the most important and typical ones for banking operations. However, lately the risk environment of banks has changed considerably. In this study we are stressing the vital importance for the single bank to have a much more sophisticated and well-structured approach to risk management than it had 15 years ago. Our main focus is on how banking objectives such as profitability and growth should govern risk management, and how these objectives are made operational into the management of those assets and liabilities exposed to changes in market prices and in customer repayments of loans.
Introduction

Only a decade ago the banking industry in Scandinavia was recovering from the massive credit losses that many major and market-leading banks experienced during the bank crises in the early 1990s. Those credit losses were more or less an inevitable outcome of the deregulation of the financial markets in the 1980s. The banks had entered into a largely biased and uncritical over lending to real estate investment companies. Real estate prices were rocketing, indirectly giving the banks an opportunity for rapid growth and an increased market share on commercial lending. However, that lending was associated with a very high exposure to market risks and credit risks. When market prices on real estate property fell drastically and the “bubble” did burst, the banks’ interest rate margins and initial (accounting) profitability were unsatisfactory in relation to the additional risk they had taken (Lindblom, 1993). In many cases they did not have enough equity capital to absorb the losses, let alone an adequate amount of qualified capital to comply with the capital adequacy requirements stipulated by the Basel Accord of 1988. As a consequence of the poor risk management of the banks some of them were acquired by other banks or even nationalized (particularly in Norway), whereas other and mainly larger banks were either rescued by government bailouts or by receiving new equity capital from their owners (e.g., SEB in Sweden).

Today there appears to be a similar battle for market share on household mortgage loans, particularly in Sweden. House prices are booming and households’ demand for new mortgage loans is increasing rapidly. After a period of historically low inflation, interest rates are extremely low at the moment with variable mortgage loan rates lower than 3%. Fixed loan rates are only marginally higher. However, banks are not only competing with low interest rates. Starting with the state-owned mortgage bank, SBAB, many banks have begun to offer low interest rate mortgage loans to household customers up to as much as 95% of the estimated market value of their residential property. Compared to the traditional level of 75%, this means that the collateral security margin is now five times lower for these mortgage loans. Some analysts are warning for a new bubble, especially after the Swedish Central Bank lowered its repo rate by 50 basis points to 1.5% in the summer of 2005 (Riksbanken, 2005). Financial analysts as well as the executive board of the Central Bank do not seem to be equally concerned, claiming that the lending of banks is more widespread and diversified this time. Moreover, they argue that most household customers would be likely to be quite reluctant to leave their home in the case of increasing interest rates. They would rather try to manage higher mortgage rates by cutting consumption and purchasing costs, in general. The more or less nonexistent customer response on the recent turn to a small upward trend of market interest rates and the repo rate (currently back to 2%) seems to lend support to this latter view. Albeit lately the executive board of the Central Bank appears to have become slightly more concerned about the high indebtedness of households. Deputy Governor Irma Rosenberg expressed the following view in March 2006 when giving an introductory speech at the Swedish Sawmill Managers Association’s annual general meeting in Stockholm:

If this development continues, we Executive Board members believe there is a risk that a situation could build up where a sudden slow down in house prices later on would cause households to perceive their debt burden as overly high and to rapidly increase their saving.
(Riksbanken, 2006)