

Investment Risk Management in the Company

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Abstract: Over the last several decades the public has witnessed the financial integration of product ranges among the big financial institutions. This is due to the increasing globalization, the development of new financial instruments, and the advance of the information technologies. These factors have forced institutions to face various risks, develop a methodology for the assessment of the risks and come up with techniques for reducing them. We believe that this process requires not only a change in the risks management approach in the companies but also a reconsideration of the risks that affect them under the conditions of integration within the financial sector. This calls for a systematization of the risk research and rethinking of the theoretical foundations. With reference to this, the aim of this paper is to study the investment risk management under the conditions of financial integration.

Key words: investment risk, innovation, strategy, scientific product

The traditional approach to risks is related to various definitions of the concept of "risk". According to Hr. Draganov [8] risk is an economic concept which is a natural aspect of an aim-oriented activity. Its realization leads to diversions from the expected results. He points out that the term "risk" is of an Italian origin (*risico*) and means "to take a decision whose outcome is unknown, uncertain".

W. Bauer and C. Murawski [4] suggest another translation of the Italian word, namely: "possible damages or negative consequences due to unpredictable circumstances". They suppose that "*risico*" is derived from the

Arabic word "*rizq*" which means "something to gain benefit from" or "something given to someone without profit". "A daily ration God gives to people" is the religious Islamic definition of "*rizq*".

The detailed W. Bauer and C. Murawski's studies of the origins of the term "risks" led them to the Aramaic language which originated from Syrian language which in turn sprung from the ancient language Pahlavi. In Pahlavi "*rôcik*" means "a daily ration (bread)".

It is considered that until the Middle ages the word "risk" had a neutral meaning with reference to people's incomes which were a subject of uncertainty. It is supposed that it started to express a negative result in the Middle Ages Italian language. According to B. Iliev the "risk" is "revealed through the distribution of the common damage and is characterised by its expected value and dispersion" [10].

Several elements of risk are mentioned in the specialized literature. They are as follows: random risk; risk caused by change; risk caused by a mistake; a risk which is a diagnosis; and a risk which is a forecast. B. Iliev claims that the last two elements refer to the risk caused by a mistake and the risk caused by change respectively. In general, in the specialized literature [9] there is an agreement and consolidation around the risk classification offered by D. Farny [8].

The administrative risk occurs when "the calculated expenses are lower than the done ones" while the management risk is related to losses suffered by the company due to inadequate management decisions. Since this differentiation of risks is not complete and does not include the risks which are directly related to the company's operations, Hr. Draganov separates them into two main groups, i.e. risks related to the main operations and risks which are not related to the main operations.

The latter are further subdivided into two categories – risks pertaining respectively to the internal and external company environment.

The risk related to the internal environment involve losses due to theft, diversion, staff disloyalty, rearrangement of the technological systems, bad management structure.

The second category, i.e. risks related to the external environment, involves risk caused by political and natural reasons as well by reinsurance. B. Iliev, D. Gushterov, and V. Vasilev offer another classification of risks from the point of view of solvency [9].

According to them companies face two types of risks, namely technical and investment risks. The technical ones result from the company's operations and are divided into two categories - current and specific risks.

The financial and insurance theories offer different definitions of investment risk. According to D. Dochev and T. Nedev, the risk is the possible deviation from the real rate of return compared to the expected one [6].

Hr. Draganov supports the idea that in insurance the term "risk" should be treated differently and does not coincide with the traditional definition of risk. This is

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due to the specific activities of the insurance companies which are affected by random events not following any predictable regularity.

Therefore, the investment risks are connected to the profitability, liquidity, and stability of the investment portfolio of the insurance companies. These risks involve the risk of “devaluation”; the liquidation risk; the interest rate risk; the risks referring to distribution, evaluation of risks, investments, and the use of derivatives.

Y.Yotov and Zh. Hristozov use a classification of the risks from the financial theory according to which they are divided into systematic and non-systematic. The group of the systematic risks is related to these factors which refer to the micro and macro economic factors, that is the state of the economy, its effectiveness, the interest rates, the incomes of the economic agents, the inflation.

The risks in this group cannot be diversified but some of them could be subject to hedging. These risks are the risk of changes in the assets’ value; the inflation risk; the political risks; the currency risks. The nonsystematic risks depend on the specific activities of the companies and the sectors they operate in. They could be reduced through diversification and involve the actuary, credit, industrial, and liquidity risks.

K. Hines studies risks through the integration of the financial services, namely by determining the approach of full servicing. With reference to this challenge to the management, the regulation organizations and investors, it is necessary to analyze, study, and assess the relations and correlations among the economic, financial, and insurance variables.

For example, the credit risk is interpreted differently in the bank and insurance sectors. This requires the appropriate identification of risks, their understanding, and assessment.

According to Hines, risks are as follows:

- Market risk – the risks which appears when there is a change in the assets prices;
- Credit risk – this is the risk of late payments or inability of paying on behalf of the other contracting party, i.e. the one emitting the bonds;
- Economic risk – the risk of changes in profits due to economic changes ;
- Currency risk – it is related to changes in the currency exchange rates ;
- Insurance risk – the risk connected to possibility of not realizing the insurance operations as it is expected;
- Interest rates risk – this is the risk of changes in the values of the assets and liabilities due to changes in the interest rates;
- Legal risk – it is related to instabilities in the legislation system;
- Liquidity risk – the risk for a company to sell its assets under their market value to meet its liquidity needs;
- Assessment risk – this is the risk of wrong assessment during a strategic planning process or a dynamic financial analysis;

- Operational risk– it is the risk of direct or indirect losses due to inadequate control, human acts or external events;

- Political risk – the risk of losses due to political instabilities;

- Reinsurance risk – the risk of late payments on behalf of the reinsurer, i.e. they could not fulfill the obligations of the reinsurance contract;

- Hedging risk – the risk related to a situation in which the counterpart in a hedging deal cannot fulfill its obligations;

- Regulatory risk – the risk of changes in the regulatory environment which may have negative effects for the company. For example, treating the accounting policy referring to investments in off-balance sheet assets, the assessment of their risk;

- Shareholder’s risk – it is related to changes in the market capitalization of the company (if it is public) under the influence of outside investors. For example, the extensive selling of shares over short periods of time. This risk is important since it is directly related to the price of capital and the opportunity for additional financing through emitting shares.

The Society of Actuaries divides risks into five categories [7]:

□ C-1 risk (risk related to assets);

□ C-2 risk (price risk);

□ C-3 risk (risk related to managing the assets and liabilities);

□ C-4 risks (mixed risks);

Another alternative is the financial classification of risks. It facilitates the thorough description of risk by distinguishing six types of risks [3]: insurance (actuary), systematic, liquidity, operational, and legal risks.

The actuary risks occurs as a result of incorrect actuary calculations which in turn lead to paying higher sums than the expected ones for covering damages or receiving an income from the insurance premiums which does not cover sufficiently the accepted risk.

The systematic risk is the risks caused by changes in the value of the insurance company’s assets and liabilities. These changes result from changes in the systematic factors. This risk is often related to the market risk and could often be minimized through hedging but could not be fully reduced through diversification.

The changes in the assets and liabilities’ value are supposed to be caused by three main economic factors which represent the basic types of systematic risks, namely insurance rate, basic, and inflation risks. Although the insurance rate risk is an element of the market risk, its importance for the financial institutions is considerable. The credit risk is connected with the impossibility or inability of the credit beneficiary to fulfill his contract obligations.

The risk of investing in bonds is managed through preparing rules for investing in this type of securities, on one hand, and control for compliance with the investment restrictions.

The rules allow for evaluation of the credit risk level of a particular asset, the adequacy of its assessment and level of liquidity. The credit risk of investing in securities is restricted by law regulations. The Bulgarian legislation is harmonized with that of the European Union and sets investment rules which restrict the type and size of the investment instruments available to the companies.

The liquidity risks refer to cases when the companies cannot collect the necessary funds to clear their due payments.

The operational risk is defined in several ways. The Basel Committee states that it is the risks of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This excludes the strategic business risk which refers to management decisions but involves the legal risk. Another type of operational risk arises when institutions suffer losses due to human mistakes or problems in the information systems.

The legal risk involves losses from changes in the law system or unfavorable court decisions.

The market risk is not part of the systematic risk but is typical of all companies because it affects their investment portfolios. It is the risk of potential losses due to unfavorable changes in the prices of the investment instruments and encompasses four types of risks, i.e. currency, interest rate, stock market, commodity risks. This requires a methodology which will facilitate the full and simultaneous assessment of these market risks.

At the beginning of the 1990s the Bank for International Settlements established the principles of market risk assessment [4] according to which the financial institutions have to use a new risk measure, namely the Value-at-Risk.

The value-at-risk calculates the risk exposition of the company on the basis of its exposition to the risk factors. These factors are observed with the help of market data while the dynamic financial analysis is a simulation model of the cash flows.

It is based on the assumptions of the managers and on computer generated scenarios which forecast the future financial state of the company. An investment, in the broad meaning of the word, is interpreted as transforming the liquid assets of a company into other property. The objects of capital investments could take various forms:

Fixed assets or basic sources such as land, buildings, equipment, facilities, etc.; Intangible fixed assets – apart from the investments in research, they could also involve investments in marketing, advertising, sales, company reorganizations, staff training, etc.; Financial fixed assets – acquisition of partnerships and company ownerships, securities, granted credits, etc.

A characteristic feature of investments is the fact that they represent considerable expenses realized at the initial stage of the investment process which do not generate profits or incomes immediately.

The investments are two types – real investments (made in the sphere of production) and financial investments. Depending on the investment

occasion, there are different categories of investments such as:

□ *Compulsory* investments which aim at increasing the product reliability and safety or protecting the environment in compliance with the new law acts or other compulsory circumstances;

□ *For retaining market positions*, established reputation, etc. mainly by improving the production quality;

□ *For rationalization of the production process* and economizing on production costs to increase the productivity and profitability;

□ *For expanding* – the aim is to improve the production capacity in the “traditional” spheres of operation;

□ *For renovation* of the basic funds used for maintaining the continuous operations and improving the quality of products and services;

□ *Risk investments* aiming at development and implementation of entirely new products (innovations) or conquering new markets. Since these investments have the biggest relative share, they will be outlined in more details.

The variety of the activities for the realization of the investment projects within the companies could involve [5]: applied development of the scientific product; designing, preparation of the company for the innovation; trial production, and marketing activities.

Regardless of the exceptional variety of specific characteristic, these groups of activities could be combined over the time.

The risk of applied development of the scientific product

The objective of the applied development of the scientific product is to prepare it for implementing. Usually its development does not take into account the specific conditions under which the new product will be produced or the new technology applied.

For this reason, it is necessary the new product to be adapted to the specific conditions under which the new production process will be carried out and the implementing company will operate.

It is also necessary to determine and specify the technical and technological requirements the new product has to meet because they would determine the innovation choice, namely an own innovation, the purchasing of a license, etc.

In the country the established practice referring the applied development of the scientific product involves the development of an economic and technical task. It outlines and regulates the technical and exploitation characteristics of the new product, the conditions of its exploitation, the requirements for its standardization and unification, the ergonomic requirements, and the deadlines for its development.



CONCLUSION

In conclusion, it could be said that the practice of investment risk assessment and management in the various spheres of activities is becoming more widely used under the conditions of market economy. The necessity of introducing something new always causes a number of psychological problems to the employees on all management levels.

These problems refer to the necessity of breaking the routine, the uncertainties of the future, lack of confidence that the managers have chosen the best direction of action, fear of making staff redundant. The overcoming of such psychological barriers is difficult but of great importance because neglecting the problems could lead to failure of the whole project.

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