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Financial Risk Management: the Elephant in the Room?

More than ever, it is time to talk about financial risk management

The conversation about financial risk may never be an easy one for the banker to have with their small or middle market business customer. When the economy is booming and businesses are upbeat, the mere mention of financial risk management by the banker is likely to be brushed aside. Bankers therefore may hesitate to bring up the subject altogether. Equally, when the boom gives way to a bust, the conversation is even more delicate. It's not easy to say "I told you so" to a client nor is it easy to explain why the banker may have hesitated in mentioning financial risk. However, it is precisely these conversations that banks should now be having with their small and middle market business customers.

The economic environment provides an easy ice-breaker to start talking about financial risk. Given that risk management products are chronically underused by small and middle market businesses, they are an obvious candidate for up-sell. Most importantly, going on the front foot and addressing the issue as it applies to each client can greatly help the banks in breaking that final frontier in relationship management – namely, being seen as business advisors.

Exposed

East & Partners' research confirms that most SMEs (A$1-20 million annual turnover) and Corporate businesses (A$20-340 million) currently use Australian Dollar Term Debt. These businesses are also actively transacting in foreign currencies and the use of Spot FX almost reaches 90 percent in both segments. In other words, the vast majority of small and middle market businesses are exposed to interest rate and foreign exchange (FX) risks.

East's research presents clear evidence that these financial risks are in many cases not 'covered', leaving businesses at the mercy of interest rate and FX fluctuations. As the chart below shows, even the larger Corporate businesses are not proactively managing their interest rate and FX exposures, with the use of risk hedging products never going too far above 40 percent. This is in stark contrast to 100 percent engagement of Term Lending and 91.4 percent of businesses that are using Spot FX.

There has, however, been an improvement in risk management product use compared to the levels seen back in 2002 when East started tracking these metrics. During the seven years to July 2009 the use of these products has roughly doubled. But this growth is off a low base and has taken place at a time when interest rate and FX risks have also grown. So while financial risk management products have become more widely used, a significant gap between risk exposures and risk hedging remains.

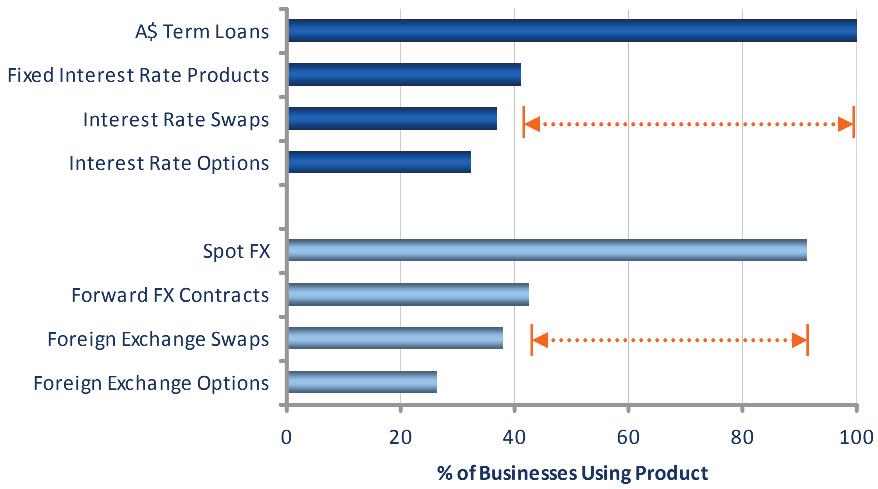
The Role of Banks

The low focus on managing financial risk leading into the current volatile environment means that some small and middle market businesses are likely to have been burnt by recent rate and FX movements. Business banks therefore have an ice-breaker to discuss financial risk with these customers. The low propensity among these businesses to hedge interest rate and FX exposures means there is substantial room for growth in the use of financial risk hedging products. Importantly, this growth can come from leveraging existing relationships rather than hunting new customers, making the sales process somewhat easier. The banks also have an opportunity to be seen as doing more than making a product push, rather they can be seen to be offering relevant advice to the customer.

These opportunities are ripe for picking but realising them will require a clear strategy and sharp execution.

As a starting point, banks need to clearly demonstrate that they understand each customer's unique business environment. In discussing financial risk management products, business bankers need to be comfortable not only with the logic of managing financial risk but also with the products they are offering to the customer. Only when an understanding of the customer and strong product knowledge come together, can effective benefit statements be developed. Effective benefit statements will convince the customer that the banker is representing their best interests, enhance customer loyalty and give new life to the bank's efforts to become a trusted business advisor.

Figure: Product use in the Corporate Segment



Source: East & Partners, Corporate Banking Markets Research Program, July 2009