Risk management critical to corporate strategy

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With the consequences of the current financial crisis spreading to the real economy, lawmakers are exploring new regulations to govern the financial markets. The concern among market participants is that policy-makers do not fully understand how risk management does and should work, and how derivatives can be beneficial.

In the "MIT Roundtable on Corporate Risk Management" that appears in the Fall 2008 issue of Morgan Stanley's *Journal of Applied Corporate Finance*, a distinguished group of academics and practitioners assess how risk management affects corporate growth and value.

For many companies, effective corporate risk management begins with an equity cushion in the capital structure. This helps to avoid raising prohibitively expensive capital following an adverse event. Excessive leverage contributed to the problems of many banks, leading to the current industry-wide de-leveraging.

Andrew Lo, Professor of Finance at the MIT Sloan School of Management and director of MIT's Laboratory for Financial Engineering, contends that too often what passes for risk management at many financial companies is really risk measurement. This offers little prescriptive advice on how to actually manage the risks, as opposed to corporate governance structures for actively and effectively managing risks. In addition, some of the current problems can be attributed to the failure of risk managers and their models to account for highly improbable events.

A paradox of risk-reducing financial innovation is that it tends to encourage market participants to increase risk-taking in other ways. Robert Merton of Harvard Business School and Nobel laureate in economics points out that the challenge from a regulatory standpoint is to find the right balance between these two offsetting forces.

Source: Wiley