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The Impact of Financial Pressures and Risk Management on Financial Performance of Investment Firms and Banks

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A B S T R A C T
In developed economies, the key role of risk management in realization of organizational goals has been well recognized so that its achievements have been correctly exploited. However, in most developing countries, the importance of risk management has not been recognized. The lack of proper risk management systems has resulted in significant losses. Managers in all organizations dealing with risk. Given the importance of risk management, the present study examines the impact of financial pressures and risk management on financial performance of investment firms and banks. For this purpose, 106 firms listed on Tehran Stock Exchange (TSE) were studied for a 5-year period from 2006 to 2011. The results of hypothesis testing showed that there is no significant correlation between risk, financial performance and financial performance of investment firms. However, a significant correlation was found between financial constraints and risks and financial performance of investment firms and banks.

Keywords: Risk, Financial Constraints, Financial Performance, Financial Pressures

INTRODUCTION

In developed economies, the key role of risk management in realization of organizational goals has been well recognized so that its achievements have been correctly exploited. However, in most developing countries, the importance of risk management has not been recognized(Agwu, 2018; Shen, Platten, & Deng, 2006). The lack of proper risk management systems has resulted in significant losses. Top management mainly focuses on the causes of risk. Management adjusts the investment risk for corporate assets against the potential return on investment. Management handles the risk in organizational portfolio and investment activities through strategic considerations(Jasson & Govender, 2017).

Measures related to market liberalization, globalization and increasing competition and diversification have exposed firms against many risks and challenges. The new situation requires constant innovation in the existing managerial methods and associated risks to take necessary advantages in the competitive environment. On the other hand, firms that face financial pressures are not able to provide the needed funds for all desired investments. Inability to provide the needed funds can be attributed to inability of financial managers in handling cash

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assets. On the other hand, a proper connection between financial and production systems in each country is considered as the most important factor for economic growth and development. Banks as the main part of financial system play a major role in financing of commercial, consumer and even governmental sectors(Guttmann, 2016).

Basically, investment in the stock market requires risk-taking. The return of investment (ROI) is a key variable. Thus, the expected profit of different investments is compared with required return(Francois, 2009; Khoufi & Khoufi, 2018). Risk management and identification is a one of the new approach used to strengthen and improve the effectiveness of organizations. In general, risk is defined as the likelihood of loss or uncertainty. There are various classifications for risk such as speculative risk and dangerous risk. All forms of risk include common elements such as content, activities, conditions and consequences(Güleç, 2017).

Another classification involves strategic and operational risks. Risk management implies risk assessment and then adopting strategies for risk management(Ikpefan, Enobong, Osuma, Evbuomwan, & Ndigwe, 2018). On the other hand, technology development allows financial institutions to analyze market data for faster reaction. The ability to receive, collate, analyze and respond to the information flow provides a competitive advantage for financial institutions. In such a fast evolving voluminous high-tech market, the importance of operational risk increases. In such an environment, a robust and efficient risk management for enterprises and banks is of great importance(Hussain, 2000; Robertson, 2016). Failure in risk management not only leads to financial losses, but will lead to bankruptcy of banks or investment firms. With the development of information technology in recent years, the importance of these risks has been highlighted(Heidari & Asady, 2019).

METHODOLOGY

Due to the nature of the subject, the aim of the present study is to examine the relationship between two or more variables as well as the significance of potential correlation and its predictive power. Accordingly, this is a correlational study. It should be noted that the present study does not seek a causal relationship, but just searches for a potential relationship. Following data analysis and hypothesis testing, the concluding remarks will be provided. The collected data were calculated using Microsoft Excel and then analyzed by SPSS and Eviews.

The present study aims to examine the impact of financial constraints and risk-taking of investment firms as well as the impact of financial constraints and risk-taking interactions on financial performance of investment firms. For this purpose, after reviewing the descriptive statistics of variables, the hypotheses are tested using multivariate regression model(Weber & Milliman, 1997).

FPi, t: the financial performance of the firm i during the period t. Return on equity (ROE) and the stock return will be used to measure this variable .

WWI, t: the financial pressure that the firm is involved with it.

Riski, t: the risk-taking of investment firms and banks. This will be measured using the annual standard deviation of monthly stock returns and the beta coefficient of the purchased stock.

Sizeit: Logarithm of the firm's market value(Epure & Lafuente, 2015).

Mom it: stock return momentum (The return of the same period in last year is used as a control variable to control the impact of severe and cross sectional volatilities) (Chen & Pan, 2012).

Betait: the beta coefficient representing the corporate risk(Chang & Hsieh, 2011). This variable represents corporate-related risk.

LEVi, t: the ratio of debt to total assets.

In the above model, α2 represents the effect on risk-taking on financial performance of the firm (the first hypothesis) and α3 represents the impact of financial pressure and risk-taking interaction on financial performance (the second hypothesis).

RESULTS

Hypotheses testing

First hypothesis: the risk-taking of investment firms and banks has a significant positive impact on the financial performance (return on assets and stock returns).

Second hypothesis: the interaction of financial constraints and risk-taking impacts on financial performance.

First, the normality of the dependent variable, the financial performance of firms, is evaluated. According to Table 1, the dependent variable is normal.

Table 1. Results of normality

		Fpit	Wwit	Riskit	FC	size	MoMit	Beta	levit	Profitit
Fpit	Pearson Correlation	1	-0.019	0.012	0.007	0.016	-0.031	-0.041	-0.007	-0.018
	Sig. (2-tailed)		0.638	0.789	0.859	0.692	0.434	0.371	0.858	0.665
	N	635	607	490	635	623	620	490	623	615

Table 2. Results of model analysis

	Fpit
Chi-Square(a)	404.961
Df	586
Asymp. Sig.	1.000

The number of data is the number of firms multiplied by the number of years. The null and opposite hypotheses used to evaluate significance of models are as follows:

$H_0 = \beta_1=\beta_2=\beta_3=\ldots=\beta=0$

$H_1= \beta_I \neq 0$, i=1, 2, 3, 4, n

1. At least, one of the β coefficients is not zero.
2. The variables in the form of a conceptual model and measurement of variables

- The model

$$FP_{i,t} = \alpha_0 + \alpha_1 WW_{i,t} + \alpha_2 Risk_{i,t} + \alpha_3 FC \times Risk_{i,t} + \alpha_4 Size_{it} + \alpha_5 Mom_{it-1} + \alpha_6 Beta_{it} + \alpha_7 LEV_{i,t} + \alpha_8 Profit_{i,t} + \varepsilon_{it}$$

In the above model, α_2 represents the effect on risk-taking on financial performance of the company (the first hypothesis) and α_3 represents the impact of financial pressure and risk-taking interaction on financial performance (the second hypothesis).

Table 3. Results of first and second hypothesizes

Dependent Variable: FP				
Method: Least Squares				
Date: 11/14/13 Time: 19:20				
Sample (adjusted): 6 105				
Included observations: 72 after adjustments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.258	2.215	1.471	0.142
Ww	-8.67E-010	0.000	-0.340	0.734
Risk	0.044	0.027	1.610	0.108
Fc*risk	4.30E-008	0.000	2.131	0.034
Size	-0.239	0.163	-1.466	0.143
MoM	-0.004	0.002	-1.626	0.105
Beta	-0.423	0.164	-2.589	0.010

Levit	-0.085	0.252	-0.339	0.735
Profit	-1.73E-007	0.000	-0.548	0.584
R-squared	0.032	Mean dependent var		1.223748
Adjusted R-squared	0.014	S.D. dependent var		1.269773
S.E. of regression	3.779	Akaike info criterion		2.284122
Sum squared resid	106.4160	Schwarz criterion		2.347363
Log likelihood	-116.2284	Hannan-Quinn criter.		2.309298
F-statistic	792^2	Durbin-Watson stat		1.911
Prob(F-statistic)	470			

The probability (or significance level, F) is equal to 0.047. Since the significance level is less than 0.05, the null hypothesis concerning the relationship between the two variables is confirmed with a confidence level of 95%. Thus, there is a significant model. The coefficient of determination is equal to 0.032, i.e. 3.2% of the changes in dependent variable is expressed by independent and control variables. The coefficient of determination is low in practice. A Durbin-Watson statistics of 1.911 indicates the absence of autocorrelation (this confirms another model assumption).

First hypothesis: the risk-taking of investment firms and banks has a significant positive impact on the financial performance (return on assets and stock returns).

Second hypothesis: the interaction of financial constraints and risk-taking impacts on financial performance.

In the above model, α_2 represents the effect on risk-taking on financial performance of the company (the first hypothesis) and α_3 represents the impact of financial pressure and risk-taking interaction on financial performance (the second hypothesis).

$$FP_{i,t} = \alpha_0 + \alpha_1 WW_{i,t} + \alpha_2 Risk_{i,t} + \alpha_3 FC \times Risk_{i,t} + \alpha_4 Size_{it} + \alpha_5 Mom_{it-1} + \alpha_6 Beta_{it} + \alpha_7 LEV_{i,t} + \alpha_8 Profit_{i,t} + \varepsilon_{it}$$

In the above model, α_2=0.044, but p> 0.05. Therefore, the first hypothesis is rejected. In other words, the risk-taking of investment firms and banks has not necessarily a significant positive impact on the financial performance (return on assets and stock returns).

Moreover, α_3=4.30E-008 and p<0.05 indicating a significant correlation between these two variables. Accordingly, the second hypothesis is confirmed. In other words, the interaction of financial constraints and risk-taking impacts on financial performance.

CONCLUSION

The recent financial crisis involved almost all countries occurred due to lack of proper functioning of the credit risk assessment and measurement of banks and financial institutions. Accrediting agencies are still evaluating many banks with high credit rating regardless of this issue. Therefore, the present study aims to examine the impact of risk-taking and financial constraints on financial performance of investment firms and banks.

Accordingly, the risk of investment firms and banks has no effect on their financial performance .

At risky conditions, firms can make a realized profit or improve their circumstances compared to current status. At the same time, there is a risk for an adverse experience or worsening circumstances.

• First hypothesis: the risk-taking of investment firms and banks has a significant positive impact on the financial performance (return on assets and stock returns).

According to the conceptual model, α2=0.044 and p> 0.05. Therefore, the first hypothesis is rejected. In other words, the risk-taking of investment firms and banks has not necessarily a significant positive impact on the financial performance (return on assets and stock returns).

Accordingly, risk taking and the use of bold policies will not necessarily lead to a positive and significant impact on financial performance of firms and the banks. In other words, such policies cannot provide growth and profitability for investment firms. Risk-taking means doing any activity with at least one ambiguous or uncertain result. The result of this hypothesis is not consistent with the results of Epure and Lafuente (2015), who found the negative impact of risk on financial performance of banks. However, it is consistent with the results of Chen and Pan (2012), who found a weak correlation between credit risk and performance. However, this is not consistent with the results of Kargi (2011), who found a significant correlation the risk and financial performance of investment firms and banks.

• Second hypothesis: the interaction of financial constraints and risk-taking impacts on financial performance.

According to the conceptual model, $\alpha 3=4.30E-008$ and $p < 0.05$ indicating a significant correlation between these two variables. Accordingly, the second hypothesis is confirmed. In other words, the interaction of financial constraints and risk-taking impacts on financial performance. In general, one of the most important issues considered by investment firms is the access to required financial resources within a desired period (shortest time) to invest in new stock. So, the lack of financial pressure is of great importance.

In general, investment firms must do risk-involved activities to satisfy their shareholders as well as to take advantage of benefits and rewards of owners. Therefore, risk-taking and investing in new situations constitute an integral part of activities of investment firms. However, one of the most important issues considered by investment firms is the access to required financial resources within a desired period (shortest time) to invest in new stock. So, the lack of financial pressure is of great importance. Thus, the most important issues considered by investment firms are the amount of risk-taking and financial constraints. Firms that involve high risks, in addition to the possibility of greater profits, are likely to earn negative returns and major loss. Thus, the deviation of the portfolio return increases. As a result, firms that are engaged in financial pressures may take low-risk activities to avoid further losses.

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