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FINANCIAL RISK MANAGEMENT

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ABSTRACT

Risk a resultant of exposure, is the probability of loss but exposure is a possibility of loss. But risk provides a basis for opportunity. Financial Markets presently have exposure to indefinite risks. Change in market prices offers risk. It's difficult to eliminate risk but strategies, active management to mitigate the risk needs to be formulated. Financial risk can be hedged or a portion of it can be hedged or hence simply accept the financial instrument with the risk. The present paper constitutes the analysis of two research paper in order to understand about financial risk and its management.

Key words: Risk, Financial risk, Risk Mitigation etc.

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1. INTRODUCTION

Business involves innumerable financial transactions due to which financial risk arises. Countless legal proceedings, new projects, merger & acquisitions, foreign party's interactions are indulged in the business transactions.
Source of Financial risk:

- Exposure towards market price fluctuation.
- Exposure due to counterparty transactions
- Exposure due to internal organizational actions

Financial Risk Management encompasses the evaluation of financial risk so that strategies consonant with the organizational policies, to mitigate the same can be formulated. Financial risk management involves:

- Classify the financial risk
- Identify risk tolerance level
- Apply risk management strategy
- Quantify, Monitor and reform as needed

2. ANALYSIS OF RESEARCH PAPER

Paper 1: Financial Risk Management in volatile global market

Authors: Francis X. Diebold

Anthony M. Santomero

Publisher: Wharton

Summary:

A paper comprehending the global financial crisis, 1997. The catastrophe which originated in Malaysia, distressed the Asian market, therefore initiated the collapse of Russian and South American market.

Varied industries are related to one another. Crisis of one began its impact over another. This correlation dramatically risen over the time frame of crisis.

Press and politician overstated the crisis matter. But this phase had not emerged as all of sudden. Asian market suffered 40% in the late quarter, 1997 and Latin America seen the dwelling crisis impact over 1998.

Cause of such crisis was Long Term Capital Management. Regional currency as well as national states had a devastating impact of hedge funds. But the constant withdrawals of small businessmen and local citizens fuelled the crisis as well. Moreover, lack of confidence among investors led the nation towards crisis mode.

Financial systems over Malaysia, Thailand, Russia, Indonesia as well as Mexico had now to undertake some repercussive measures to overcome the devastation.

Different nations over the world are interlinked through trade. Hence crisis was likely to spread.

Therefore, the countries need to devise their risk management mechanism. Exposure towards risk must be recognized, quantified and hence effectively managed. Risk managers need to carefully gauge the global transformations as well as its exposures. Technological upgradations to support the same is another mandate. Strong network which could update global positions would deploy positive outcomes. Risk manager need to understand the volatility of the market and the correlation among factors which would enable risk management.

Henceforth complete risk elimination is impossible but one can take measures to minimize the impact of the same.

Analysis:

The current research paper emphasises effective risk management. Risk can be minimized, if the mechanism is strong. Risk manager, on the other hand, should be able to understand the factors emanating the risk and its positive correlation.

Similar situation is persistent over the market. Trade linkage had spread this risk over different nations. It was even believed that in India too, the Press and Politicians amplified the matter. Firms can easily minimize the risk by diversifying its portfolio.

Paper 2: Place of Risk Management in financial institutions

Authors: George S. Oldfield
Anthony M. Santomero

Publisher: Wharton

Purpose: The current research paper focussed on the following:

- Role of institutions in the financial sector.
- Risk management techniques

Key objective: The primary objective of this paper is to elaborate how risks are transferred to the owner and sometimes, these are even absorbed by the firm who has introduced such financial products.

Unpredictability of financial performance can be gauged with the help of following:

- Superior-subordinate self interest
- Taxation
- Cost of financial distress
- Inadequacies of Capital market

Risk mitigation process:

Risk mitigation can be instigated with the help of following:

- Business procedure
- Risk transference
- Active management

1. A thorough understanding of hedges, diversification, syndication, asset-liability match as well as standards would instigate such risk mitigation process.

2. Purchase or Sale of financial instruments may lead to risk transference. Selling of such assets with risks which do not possess any advantage in managing would prove to be fruitful for the firm. Therefore, more attention towards those financial instruments which do possess some competitive advantage would turn advantageous for the firm.

3. Firm may even offer service who don't have any knowledge about hedging or trade practices.

Types of financial services

Origination: It involves creation of new financial instrument as desired by the clients

Distribution: This involves selling of newly created financial products in order to reap benefits.

Servicing: Payment collection in order to generate revenue and serve the undue.

Packaging: Packaging is to gather the financial assets into a pool in order to sell it to the clients.

Market making: Market making is to purchase or sale an identical lot by the dealer.

Financial Service Risks

Risk can be categorised as:

- Systematic risk: Undiversifiable risk is a type which cannot be diversified absolutely. However, such a risk can be hedged with proper mechanisms.
- Credit risk: Unwillingness or inability of client, who defaults in his payment may lead to such a type of risk.
- Counterparty risk: Counterparty's inability to perform leads to the generation of counterparty's risk.

- Operational risk: Inoperability over the field for instance settling or making out any delivery creates operational risk.
- Legal risks: Employees must be made aware about new regulations, laws etc. in order to avoid legal risk.

Almost all financial institutions have to bear these risks. Hence active management may help to mitigate the risk to some extent.

In order to mitigate risk, following four step processes can also be adopted:

- Setting the Standards and report preparation
- Formulating rules and setting the Position Limits
- Strategy
- Compensation

Setting the Standards and report preparation

Firms need to gauge their risk undertaking capacity. Crucial study of risk creating factors and effective measures to control them is further more important in order to attain profit maximization.

Report preparation is also important. Firms may undergo internal reporting, that too of short duration in order to gain true financial picture.

Formulating Rules and setting the Position Limits

Rules are essential to formulate in order to contain systematic risk.

Strategy

Active management involves development of strategy. Senior management should be made aware about the risks that organization had to face, so that they may formulate strategies in order to absorb the risk.

Compensation

Suitable incentives must be rewarded to those who have risk borne capability.

3. CONCLUSIONS

Financial risk has grown tremendously as the reach of financial instruments towards global reach has risen enormously. But even the risk and its management are not at all the contemporary issue. Continuous modifications over exchange rates, commodity prices etc pose another category of risk. Further counterparty offers another category of risk. Thereby assessment of financial risk is one of the primary footstep to ensure risk management. Strategy formulation and Active management are key techniques for effective management of financial risk.

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