

„Methods of Managing Financial Risks“

Risk Taking and Risk Avoiding

Financial Risk Management

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Introduction

What are Financial risks?

Risks are having the most impact on financial viability of the organization. These risks are directly influencing the generated cash flows.

Financial risk is:

Probability of occurrence such event, which will cause loss of money.

Financial risks have to *be identified, analyzed and responed* within projects, portfolios and business plans.

List of Typical Financial Risks

1. Construction delay
2. Corporate bond risk
3. Liquidity risk
4. Counter-party risk
5. Maintenance risk
6. Taxation risk
7. Reinvestment risk
8. Country Risk
9. Currency risk
10. Interest rate risk
11. Equity risk



Managing Financial risks

Currency risk occurs:

- Currency flow from country to other country
- Fluctuating according supply and demand
- Money market adds volatility to the exchange rates

Foreign exchange transactions are subject to currency risk

Risk management techniques and instruments:

1. Currency Forward Exchange
2. Currency Swaps
3. Currency Options
4. Use Local Currency

RM Techniques and Instruments

1. Currency Forward Exchange

Eliminates risk by fixing the exchange rate at which future trade will take place. A future contract states the exchange rate for future payments at a current rate.

2. Currency Swaps

Manager borrows in a hard (strong) currency and finances the project in the local currency. Thus, hard currency is swapped for the local currency, allowing hard currency to financing.

3. Currency Options

This method of risk reduction is to fix the exchange but give manager an option to buy from open market if the rates are favorable to the company.

4. Use Local Currency

The use of local currency in developing countries to finance the projects can be an advantage because it reduces reliance on foreign currency.

Managing Financial risks (Cont'd)

Interest Rate risk is:

- ◉ Directly affects both borrower and investor
- ◉ Classified into two categories:
 1. Risk on securities or financial instruments, short-term finance (less than 1 year), e. g. Bonds, short-term loans, bills (debts), certificates.
 2. Financial instruments, which have longer maturity (more than 1 year), e. g. Securities, loans, stocks.

Risk management techniques and instruments:

- ◉ Interest Rate Forward Agreement
- ◉ Interest Rate Swap
- ◉ RPI Swaps
- ◉ Caps and Floors

RM Techniques and Instruments

1. **Interest Rate Forward Agreement (FRA)** - These agreements are similar to future contracts. E. g. Manager borrows 5 Mln. for six months, when the current loan has been paid, but manager expects the interest rate to rise. This expected rise in interest rate can be compensated by FRA.
2. **Interest Rate Swap** - This is an agreement between two parties to pay each other a series of cash flows, based on fixed or floating interest rate, in the same currency, over a given period of time.
3. **RPI Swaps (Retail Price Index-linked)** - Manager is in receipt of fixed cash flows. And the inflation is expected. Thus, manager makes this swap agreement and pays to other party cash flows and receives cash flow that will have the same purchasing power through time.
4. **Caps and Floors** - Manager agrees on a loan (+2%) and pays no higher than 7% (*cap*). However, if interest rate falls below 5% (*floor*), manager has to pay difference.

Managing Financial risks (Cont'd)

Equity Risk is:

- Rise and fall of share prices
- Threat of fall in value of the company, in case market value of shares falls

Risk management techniques and instruments:

- Reinsurance, hedging
- Issue of stocks below market price for existing equity owners

RM Techniques and Instruments

1. Reinsurrance, Hedging

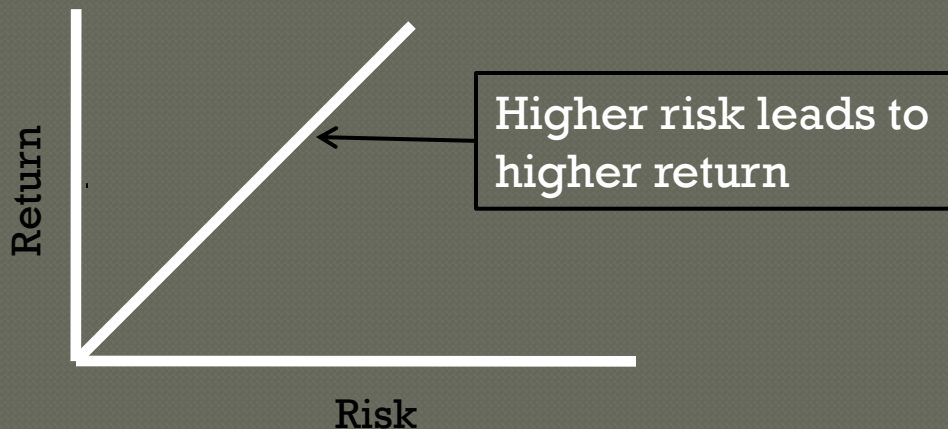
For the issuer of equity the risk of changes in the price of equity is not direct but indirect. The market price of the equity is a rough barometer of the health of the company. An example of a hedging would be if a investor owned a stock, then sold a futures contract stating that he/she will sell that stock at a set price, therefore avoiding market fluctuations.

2. Issue of stocks below market price for existing equity owners

The issuers of equity are not allowed to deal in their own shares because they have internal information which will cause speculation. However, companies in need of funds when their equity price is falling, can issue bonus shares to the existing equity owners at a below market price to retain the interest and also to raise resources.

Portfolio Risk Management

- Depending on company's financial position and future needs, it can hold money in a number of investments, which together form a **portfolio**. Portfolio selection is a periodic activity of selecting projects into portfolio, which meets company's objectives.
- All projects involve risk. No Risk, No Return.
- Successful Portfolios are likely to have effective risk management processes and practices, in order to ensure balance between risk and return.



Portfolio Strategy

Investor must develop Portfolio strategy.

Portfolio strategies classified into two categories:

1. **Active** – uses available info and forecasting for better performance.
2. **Passive** – involves minimum expectational input and relies on diversification.

An essential Portfolio is one that provides the greatest expected return for a given level of risk.



Portfolio Risk Management (Cont'd)

Portfolio Risk Management has following stages:

Risk Identification, risk classification, risk analysis, risk response

Portfolio Risk management has the following benefits:

- Reduces the cost of capital by managing portfolio risk rather than individual project risks.
- Reduces the risk of projects from developing their own inertia.
- Increases the awareness of the critical risks by senior managers.
- Reduces project overrun and overspend.
- Identifies which risks exploit competitive advantage.
- Protects and enhances shareholder value.

Portfolio Risk Management (Cont'd)

Because...

- Some funds in portfolio would go into low-risk, fixed interest, easy liquidated savings or securities, and the remainder might go into high-income capital growth securities. Reducing risk and stabilizing income.
- Portfolios ensure an optimal balance between risk and return.
- As far as RM associated with portfolio, the critical risks can be identified, which can guide senior managers in analysis and strategic choices. E.g. Country risk, customers, local creditworthiness.
- Risks inherent in projects cannot be separated from the aspects of general business management.
- Portfolio Risk Management first considers the risks associated with the economic parameters of each project within the portfolio and project interdependencies before assessing the portfolio of projects as one entity.

Diversification of Risk

- **Diversification** is a key in management of risks in portfolio.

Because it allows investors to lower portfolio risk significantly without negatively affecting return.

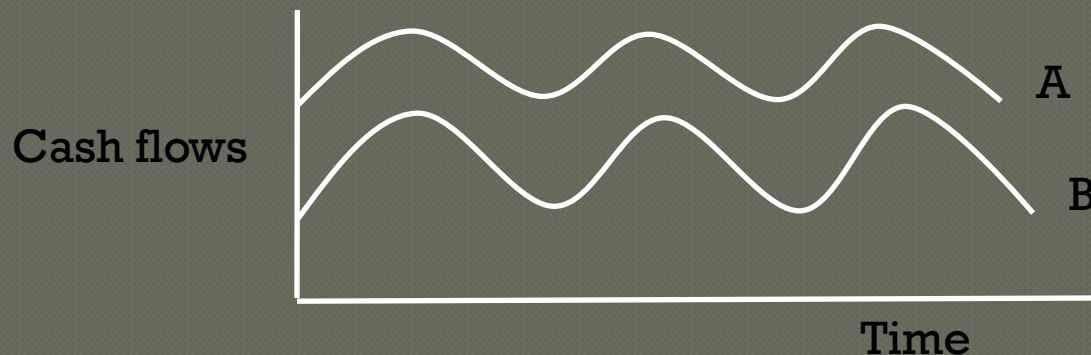
- **Diversification** is used to minimize risk and stabilize the income.

Because diversification of risk profiles between the projects within a portfolio allow investors to finance more economically. Projects with strong revenues may compensate and diversify the risk on those that have less stable cash flows.

Diversification of Risk (Cont'd)

- **Correlation** of risks in portfolio is essential. It is a key concept in risk diversification. The greater the correlation of identified risks in the portfolio, the higher the risks.

Because this is the process of identifying how the risks in the portfolio are related to each other. If two risks behave similarly, they increase for the same reason or by the same amount, they would be considered highly correlated.



Conclusion

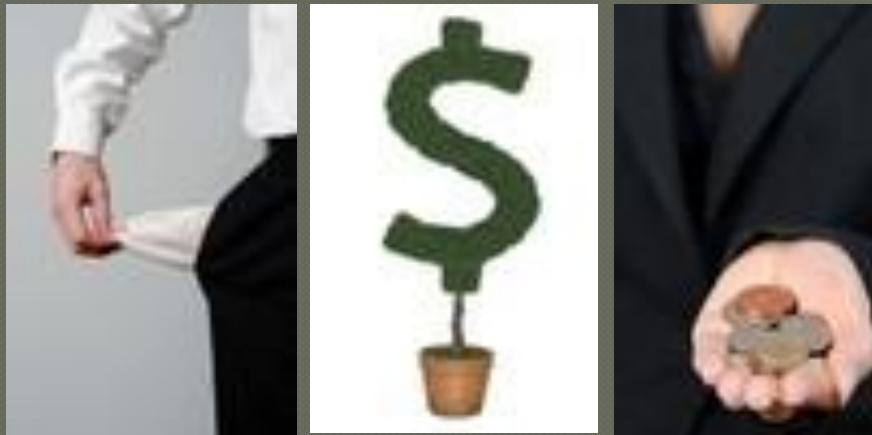
Factors that affect the portfolio's level of riskiness are:

1. Decisions made by financial managers
 - Investment decisions
 - Financing decisions (the relative use of debt financing)
 - Dividend policy decisions
2. The external environment

Management of financial risks plays vital role in the process of establishment successful and long term business.

All observed methods are called to be fundamental practices, which keep financial risks in a controllable level.

Thank You For Your Attention



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