

ORGANIZATION

A business organization faces **many types of risks**. Important among them are discussed as below:

1) Strategic Risk

A successful business always needs a **comprehensive and detailed business plan**. But, if things changes, **even the best-laid plans can become outdated if it cannot keep pace with the latest trends**. This is what is called as **strategic risk**.

So, **strategic risk** is a risk in which a company's **strategy becomes less effective** and it struggles to achieve its goal. It could be due to **technological changes, a new competitor entering the market, shifts in customer demand, increase in the costs of raw materials** etc

One example is Kodak which was able to develop a digital camera by 1975. But it considers this innovation as a threat to its core business model, and failed to develop it. Similar example is Nokia when it failed to upgrade its technology to develop touch screen mobile phones. That delay enables Samsung to become a market leader in touch screen mobile phones.

2) Compliance Risk

With **advent of Companies Act, 2013**, and continuous **updating of SEBI guidelines**, each business has to **comply** with plethora of **rules, regulations and guidelines**. Non-compliance leads to penalties in the form of fine and imprisonment.

However, when a company ventures into a new business line or a new geographical area, the real problem then occurs.

For example, a company pursuing cement business likely to venture into sugar business in a different state. But laws applicable to the sugar mills in that state are different. So, that poses a compliance risk. If the company fails to comply with laws related to a new area or industry or sector, it will pose a serious threat to its survival.

3) Operational Risk (Internal Risk)

It relates to **failure** of the company **to cope with day to day operational problems**.

Operational risk relates to 'people' as well as 'process'.

For example, an employee paying out ₹ 1,00,000 from the account of the company instead of ₹ 10,000. This is a people as well as a process risk. An organization can employ another person to check the work of that person who has mistakenly paid ₹ 1,00,000 or it can install an electronic system that can flag off an unusual amount.

4) Financial Risk

Financial Risk is referred as the **unexpected changes** in financial conditions such as **prices, exchange rate, Credit rating, and interest rate** etc.

Financial Risk can be divided into following categories:

(i) **Counter Party Risk** - Non-honoring of obligations by the counter party (Like failure to deliver goods for payment already made or vice-versa or repayment of borrowings and interest etc.)

- (ii) **Political Risk** - this type of risk is faced by an overseas investor, as the adverse action by the government of host country may lead to huge losses. This can be on any of the following forms.
- Confiscation or destruction of overseas properties.
 - Rationing of remittance to home country.
 - Restriction on conversion of local currency of host country into foreign currency.
 - Invalidation of Patents
 - Price control of products
- (iii) **Interest Rate Risk** - This risk occurs due to change in interest rate resulting in change in asset and liabilities.
- (iv) **Currency Risk** - Affects organization dealing with foreign exchange as their cash flows change with the movement in the currency exchange rates.
- (v) **Liquidity Risk** - liquidity risk can be defined as inability of organization to meet its liabilities whenever they become due. This risk mainly arises when organization is unable to generate adequate cash or there may be some mismatch in period of cash flow generation.

EVALUATION OF FINANCIAL RISK

The financial risk can be evaluated from different points of view as follows:

- 1) **From stakeholder's point of view:** Major stakeholders are equity shareholders and they view financial gearing (i.e. debt ratio in capital structure) as risk since in event of winding up of a company they will be least prioritized.

Even for a lender, existing gearing is also a risk since a company having high gearing faces more risk in default of payment of interest and principal repayment.
- 2) **From Company's point of view:** if a company borrows excessively or lends to someone who defaults, then it can be forced to go into liquidation.
- 3) **From Government's point of view:** failure of any bank or (like Lehman Brothers) downgrading of any financial institution leading to spread of distrust among society at large.

VALUE-AT-RISK (VAR)

VAR is a measure of risk of investment. Given the normal market condition in a set of period, say, one day it estimates how much an investment might lose.

VAR answers two basic questions -

- i. What is the worst case scenario?
- ii. What will be the loss?

Features of VAR

Following are the main features of VAR

- (i) **Components of Calculations:** VAR calculation is based on the following three components:
 - a) Time Period
 - b) Confidence Level - Generally 95% and 99%
 - c) Loss in percentage or in amount

- (ii) **Statistical Method:** It is a type of statistical tool based on Standard Deviation.
- (iii) **Time Horizon:** VAR can be applied for different time horizons say one day, one week, one month and so on
- (iv) **Probability:** Assuming the values are normally attributed, probability of maximum loss can be predicted.
- (v) **Control Risk:** Risk can be controlled by setting limits for maximum loss.
- (vi) **Z Score:** Z Score indicates how many standard Deviations is away from Mean value of a population. When it is multiplied with Standard Deviation it provides VAR.

Application of VAR - VAR can be applied

- a) to **measure the maximum possible loss** on any portfolio or a trading position.
- b) as a **benchmark for performance measurement** of any operation or trading.
- c) to **fix limits** for individuals dealing in front office of a treasury department.
- d) to enable the management to **decide the trading strategies**.
- e) as a **tool for Asset and Liability Management** especially in banks.

APPROPRIATE METHODS FOR IDENTIFICATION AND MANAGEMENT OF FINANCIAL RISK

As we have classified financial risk in 4 categories, we shall discuss identification and management of each risk separately under same category.

1) Counter Party Risk:

The various hints that may provide counter party risk are as follows:

- a) Failure to obtain necessary resources to complete the project or transaction undertaken.
- b) Any regulatory restrictions from the Government.
- c) Hostile action of foreign government.
- d) Let down by third party.
- e) Have become insolvent.

The various techniques to manage this type of risk are as follows:

1. Carrying out Due Diligence before dealing with any third party.
2. Do not over commit to a single entity or group or connected entities.
3. Know your exposure limits.
4. Review the limits and procedure for credit approval regularly.
5. Rapid action in the event of any likelihood of default
6. Use of performance guarantee, insurance or other instruments.

2) Political risk:

From the following actions by the Governments of the host country this risk can be identified:

- Insistence on resident investors or labour.
- Restriction on conversion of currency.
- Expropriation of foreign assets by the local govt.
- Price fixation of the products.

Since this risk mainly relates to investments in foreign country, company should assess country risk:

1. By referring political ranking published by different business magazines.
2. By evaluating country's macro-economic conditions.
3. By analyzing the popularity of current government and assess their stability.
4. By taking advises from the embassies of the home countries in the host countries.

Further, following techniques can be used to mitigate the risk:

- (i) Local sourcing of raw materials and labour.
- (ii) Entering into joint ventures
- (iii) Local financing
- (iv) Prior negotiations

3) **Interest Rate Risk:**

Generally, interest rate Risk is mainly identified from the following:

- Monetary Policy of the Government.
- Any action by Government such as demonetization etc.
- Economic Growth
- Release of Industrial Data
- Investment by foreign investors
- Stock market changes

4) **Currency Risk:**

Just like interest rate risk the currency risk is dependent on the Government action and economic development. Some of the parameters to identify the currency risk are as follows:

- (i) **Government Action:** The Government action of any country has visual impact in its currency. For example, the UK Govt. decision to divorce from European Union i.e. Brexit brought the pound to its lowest since 1980's.
- (ii) **Nominal Interest Rate:** As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.
- (iii) **Inflation Rate:** Purchasing power parity theory discussed in later chapters impact the value of currency.
- (iv) **Natural Calamities:** Any natural calamity can have negative impact.
- (v) **War, Coup, Rebellion etc.:** All these actions can have far reaching impact on currency's exchange rates.
- (vi) **Change of Government:** The change of government and its attitude towards foreign investment also helps to identify the currency risk. So far as the management of currency risk is concerned, it has been covered in a detailed manner in a separate chapter