Master 1 ; Financial Management

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Lesson; 3 Financial Risk Management

What is Financial Risk?

The possibility of losing money invested in a project or business venture is known as financial risk. It is a type of threat that can cause the loss of capital to the interested parties. The failure in controlling monetary policy and default on bonds or other debt issued in the country is a financial risk for the government. A company can also face the possibility of failure in the undertaking of debts which can cause a financial burden on the corporation.

There are lots of macroeconomic forces, fluctuations in market interest rate, and the chances of default by the sectors or large corporations which increase the financial risk in the financial market. Financial risk can also take place in the life of an individual when his/her decision may jeopardize the income or ability to clear debts.

Financial risk arises in every field of life in many shapes and sizes and affects nearly everyone. That's why everyone needs to be aware of it so that future losses can be avoided. However, if you figure out the risk prior and take proper measures to protect yourself then it means not that you can eliminate the risk but it can mitigate their harm and decrease the possibility of a negative

Types of Financial Risk :

1. Market Risk :

As clear from its name, the risk which is related to the **marketplace** in which the business activities take place, is known as market risk. For example, if you are running a brick-and-mortar clothing store, then the rise in customers' tendency to online shopping would be a market risk. In this situation, only those businesses can survive which can adapt to the online selling system and serve the online crowd. On the other hand, the businesses who stuck to the offline business model will bear losses.

Every business sector faces the risk of being outpaced by competitors. The market conditions and customers' demands and preferences change rapidly. So it is a must for a business to keep up with market trends and pricing demands to grab the market and compete with other producers.

2. Foreign Exchange Risk :

Foreign exchange risk refers to the risk associated with any financial instrument denominated in a **foreign currency.** For example, if an American company invests in India and the domestic investment does well in rupee terms, the American company may nevertheless lose money since the rupee's value has declined against the US dollar. As a result, when the firm redeems its investment at maturity, it will receive fewer US Dollars.

The rupee has dropped dramatically in recent years due to the pandemic. Because of which our country's forex risk as an investment destination has skyrocketed.

3. Credit Risk :

Credit risk refers to the possibility of losing money because the performance of a **creditor** is not as per the terms of the contract. Such debts are categorized as **bad debts.** For example, if the goods are delivered to customers on 30-days payment terms and the customer couldn't pay the invoice on time (or in the future also), then the company will suffer a credit risk. This risk can also increase the possibility of a **cash flow shortage.** So, it is advisable to retain sufficient cash reserves to cover the company's accounts payable.

4. Liquidity Risk :

Liquidity risk includes all those risks that arise when the organization tries to sell assets or raise funds. This risk is also known as **funding risk.** If something is becoming a barrier in the path of raising funds fast, then it will be called liquidity risk. For example, a seasonal business can suffer from a shortage of cash flow during the off-season. So here the financial manager should figure out, does the company has enough cash available to meet the potential liquidity risk? And how quickly the company can dispose of old inventory or assets to regulate the cash flow in the business?

Interest rate and currency risk are both examples of liquidity risk. As a result, the financial manager must be aware of the impact of a rapid shift in interest rates or exchange rates on the cash flow of the organization.

5. Operational Risk :

All other risks that the business can face in its **daily operations** are called operation risks. These risks include staff turnover, fraud, poor budgeting, theft, unrealistic financial projections, lawsuits, and improper market plans. All these risks can affect the bottom line of the business if they are not dealt with and handled carefully.

6. Other Risks :

Some other types of risks are legal risk, equity risk, reputational risk, interest rate risk, reinvestment risk, country risk, inflationary risk, political risk, valuation risk, model risk, IT risk, etc.

Homework ; 3

1-what are the fields that Financial risk can be risen ؟

- **2- Extract from the texts all terminologies and translated from english into Arabic (قم باستخراج كل المصطلحات وقم ترجمتها من الإنجليزية الي العربية**

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