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Financial Risk Management

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Abstract—*Current research on financial risk management centres on assessment of uncertainty, contingency and there after management of fiscal risk. Any economy is prone to credit risk and market risk primarily while secondary risks like forex risk, liquidity risk, inflation risk, votality risk and shape risk may also damage the pecuniary reserves of a firm. Multinational companies face different hindrances to overcome these challenges posed to them. However, the main focus of firms is to efficiently use financial instruments in an order where they conclude their hedging strategies . Desideratum to offset potential or substantial losses/gains that may be incurred by an organization.*

Keywords*: Risk, finance, companies, desideratum .*

1. INTRODUCTION

Risk is inherent in every trade. Risk is perceptible both in absolute and in relative terms. A better understanding of risk in its different forms can help investors to better understand the opportunities, trade-offs and costs involved with different investment approaches. Financial risk incorporates different type of risk pertaining to financial transactions that include firm loans in possibility of default. The downside peril of financial risk is always uncertain and unwanted by any firm because it accounts for loss and debt. Even the best trading house across the globe can incur loss with improper risk management. Risk management can be limiting trade lot size, hedging, trading only during certain hours or days, or knowing when to take losses. Mostly traders trade in the forex markets to make money on changes in the values of currencies over time. Risk management is one of the most key concepts to surviving as a forex trader.

Foreign-exchange risk applies to almost all of the financial instruments that are in a currency other than domestic currency. In liquid risk a given security or asset cannot be traded quickly enough in the market to achieve required profit. Default risk, is the risk associated with a borrower going who is most probably going to default. When investing in a stock it is possible to buy an option to sell that stock at a defined price at some point in the future which can result in positive hedging. The difference in pricing between beta risk and alpha risk encourages many investors to try and separate these risks: i.e. to pay lower fees for the beta risk and fixate their more expensive exposures to specifically defined alpha opportunities. Strategic and tactical asset distribution are based on modern portfolio theory, which emphasizes diversification in order to reduce risk and improve portfolio returns.

2. LITERATURE REVIEW

- Rene M stulz (1996) says that when management believes that it can identify market inefficiencies, it should exploit these carelessness paying close attention to the probability that adverse outcomes would put the firm close to or in financial blues.
- Froot A Kenneth and Stein C Jeremy togetherly state that even if the currency risk inherent in the swap can be easily laid off by the dealer bank the same is not true for default risk.
- *In the presence of any dynamics conditional densities can provide a better description of short term asset price movements than unconditional densities. This may be important for financial risk management, especially when highly leveraged instruments, such as futures contracts, are involved as discussed by David A Hsieh (1992).*
- Peter christoffersen demonstrates with Silvia Gonclaves (2004) that, issue of estimation risk is probably even more important in the more richly parameterized multivariate case.
- John M Mulvey, Daniel P Rosenbaum and Bala Shetty (1997) ellaborate more upon, how different factors contribute to the growth of financial engineering, including technological advances, changing regulations, globalisation of financial markets, increased competition ability to solve complex financial models and price votality.

3. OBJECTIVE

To get understanding of how Multi national firms use financial tools and techniques to avoid and sometimes get through financial risk and its proper management.

4. METHODOLOGY

This paper uses case research approach to understand perspective and decision making process to reduce loss and thereby effectively controlling financial risk management in the market individually and in some firms. Individual stocks possess two general categories of risk: unsystematic risk and systematic risk. Unsystematic risk is company-specific and is the liability that a certain company's price can be affected by events including governmental action, increased competition in their sector, structural changes in their industry, change of upper management (such as the departure of a person from higher post like MD or CEO), changes in consumer taste, and technological change affecting production costs. For example, disclosure to insurance companies after a large natural disaster can be costly specifically because those companies will experience unusually high amounts of claims all at once. Unsystematic risk can be reduced by constructing an adequately varied portfolio that includes a number of different stocks in a number of different sectors. Systematic risk is the fundamental economic risk deep-rooted in the system that cannot be diversified away. According to financial theory, systematic prospect is the only risk for which equity investors are rewarded. To reduce the risk of an adverse price movement is through the use of order management and with descendant. Order management strategies, such as stop-loss orders, can be sparked to avoid excess losses. Discerning how diversification within an asset class can eliminate unsystematic risk, and how diversification between asset classes can serve to further reduce risk without impacting expected return is crucial. Utilizing techniques such as order management and derivatives can also prevent excess loss from adverse price movements.

A case study on Financial Risk Management in **BMW - Bayerische Motoren Werke**

With the increasing effectiveness of internationalization, multinational firms face challenge of sustaining in the market with their earlier allure .Therefore BMW continuously improves its risk management system in order to become intimate with the respective country, industry and product risks and to ensure compliance with their sustainability standards. BMW took a two-angled approach to manage its foreign exchange exposure.

1. Natural hedge - In this approach it would develop ways to spend money in the same currency as where sales were taking place, meaning revenues would also be in the local currency.
2. Financial hedge – To reduce financial loss and manage the risk factor BMW set up regional treasury centres in the US, the UK and Singapore.

Implementation of the natural hedge strategy was implemented in two ways. The first involved establishing factories in the markets where it sold its products; the second involved making more purchases denominated in the currencies of its main markets. BMW now has production facilities for cars and components in 13 countries. In 2000, its overseas production volume accounted for 20 per cent of the total. By 2011, it had risen to 44 per cent. BMW had become one of the first premium carmakers from overseas to set up a plant in the US in mid 1990s. In 2008, BMW announced it was investing $750m to expand its Spartanburg plant in the US. The company advanced its purchasing in US dollars generally, especially in the NAFTA (North American Free Trade Agreement) region. Its office in Mexico City made $ 615m of purchases of Mexican auto parts in 2009. A joint venture with Brilliance China Automotive was set up in China, where half the BMW cars for sale in the country are now manufactured. At the end of 2010, BMW announced it would invest 1.8billion rupees in its production plant in Chennai, India, and increase production capacity in India from 6,000 to 10,000 units. Meanwhile, the overseas regional treasury centres were instructed to analyze the exchange rate exposure in their regions on a weekly basis and report it to a group treasurer, part of the group finance operation, in Munich. The group treasurer team then consolidates risk figures globally and recommends actions to mitigate foreign exchange risk.

5. RESULT

By manufacturing into foreign markets the company not only reduces its foreign exchange exposure but also benefits from being close to its customers. In addition, sourcing parts overseas, and therefore closer to its foreign markets, also helps to diverge supply chain risks.

6. CONCLUSION

Exploring the range of risks that organizations may be exposed to. Many companies have not only managed themselves to the main financial risks but also to the other risks which may indirectly impact on the finances of organizations – such as operational, reputational and legal and regulatory risk. Firms may have small exposures to the individual risks, but when these are aggregated they may have, in total, substantial financial and non-financial risks that require careful management. There is, however, no ‘one size fits all’ way of implementing financial risk management. Instead the process must be modified to fit the size, complexity, industry competition and environmental uncertainty facing the organization. For a small organization the process may be very informal, while for a company like BMW or APPLE it must be much more formalized, documented and provided with dedicated resources in the form of staff and budget.

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