TYBA Economics (2021 2022 Syllabus)
IBF II Semester 6

Module IV: Risk Management
Risk management and Derivatives- Types of Risks: Transaction risk, Translation risk, Economic risk, Settlement risk - Arbitrage- Hedging-Internal and External hedging- Derivative instruments for Risk Management -Forwards- Futures--Swaps- Options.

Topic 1: Risk management and Derivatives- Types of Risks: Transaction risk, Translation risk, Economic risk, Settlement risk

Risk management: 'It is a process of understanding and managing the risks that the entity is inevitably subject to in attempting to achieve its corporate objectives. For management purposes, risks are usually divided into categories such as operational, financial, legal compliance, information and personnel. One example of an integrated solution to risk management is enterprise risk management.' CIMA Official Terminology, 2005

What is financial risk?
'Relating to the financial operation of an entity and includes:
• **Credit risk**: possibility that a loss may occur from the failure of another party to perform according to the terms of a contract
• **Currency risk**: risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates (IAS 32)
• **Interest rate risk**: risk that interest rate changes will affect the financial well-being of an entity
• **Liquidity risk**: risk that an entity will encounter difficulty in realizing assets or otherwise raising funds to meet commitments associated with financial instruments – this is also known as funding risk.
CIMA Official Terminology, 2005
Financial risk management identifies, measures and manages risk within the organization's risk appetite and aims to maximize investment returns and earnings for a given level of risk.

Derivatives can be used to manage or reduce risk as well as to speculate.
A derivative is a financial instrument whose value depends on or is derived from the price of other financial assets or some underlying factors. The underlying variables may be commodities such as oil and gold, stocks, interest rates, currencies or some abstract conditions such as the weather. There are four main basic types: forward contracts, futures contracts, options contracts and swaps. Hybrids of these also exist.
Derivative products can be classified into exchange traded derivatives and over the counter (OTC) derivatives.

1. Exchange traded products include futures contracts and products traded on organized exchanges such as the London International Financial Futures and Options Exchange (LIFFE).

2. OTC derivatives, such as forward or swap contracts, are individually negotiated between the buyer and the seller.

Some products are available in both types of markets, such as options.

Types of Risks are discussed below:

1. **Transaction Risk**: It refers to the adverse effect that foreign exchange rate fluctuations can have on a completed transaction prior to settlement. It is the exchange rate, or currency risk associated specifically with the time delay or time lag between entering into a trade or contract and then settling it. (Investopedia)
2. **Translation Risk**: Translation Risk is the risk of change in the financial position of the company (assets, liabilities, equity) due to exchange rate changes. It is usually seen while reporting the consolidated financial statements of multiple subsidiaries operating overseas in domestic currency. It is a recurring phenomena and hence has to be recorded in every years' financial statement. Since currency fluctuations are difficult to predict, translation risk can be unpredictable. This risk is different from the transaction risk.
3. **Economic Risk**: Economic risk is referred to as the risk exposure of an investment made in a foreign country due to changes in the business conditions or adverse effect of macroeconomic factors like government policies or collapse of the current government and significant swing in the exchange rates. It is of three types-
    a) **Sovereign Risk** is the risk that a government cannot repay its debt and default on its payments. When a government becomes bankrupt, it directly impacts the businesses in the country. Sovereign Risk is not limited to a government defaulting but also includes the political unrest and change in the policies made by the government. A change in government policies can impact the exchange rate, which might affect the business transactions resulting in a loss where the business was supposed to make a profit. For example: Greek Problem after 2007-2008 Global financial Crisis.
    b) **Unexpected Swing in Exchange Rate** affects international trade. This can be due to speculation or the news that can cause a fall in demand for a particular product or currency. Oil prices can significantly impact the market movement of other traded products. As mentioned above, government policies can also result in a dip or hike in the market movement. Change in inflation, interest rates, import-export duties, and taxes also impact the exchange rate. Since this directly impacts trade, exchange rates risk seeming to be a significant economic risk.
    c) **Credit Risk** is the risk that the counterparty will default in making the obligation it owes. Credit risk is entirely out of control since it depends on another entity's worthiness to pay its debts. The counterparty's business

activities need to be monitored on a timely basis so that the business transactions are closed at the right time without the risk of counterparty default to make payments.

Economic risk can cause the downfall of not just the business but the whole market.

Although economic risk can be mitigated, it cannot be negated entirely.

Economic risk impacts international trade and has the potential to create a lasting effect on the business activities of all participants.

- Economic risk makes a native investment look more attractive than an international investment due to its calm nature and reduced risk for an investor.
- Economic risk can be mitigated by investing in international mutual funds which enable them to invest in a plethora of products, thereby reducing the losses arising out of an unforeseen event.

4. **Settlement risk**: This risk is more often associated with currency trading. It implies the risk or probability that one party will not uphold their contractual obligation in a transaction or deal. It can also apply to any contractual deal between two parties. This is very inherent in two or multiparty transactions. It represents a loss on the part of the other party. For this reason, settlement risk is the risk of loss for either party should the counterparty not come through.