Managing financial risk essay

Business, Company

The chapter deals with discussion over ever increasing financial risk in today's financial environment for the organizations. Author blames the end of Breton Woods System in 1972 that led to volatility of interest rates, exchange rates and commodity prices. However, post 1970 arena was a welcome for increasing financial risk as the CEO's and CFO's linked this volatility with higher profitability in response to large movements in interest rates and exchane rates and in recognition to this increased financial risk the top executives in an organization deals with following issues:

- Extent to which their firm is exposed to interest rates, exchange rates or commodity prices.
- Financial tools available as a solution for managing these risk exposures
- How will the financial tools be helpful in managin these risks.

And the author deals with discussion over these issues only.

In terms of measuring the risk exposure, author cites the example of Saving and Loans which are negatively related to the interest rates. This is because Saving and Loans are used primarily for funding the long term lived assets with liabilitiesrepricing on frequent basis, thus when interest rates rises, value of Saving and Loans declines and with little affect on liabilties, it is the shareholder's equity that falss substantially and vice-versa. Following graph depicts the relationship between Interest Rates and Saving and Loans:

Risk Profile

The graph depicts risk profile of Saving and Loans. As the actual interest rates rises above the expected rates, the value of Saving and Loans's asset declines relative to the value of its liabilities and thus, the value of the firm

declines.

After discussing various aproaches of measuring the financial risk and available tools to counter these financial risks, author concludes the chapter by discussing as how the available tools will help in managing the financial risks, to which he states as:

- Exposure can be managed in number of ways as individually using a financial instrument-for example by using interest rate swap to hedge against interest risk.
- Using combinations of available tools to manage the financial risk-for example buying a call and selling a put to minimize the out of pocket costs to hedge.

Works Cited

Clifford Smith, C. S. Managing Financial Risk. In Risk Management (pp. 345-366).