ARTICLE ON FINANCIAL RISK

(Part-1)

Financial risk is a broader term and may differ from person to person. From an investor point of view it may be any downward movement in the returns from expected/proposed and from the banker's point of view delays/defaults in the payment of principle and/or interest. Hence financial risk is an umbrella term for any risk associated with any form of financing.

A. Investment risk

On ground of assurance of the return, there are two kinds of Investments - Riskless and Risky. Riskless investments are investments which are backed by guarantee of stable government. Investments in government securities are generally called riskless. These investments carry lower returns in comparison to other. But in today scenario it is also become Risky if we see the position of European Countries specially Portugal, Greece and Spain. Investors are so scared that they find it difficult to see how these economies are going to return to reasonable growth.

Further there may be risk of devaluation of the currency (inflation) is a form of risk appropriately called "inflation risk." Therefore no venture can be said to be by nature "risk free" - merely very close to it where the guarantor is a stable government.

Depending on the nature of the investment, the following are considered as investment risk.

1. Capital risk is the risk of losing the initial amount invested (also known as "the capital"). It means negative cash flows or internal rate of return (IRR) is lower than the cost of capital.

2. Currency risk is the risk associated with the foreign currency movement affecting the value of an asset if the invested assets are being held in that currency. The USA and China are quarrelling on the issue of free movement of Renminbi, reason being the increasing trade deficit of USA because of undervaluation of Chinese currency.

3. Many forms of investment may not be readily saleable on the open market (e.g. immovable assets) or the market has a low capacity and may therefore take time to sell. On the contrary assets that are easily sold are termed liquid; therefore this type of risk is termed "liquidity risk."

Therefore, the risk that there may be a disruption in the internal financial affairs of the investment, thereby causing a loss of value, is called "financial risk." A prime example of that form of risk was experienced by the investors in Enron, or one of the "dot-com" stocks that really never did have a profitable financial footing. Many of the employees of Enron experienced both liquidity and financial risk as the price decline in the stock of that company occurred just as there was a "freeze" on stock liquidation in their retirement plans.

B. **Business risk**

The risk that a company or project will not have adequate cash flow to meet financial obligations; thus causing the business to file for bankruptcy.

Financial risk is the additional risk a shareholder bears when a company uses debt in addition to equity financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.

Whilst higher risk normally implies higher overall rewards, this is not always the case. For example a high risk mortgage client or unsecured business loan client may be required to pay a higher interest rate. Also few NBFC's take unaccounted incomes as a basis for calculating the repayment capacity but charge very high interest say 20% to 36% pa.

But this higher interest rate itself increases the risk to the bank/financial institution that the customer cannot meet their interest payments timely, further increasing the risk. Higher interest rates for high risk borrowers make the borrowers even less likely to be able to pay back the loan, further increasing the default risk. We have example like Citi bank and Barclay which were very active in personal loan, unsecured business loan and other similar products but ultimately shifted their business model due to high defaults.

C. **Credit risk**

Credit risk is a lenders risk of loss of money which it has lent (secured and/or unsecured) arising due to non payments of principle and/or interest as promised. Such an event is called a default. Another term for credit risk is **default risk**.

Lender losses include lost of principal and/or interest, decreased cash flow, increased collection costs, delays of servicing of installment, settlements of loan at lower amount etc.

Assessing credit risk:

Significant resources and sophisticated programs are used to analyze and manage risk. Some companies run a credit risk department whose job is to assess the financial health of their customers, and extend credit (or not) accordingly. They may use in house programs to advice on avoiding, reducing and transferring risk. For example every bank has its own system of internal rating which decides whether a proposal is doable or not.

They also use third party provided intelligence. Companies like CARE, Fitch, ICRA and CRISIL provide such information. As per Basel-II norms, Bankers must ask to the client to take External Rating done by one of External agency (mentioned above) if the exposure is more than 5 cr.

Most lenders employ their own models (credit scorecards) to rank potential and existing customers according to risk, and then apply appropriate strategies. With products such as unsecured personal loans or mortgages, lenders charge a higher price for higher risk customers and vice versa. With revolving products such as credit cards and overdrafts, risk is controlled

through the setting of credit limits. Products such as extending credit in the form of Cash Credit, Term loan etc bank is asking for security ranging from 75% to 200% depending upon the nature of industry most commonly in the form of property. Here we can say now-a-days banks are giving loans/ credit facilities against some security (movable or immovable). For example working capital limits are secured by current assets as well as by some collateral (land and/or building). But the collateral should be mortgage-able otherwise the bank will not accept the same.

Credit scoring models also form part of the framework used by banks or lending institutions grant credit to clients. For corporate and commercial borrowers, these models generally have qualitative and quantitative sections outlining various aspects of the risk including, but not limited to, operating experience, management expertise, asset quality, and leverage and liquidity ratios, respectively. Once this information has been fully reviewed by credit officers and credit committees, the lender provides the funds subject to the terms and conditions presented within the contract.

Now a day's, CIBIL is very important source to know whether the borrower has done any defaults, over-dues of installments, settlements, and write-off of loans. It contains the credit history of the clients. Reserve Bank of India is also release a report on regular basis having the details of the defaults which is circulated to banks, financial institutions and credit rating agencies.

Credit risk has been shown to be particularly large and particularly damaging for very large investment projects, so-called megaprojects. This is because such projects are especially prone to end up in what has been called the "debt trap," i.e., a situation where – due to cost overruns, time over run, etc. – the costs of servicing debt becomes larger than the revenues available to pay interest on and bring down the debt. These projects are normally guaranteed by governments and appraisal is done by highly qualified/experienced independent agencies so that any kind of cost overrun and time overrun could be checked/controlled well in advance.

D. Sovereign risk

Sovereign risk is the risk of a government becoming unwilling or unable to meet its loan obligations, or fails to carry out promise or commitment on loans it guarantees. The existence of sovereign risk means that creditors should take a two-stage decision process when deciding to lend to a firm based in a foreign country. Firstly one should consider the sovereign risk quality of the country and then consider the firm's credit quality.

Five macroeconomic variables that affect the probability of sovereign debt rescheduling are:

- Debt service ratio
- Import ratio
- Investment ratio
- Variance of export revenue
- Domestic money supply growth

E. Counterparty risk

Counterparty risk is the risk that an organization does not pay out on a bond, credit derivative, credit insurance contract, or other trade or transaction when it is supposed to pay. Even organizations who think that they have hedged their bets by buying credit insurance of some sort still face the risk that the insurer will be unable to pay, either due to temporary liquidity issues or longer term systemic issues.

Large insurers are counterparties to many transactions, and thus this is the kind of risk that prompts financial regulators to act, e.g., the bailout of insurer AIG.

For any query, assistance and suggestion, kindly contact to undersigned.

Manoj Gupta & Co

CA. Manoj Kumar Gupta

Cell: 9350760606