Chapter 8

A Study on Risk Management in Financial Market

Smruti Rekha Das
SOA University, India

Kuhoo
College of Engineering and Technology, India

Debahuti Mishra
SOA University, India

Pradeep Kumar Mallick
Vignana Bharathi Institute of Technology, India

ABSTRACT

The basic aim of risk management is to recognize, assess, and prioritize risk in order to assure that the uncertainty should not deviate from the intended purpose of the business goals. Risk can take place from various sources, which includes uncertainty in financial markets, recessions, inflation, interest rates, currency fluctuations, etc. Various methods used for this management of risk are faced with various decisions such as the market price, historical data, statistical methodologies, etc. For stock prices, the information derives from the historical data where the next price depends only upon the current price and some of the outside factors. Financial market is very risky to invest money, but the proper prediction with handling the risk will benefit a lot. Various types of risk in the financial market and the appropriate solutions to overcome the risk are analyzed in this study.

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INTRODUCTION

Financial risk is basically a risk associated with financing, which includes financial transactions such as purchasing, loan, mortgage, bank account, credit card, debit card etc. In terms of handling the business in finance, the risk is faced; apart from managing the financial risk other types of risk may come, which has a great impact over the business phenomenon such as natural disasters, political issues, disease breakouts by giving an importance to employee health issues etc. Various types of risk is related with financial market such as market risk, liquidity risk, equity price risk, foreign exchange risk, commodity price risk, credit risk, foreign investment risk, operational risk, model risk, financial risk etc. The financial risk management concept dramatically changes on various future time horizons.

In this study, we will analyze about various types risk and how to overcome from the risk with the effective factor of the solution. This study undergoes the analysis of various types of risk occurring in the financial market. The work flow of the paper is ordered as follows: section 2 analyses over various risk factors of financial market, section 3 describes about approaches to solve the issues arising in the form of risk in the financial market and finally section 4 concludes the study.

ANALYSIS OF VARIOUS TYPES OF FINANCIAL RISK

Market Risk

Market risk arises due to the market price movements of financial instruments. Under market risk another sub category of risk is associated, which is known as interest risk. It arises due to the movement of interest rate. Through this the interest related price is affected, such as bonds, loans, etc. If the interest rate will be increased, then the value of bonds will be decreased. To manage this type of risk, various hedges are available, such as forward rate agreements and interest rate swaps. Hedging concept is introduced to mitigate the risk basically reduce any type of substantial losses, when a combination of assets is selected for investment to offset the movements. When investing in stocks, simultaneously there is a sell option is available to sell out that stock at some point in the future. Like hedging, derivatives are also used to reduce various types of risk. Market risk can be arranged in various classes such as risk exists in interest rate, risk exists in exchange rate, risk exists in equity, risk exists in commodity price and so on (Dowd, 2007).

How to manage the risk before estimating the value at risk is possible by various methods such as analysis of gap, analysis of duration, analysis of scenario, portfolio theory etc. Analysis of Gap will determine a particular time horizon, so that the
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