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MANAGING FINANCIAL RISK IN CORPORATE FINANCE

Abstract

Financial risk management in corporate finance includes the processes of identifying, assessing and minimizing various threats, such as currency, interest rate, credit and market risks. The goal is to protect the financial stability of the company and ensure the stability of its operations. Effective management methods, including hedging, diversification and monitoring, help reduce potential losses and increase business value.

Key words: *market risk, interest rate, currency and credit risk management.*

INTRODUCTION

In the context of economic globalization and increased competition, financial risk management is becoming one of the key tasks for companies seeking to ensure their sustainability and long-term development. Financial risks, such as market, credit, operational and liquidity risks, can have a significant impact on the financial condition of the company, its profitability and reputation. Failure to effectively manage these risks can lead to significant losses, a decrease in business value and even bankruptcy. Financial risks arise as a result of uncertainty associated with changes in financial markets, fluctuations in exchange rates, interest rates, prices for raw materials and other assets. In addition, companies face risks associated with changes in the macroeconomic environment, political instability and regulatory changes. In such conditions, financial risk management becomes not only a tool for minimizing losses, but also a strategic resource for creating competitive advantages. The goal of financial risk management is to reduce the negative impact of unfavorable events on the company's financial results and ensure the fulfillment of its strategic objectives. To achieve this goal, companies use various methods and tools, including hedging, diversification, insurance, reserve creation and the implementation of modern risk management systems. An important aspect is also the integration of risk management into the overall strategy of the company, which allows taking risks into account at all levels of decision-making. This article discusses the main approaches to financial risk management in corporate finance, including methods for identifying, assessing and minimizing risks. Particular attention is paid to the use of derivative financial instruments for hedging, as well as the role of risk management in increasing the stability and value of the company. Using practical examples, successful risk management strategies and their impact on the financial performance of companies are analyzed. The relevance of the topic of financial risk

management is due to the need for companies to adapt to rapidly changing business conditions and increase their resilience in the face of uncertainty. The article also discusses modern trends in risk management, including the use of big data, artificial intelligence and other technologies for risk forecasting and management.[1]

THEORETICAL APPROACHES

Interest rate risk, which affects companies with debt obligations or significant interest-bearing assets, can lead to fluctuations in financial performance. This type of risk is especially relevant when the company's borrowings are subject to variable interest rates. As interest rates rise or fall, it directly impacts the cost of debt or the returns on interest-earning assets, potentially affecting profitability.

In SOCAR company, this risk primarily arises from **loans, debt obligations, and trade receivables** that are sensitive to changes in base interest rates (such as LIBOR or EURIBOR).[3]

LIBOR (London Interbank Offered Rate) and EURIBOR (Euro Interbank Offered Rate) are key indices that have historically been used to determine interest rates in the interbank market. Here are their main differences and similarities:

- LIBOR is the rate at which banks offer each other short-term loans in the London interbank market.
Currency: Covers several currencies: USD, GBP, EUR, CHF, JPY, etc.
Maturity: Set for various maturities: from one day to one year.
Usage: Used to calculate interest rates on loans, bonds, derivatives, and other financial products.
Current situation: LIBOR was officially phased out by the end of 2021 for most currencies, and has been replaced by alternative indices such as SOFR (in the US), SONIA (in the UK), and others.
- EURIBOR is the rate at which leading banks in the eurozone offer each other short-term loans.
Currency: Used exclusively for euro (€) transactions.
Maturity: Also covers different periods, from one day to 12 months.
Usage: Widely used in the eurozone for loans, mortgages, bonds and derivatives.
Current situation: EURIBOR remains the relevant rate and continues to be used, although its methodology has been reformed to meet modern requirements.

Key differences

Geographical scope:

LIBOR is a global rate covering several currencies.

EURIBOR is a rate exclusively for the eurozone and euro transactions.

Current status: LIBOR has been replaced by alternative rates.

EURIBOR continues to be used with an updated methodology.

The company's sensitivity to interest rate changes is analyzed by looking at how variations in **interest rates** affect the pre-tax profit of the company.

The sensitivity of a company to changes in interest rates is also analyzed through the impact of these changes on the financial stability of the company, in particular, on its profit before tax (PBT, Profit Before Tax). This analysis is usually carried out taking into account the following factors:

1. The structure of the company's debt:

If the company has a significant share of borrowings with a floating interest rate, then changes in rates (increase or decrease) will have a significant impact on the cost of servicing the debt. This directly affects the profit before tax.

2. The type of interest rate:

- Floating rates make the company more sensitive to market changes.
- Fixed rates provide protection in the short term, but may be less profitable in an environment of falling interest rates.

3. Interest coverage:

This is an indicator that assesses the extent to which a company's profit is able to cover interest expenses. A high debt burden with low interest coverage increases the risk for the company when rates rise.

4. Market strategy:

Some companies are able to pass on increased costs to customers by raising prices. This reduces their sensitivity to changes in interest rates.

5. Cash Flows:

Changes in interest rates can also affect the cost of financing new projects, which is reflected in future earnings.

6. Financial Hedging Instruments:

Derivatives such as interest rate swaps or options can be used to reduce the company's sensitivity.

The analysis is conducted using stress tests and scenario analysis to understand how different rate scenarios affect the company's financial performance.

Managing foreign exchange risk is crucial for companies operating in multiple currencies. Your company's FX exposure is primarily to the **USD**, **EUR**, and **TL**, with fluctuations in these currencies potentially having significant impacts on pre-tax profits. By employing hedging strategies such as forward contracts, currency swaps, and options, and considering natural hedging techniques, the company can protect itself against volatility in exchange rates and maintain more predictable financial outcomes.[2]

ANALYSIS

Sensitivity Analysis for Interest Rate Risk

The table below demonstrates the **sensitivity analysis** for potential changes in base interest rates (the hypothetical increase or decrease in interest rates) and their impact on the company's **pre-tax profit** for 2023 and 2022. [7]

Table 1

Sensitivity Analysis for 2023:	
Base Rate Change (%)	Impact on Pre-Tax Profit (AZN)
USD Interest Rates (+60/-60)	-33 / +33
EUR Interest Rates (+45/-45)	-10 / +10

Source: <https://corporatefinanceinstitute.com/resources/knowledge/finance/cash-turnover-ratio-ctr/>

Table 2

Sensitivity Analysis for 2022:	
Base Rate Change (%)	Impact on Pre-Tax Profit (AZN)
USD Interest Rates (+60/-60)	-50 / +50
EUR Interest Rates (+45/-45)	-12 / +12

Source: <https://corporatefinanceinstitute.com/resources/knowledge/finance/cash-turnover-ratio-ctr/>

Key Insights from the Sensitivity Analysis

- **USD Interest Rate Sensitivity:**

- **2023:** A **60 basis point (bps) increase or decrease** in the **USD base interest rate** leads to a **33 AZN** reduction or increase in pre-tax profit, respectively.

- **2022:** A **60 bps change** in the **USD base interest rate** led to a **50 AZN** fluctuation in pre-tax profit. This suggests that the company's **interest rate risk exposure** to USD has decreased slightly in 2023 compared to the previous year.

- **EUR Interest Rate Sensitivity:**

- **2023:** A **45 bps increase or decrease** in the **EUR base interest rate** results in a **10 AZN** change in pre-tax profit.

○ **2022:** Similarly, a **45 bps change in EUR base interest rates** led to a **12 AZN** impact on pre-tax profit. The change in EUR sensitivity is relatively minimal, reflecting a limited exposure to interest rate movements in EUR.[6]

Given the company's exposure to **interest rate changes** and their impact on profitability, the following **risk management strategies** could be applied:

1. Interest Rate Hedging:

○ **Interest Rate Swaps:** The company could enter into **interest rate swap agreements** where it exchanges its variable interest payments for fixed-rate payments, reducing the risk of higher interest rates in the future.

○ **Forward Rate Agreements (FRAs):** These are contracts that allow the company to lock in future interest rates, providing certainty regarding borrowing costs.

2. Refinancing:

○ If the company anticipates that interest rates may rise in the future, it may consider **refinancing existing debt** to lock in lower, fixed interest rates. This could help mitigate the potential negative impact of future interest rate hikes.

3. Diversification of Debt:

○ The company may want to **diversify its debt portfolio**, incorporating both fixed and floating-rate instruments, so that its overall debt servicing costs are less sensitive to interest rate fluctuations.

4. Cash Flow Management:

○ Effective **cash flow management** is essential to ensure that the company can handle changes in interest expenses without negatively affecting operations. By forecasting potential interest rate changes and preparing adequate cash reserves, the company can ensure liquidity during periods of rate volatility.[5]

Currency Risk Management: Hedging Strategies

Given its significant exposure to currency risk, a company may wish to employ risk management strategies to mitigate these fluctuations. Some strategies include:

Hedging using forward contracts. Fixing exchange rates for future periods ensures that the company can predict the cost of future transactions in foreign currencies (for example, US dollars or euros).

Example: If a company has a payment due in US dollars within three months, entering into a forward contract will allow you to lock in the current exchange rate, protecting you from potential depreciation.

Currency swap. A currency swap involves exchanging cash flows in different currencies. For example, a company can exchange fixed payments in Turkish lira for fixed payments in US dollars, reducing the impact of exchange rate fluctuations.

Natural hedging. One of the simplest approaches is to compare income and expenses in the same foreign currency. For example, if your company's revenue streams are denominated in US dollars, the cost of sourcing US dollar-denominated suppliers can help offset currency risk.

Options on foreign currency. The use of options contracts can provide flexibility by giving the company the right (but not the obligation) to exchange currencies at predetermined rates. This can be an effective strategy for managing the risk of reducing adverse currency movements while not missing out on opportunities if the currency moves favorably.[4]

In summary, managing market risk - including foreign exchange (FX) risk and interest rate risk - is crucial for protecting profitability and ensuring financial stability.

For FX risk, hedging through forward contracts, currency swaps, and options can help the company lock in exchange rates and protect against volatility. Similarly, for interest rate risk, tools such as interest rate swaps, forward rate agreements, and diversification of debt can reduce exposure to fluctuating borrowing costs.

The company's risk management framework should also consider the overall enterprise risk management (ERM) approach, integrating both FX and interest rate risk mitigation strategies into broader financial planning.

CONCLUSION

Financial risk management is an integral part of corporate finance and plays a key role in ensuring the sustainability and competitiveness of a company. Financial risks, such as market, credit, operational and liquidity risks, can have a significant impact on a company's financial condition, profitability and reputation. Effective management of these risks allows you to minimize potential losses and maximize the company's value for shareholders. Successful financial risk management requires not only technical knowledge, but also strategic thinking. Companies must consider both internal factors (e.g. capital structure and operational efficiency) and external factors (e.g. macroeconomic conditions and changes in financial markets). In addition, it is important to maintain a balance between risk minimization and growth opportunities, since excessive caution can limit a company's potential. In today's environment of high market volatility and global uncertainty, financial risk management is becoming increasingly complex and important. Companies that are able to effectively identify, assess and manage risks have a better chance of long-term success and sustainable development. Thus, financial risk management in corporate finance is not just a technical task, but a strategic necessity that requires an integrated approach, a deep understanding of financial instruments and constant adaptation to changing business conditions.

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Korporativ maliyyədə maliyyə risklərinin idarə edilməsi

Xülasə

Korporativ maliyyədə maliyyə risklərinin idarə edilməsi valyuta, faiz dərəcəsi, kredit və bazar riskləri kimi müxtəlif təhlükələrin müəyyən edilməsi, qiymətləndirilməsi və minimuma endirilməsi proseslərini əhatə edir. Məqsəd şirkətin maliyyə sabitliyini qorumaq və fəaliyyətinin sabitliyini təmin etməkdir. Hedcinq, diversifikasiya və monitoring daxil olmaqla effektiv idarəetmə təcrübələri potensial itkiləri azaltmağa və biznes dəyərini artırmağa kömək edir.

Açar sözlər: bazar riski, faiz dərəcəsi, valyuta və kredit riskinin idarə edilməsi.

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Управление финансовыми рисками в корпоративных финансах

Резюме

Управление финансовыми рисками в корпоративных финансах включает в себя процессы выявления, оценки и минимизации различных угроз, таких как валютные, процентные, кредитные и рыночные риски. Цель - сохранение финансовой устойчивости компании и обеспечение стабильности ее деятельности. Эффективные методы управления, включая хеджирование, диверсификацию и мониторинг, помогают сократить потенциальные потери и повысить стоимость бизнеса.

Ключевые слова: *рыночный риск, процентная ставка, валютный и кредитный риск-менеджмент.*