What is Financial Risk? How Can It Be Reduced?

Meaning of Financial Risk

Financial risk refers to the **possibility of loss arising from the use of borrowed funds (debt)** in the capital structure of a business. It is the risk that a company may **not be able to meet its fixed financial obligations**, such as **interest payments, loan instalments, and preference dividends**, especially during periods of low earnings.

In simple words, financial risk arises because of **financial leverage**—the use of fixed-cost sources of finance. Higher the debt in the capital structure, **higher is the financial risk**.

Nature of Financial Risk

- It is related to the **financing decision** of the firm
- It affects **equity shareholders** directly
- It increases with higher **fixed financial charges**
- It exists even if business risk remains constant

Causes of Financial Risk

1. **Excessive Use of Debt**
   Heavy dependence on loans and debentures increases fixed obligations.
2. **High Fixed Interest Charges**
   Regular interest payments must be made irrespective of profits.
3. **Low or Fluctuating Earnings**
   Unstable profits increase the possibility of default.
4. **Poor Financial Planning**
   Improper capital structure and cash flow management add to risk.
5. **Economic and Market Conditions**
   Inflation, recession, and high interest rates worsen financial risk.

How Can Financial Risk Be Reduced?

1. Balanced Capital Structure

A company should maintain a **proper balance between equity and debt**.
Over-capitalization through debt should be avoided.

Benefit:
Reduces fixed financial burden and risk of insolvency.

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2. Increase Equity Financing

Raising funds through:

- Equity shares
- Retained earnings

helps reduce dependence on borrowed funds.

Benefit:
No fixed interest obligation.

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3. Maintain Adequate Coverage Ratios

Companies should ensure:

- Sufficient **interest coverage ratio**
- Adequate **debt service coverage ratio (DSCR)**

Benefit:
Improves confidence of lenders and investors.

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4. Proper Financial Planning and Forecasting

Sound financial planning includes:

- Cash flow forecasting
- Matching debt maturity with income generation

Benefit:
Ensures timely payment of financial obligations.

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5. Use of Long-Term Debt Wisely

Long-term debt should be:

- Used for long-term projects
- Avoided for short-term needs

Benefit:
Reduces refinancing and liquidity risk.

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6. Maintain Adequate Liquidity

Maintaining:

- Sufficient cash balance
- Liquid assets

helps meet obligations during difficult periods.

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7. Diversification of Income Sources

Diversifying:

- Products
- Markets
- Revenue streams

stabilizes earnings.

Benefit:
Reduces uncertainty in profits.

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8. Control of Fixed Costs

Reducing fixed costs improves:

- Operating profits
- Ability to pay interest

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9. Conservative Dividend Policy

Retaining profits instead of distributing them fully as dividends strengthens the financial position.

Difference Between Financial Risk and Business Risk

Basis	Financial Risk	Business Risk
Cause	Use of debt	Nature of business operations

Basis	Financial Risk	Business Risk
Control	Can be reduced	Cannot be fully controlled
Fixed cost	Interest and dividends	Operating expenses
Affects	Equity shareholders	Entire business

Financial risk is an **avoidable and controllable risk** that arises due to excessive dependence on borrowed funds. By adopting a **balanced capital structure, sound financial planning, adequate liquidity, and prudent debt management**, a firm can significantly reduce financial risk and ensure long-term financial stability.