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The Significance Of Market Risk For A Financial Organization

M.Kh. Akhunova

Lecturer, Fergana State Technical University, Fergana, Uzbekistan

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Abstract: One of the most significant challenges in modern economic science is the steady growth of risks associated with operations in financial and stock markets. Among the various types of financial risks, market risk occupies a central position due to its direct impact on the stability and performance of financial organizations. Market risk arises as a result of fluctuations in market variables such as interest rates, exchange rates, equity prices, and commodity prices, which can adversely affect the value of financial assets and liabilities. This paper analyzes the main causes and sources of market risk formation in the context of contemporary financial markets. Special attention is paid to the conditions under which market risk intensifies and influences the decision-making processes of different groups of financial market participants. Furthermore, the study outlines key conceptual approaches to defining market risk and reviews commonly used methods for its measurement and assessment. Understanding the nature of market risk and its implications is essential for improving risk management systems and ensuring the financial sustainability of organizations.

Keywords: Risk, market risk, market risk definition, market risk assessment, measurement methods.

Introduction: Market risk is defined as the risk arising from changes in interest rates, exchange rates, prices of securities, derivative instruments, commodities, and other factors that directly or indirectly affect the value of financial instruments. Unlike operational or credit risks, market risk has a pronounced macroeconomic nature, as its sources are primarily linked to the overall performance of the financial system, including market indices, monetary policy indicators, and global economic conditions [1]. As a result, market risk plays a critical role in determining the financial stability and resilience of financial organizations.

In the course of their activities, enterprises and financial institutions are exposed to a wide range of risks that can significantly affect their profitability and sustainability. Effective risk management requires a systematic approach that includes the identification, classification, analysis, and assessment of various risk types. Among these stages, the classification of risks and the identification of their underlying causes serve as the foundation for developing appropriate risk mitigation strategies [2]. Without a clear understanding of risk categories and their origins, it becomes difficult to design efficient tools for risk reduction.

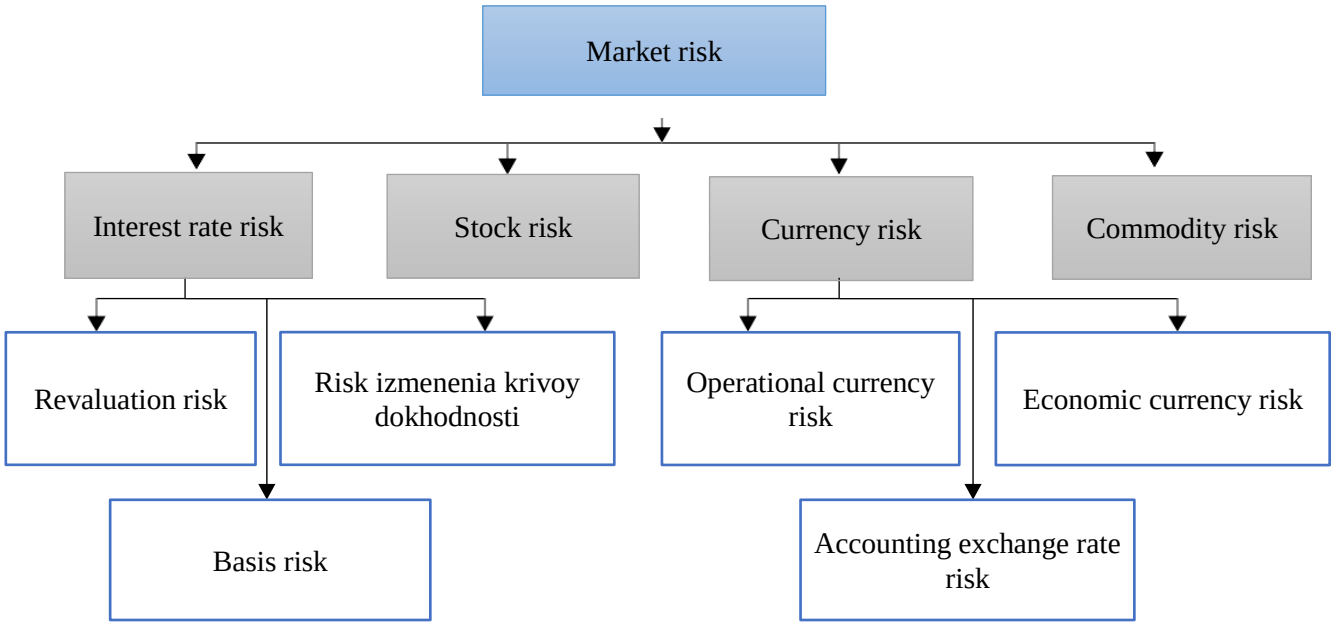
There are numerous approaches to risk classification in economic and financial literature. These approaches differ depending on the selected classification criteria, such as the source of risk, the nature of its impact, or the level at which it manifests itself [3]. Some classifications emphasize financial versus non-financial risks, while others focus on internal and external risks or systematic and unsystematic risks. Market risk is commonly classified as a systematic risk, as it affects all market participants to varying degrees and cannot be eliminated through diversification alone [4].

According to the author's perspective, the most significant criteria for risk classification include the time of occurrence, factors of emergence, place of occurrence, sphere of influence, nature of consequences, and the magnitude of potential losses. These criteria allow for a comprehensive assessment of risks and facilitate the selection of appropriate management methods. In particular, the classification based on the size of possible losses enables organizations to prioritize risks and allocate resources more efficiently [5]. A summarized classification of risks

based on these criteria is presented in Table 1.

In modern financial markets, the importance of market risk has increased due to globalization, financial integration, and the growing complexity of financial instruments. Volatility in global markets, rapid capital flows, and increased sensitivity to macroeconomic shocks amplify the potential impact of market risk on financial organizations. Therefore, the study of market risk, its sources, and classification features remains a relevant scientific task aimed at improving risk management practices and enhancing financial stability [6].

Table 1. Classification of Risks



Causes of Economic and Market Risks

The causes of economic risks in a market economy are diverse and multifaceted. One of the primary sources of risk is the uncertainty of market conditions. In pursuit of profit, producers attempt to anticipate consumer demand and sell products at favorable prices. However, in doing so, they face the risk of being overtaken by competitors, investing resources in non-promising goods that lack market demand, or producing volumes that exceed actual market needs. Such miscalculations may result in financial losses and inefficient allocation of resources.

Another significant source of economic risk is natural disasters, which can negatively affect the quality and efficiency of a firm's capital resources. Natural hazards may disrupt production processes, damage infrastructure, and reduce overall operational capacity. In addition, unfavorable combinations of factors related to production disruptions, downtime, or interruptions in core business activities can further intensify economic risks and lead to unexpected losses.

Economic risks are also influenced by changes in prices, taxation systems, depreciation rules, and accounting regulations. Such changes may reduce the income remaining at the disposal of companies and weaken their financial position. Furthermore, shifts in the political environment, fluctuations in exchange rates, and instability in financial markets increase uncertainty and amplify market risk exposure.

Illegal activities, including fraud or dishonest behavior by employees in the performance of their duties, represent another important source of risk. These internal threats can undermine organizational integrity and lead to both financial and reputational losses. Additionally, changes in legislation, imperfections in legal frameworks, incorrect application of laws by state authorities, and deficiencies in the judicial system contribute to an unstable business environment and increase risk levels.

Finally, the occurrence of economic crises and production downturns significantly elevates market and economic risks. Periods of recession are typically accompanied by declining demand, reduced investment activity, and heightened volatility in financial markets, all of which adversely affect the stability of financial organizations.

It should be emphasized that the emergence of market risk may be caused by both internal and external factors. Internal factors are primarily related to management decisions, organizational structure, and

operational processes, while external factors stem from macroeconomic conditions, political changes, legal frameworks, and global market fluctuations. A systematic classification of internal and external causes of market risk is presented in Table 2.

Table 2. Internal and external causes of market risk

Internal Causes	External Causes
Malicious manipulations in the acquisition and sale of financial instruments	Changes in foreign exchange rates
Erroneous actions in the purchase/sale of financial instruments, including mistakes in timing and volume	Mismatch of maturities of assets, liabilities, and off-balance-sheet claims and obligations on instruments with variable interest rates (interest rate repricing risk)
Improper use of the banking system and financial infrastructure	Mismatch of maturities of assets, liabilities, and off-balance-sheet claims and obligations on instruments with fixed interest rates

Measurement of Market Risk

Let us consider the measurement of market risks. At present, one of the most widely used methodologies for measuring market risk worldwide is the Value-at-Risk (VaR) approach. VaR is a statistical method based on probability distributions, which link all possible changes in market conditions to their corresponding probabilities.

The VaR methodology has several undeniable advantages. First, it allows market risk to be measured in terms of potential losses associated with a given probability level. Second, VaR makes it possible to aggregate the risks of individual positions into a single comprehensive measure for the entire portfolio, while taking into account the number of positions, market volatility, and the holding period of assets. Owing to these characteristics, VaR represents a unique and highly practical approach to the assessment of market risk.

To calculate VaR, it is necessary to determine a number of basic elements that influence its magnitude. The most important of these is the probability distribution of market factors that directly affect changes in the prices of assets included in the portfolio. Clearly, constructing such a distribution requires historical statistical data on the behavior of each asset over time. If it is assumed that the logarithms of asset price changes follow a normal (Gaussian) distribution with a zero mean, then it is sufficient to estimate only volatility, that is, the standard deviation of returns. However, in real financial markets, the assumption of normality is often violated due to the presence of fat tails, skewness, and extreme events.

An illustrative example explaining the concept of VaR is shown in Figure 1. The curve in the figure represents the probability distribution of profits and losses for a given portfolio and holding period. The lightly shaded area corresponds to the selected confidence level (97.5%), meaning that its area constitutes 97.5% of the total area under the curve. VaR is defined as the magnitude of potential losses corresponding to the chosen confidence level, indicating the maximum expected loss that will not be exceeded with a given probability over the specified time horizon.

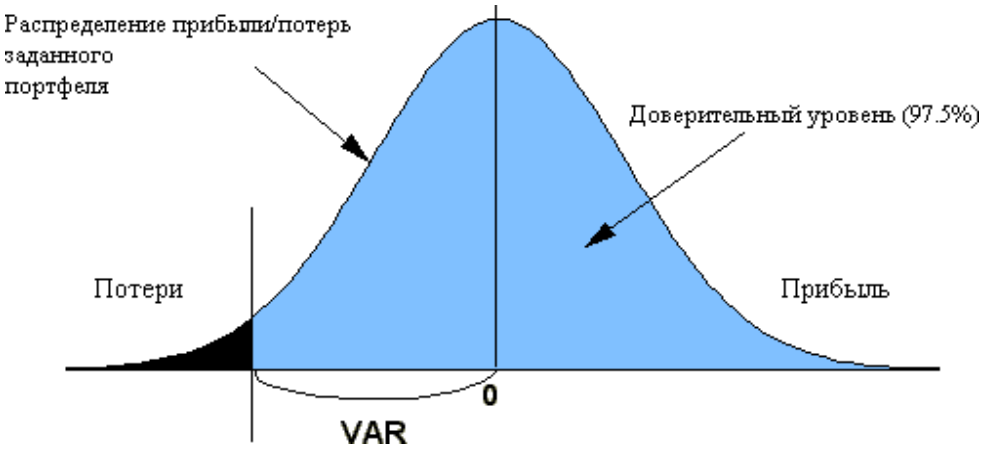


Figure 1. An Example Illustrating the Concept of Value-at-Risk (VaR)

The primary danger of market risk, as with any type of financial risk, lies in the fact that it leads to instability of cash flows over time. Ultimately, this instability has a serious impact on an organization's financial performance and, above all, on its financial sustainability. Fluctuating market conditions may cause unpredictable gains and losses, complicating financial planning and weakening long-term stability.

The lack of sufficient attention to market risk is often explained by the belief that, in real-life conditions, market risks may be naturally neutralized. A typical example is the practice of exporters who repeatedly convert foreign currency revenues. Losses resulting from unfavorable price movements in some transactions are, on average, "netted" against additional profits arising from favorable price changes in transactions of the opposite direction. At first glance, it may appear that the longer an organization operates in the market and the greater the number of transactions performed, the more justified the expectation of natural risk neutralization becomes. However, to assess how justified such expectations are, it is necessary to conduct a simple "experimental" analysis.

When considering risk management under Russian economic conditions, it can be noted that during the initial stage of development of the banking and financial sector, the primary concern was the risk of losses resulting from counterparties' failure to meet their obligations, that is, credit risk. The subsequent development of the financial sector in line with Western standards led to a shift in priorities. Issues related to the management of interest rate risk, foreign exchange risk, and the risk of changes in the market value of securities and derivative financial instruments—collectively referred to as market risk—came to the forefront.

The global stock market crisis and the subsequent announcement by the Central Bank regarding a horizontal exchange rate corridor resulted in sharp fluctuations in the yields of government and corporate securities, amounting to 10–20 percent. In this case, market risk was the primary source of significant financial losses. Of particular interest is the assessment of the risk inherent in such natural neutralization mechanisms.

Several general principles can be identified as the foundation of an effective risk management system:

- The initiative to establish a risk management system originates from top management and is driven by an understanding of the importance of risk management;
- The implementation of an integrated and functioning risk management system aimed at achieving the company's strategic objectives;
- The creation of a specialized support unit responsible for risk analysis and management;
- Compliance with the principle of independence of the risk management unit from other divisions of the company;
- The development of a regulatory and documentation framework that enables comprehensive risk analysis of investment projects;
- The application of a risk management mechanism based on five stages of risk analysis (identification, assessment, decision-making, control, and evaluation of results);
- Continuous monitoring and timely response to risks and the factors that cause them;
- Adherence to the principle of responsibility when implementing measures aimed at risk reduction.

A properly structured risk management system not only ensures the stability of business development but also contributes to improving the overall economic efficiency of the organization.

CONCLUSIONS

Market risk represents one of the most significant threats to the financial stability and sustainable development of financial organizations in modern economic conditions. The study has shown that market risk is primarily driven by macroeconomic factors, including fluctuations in interest rates, exchange rates, securities prices, and broader market conditions, which directly affect the value of financial instruments and cash flows. Due to its systematic nature, market risk cannot be fully eliminated through diversification and therefore requires comprehensive measurement and management approaches.

The analysis demonstrates that effective risk classification and identification of internal and external causes play a crucial role in understanding the nature of market risk. Internal factors, such as managerial errors and improper use of financial instruments, interact with external factors, including market volatility, regulatory changes, and economic crises, thereby amplifying overall risk exposure. This interaction highlights the importance of adopting an integrated approach to risk assessment.

The paper emphasizes the significance of the Value-at-Risk (VaR) methodology as a widely used tool for measuring market risk. VaR provides a quantitative assessment of potential losses under specified confidence levels and time horizons, enabling financial

organizations to aggregate individual risks at the portfolio level. However, the study also acknowledges the limitations of VaR, particularly its reliance on distributional assumptions that may not hold under real market conditions, especially during periods of extreme volatility.

Finally, the findings underline that a well-designed risk management system is a key factor in ensuring financial resilience and improving economic efficiency. Such a system should be supported by top management, based on clear regulatory frameworks, and incorporate continuous monitoring, independent risk control functions, and systematic decision-making processes. Strengthening market risk management practices allows financial organizations not only to mitigate potential losses but also to enhance strategic planning and long-term stability in an increasingly uncertain financial environment.

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