

Forex Risk Management: Ways for Succeeding in Turbulent Economic Times

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Abstract—Globalisation of financial markets and developments in exchange markets have resulted into complicated transnational exposure management. It is complex mainly because of (a) the increasing size and variety of exposures which companies incur as they grow globally and (b) the increasing volatility & fluctuations in exchange rates of the foreign exchange markets. Due to this complexity, a logical balanced approach is required in view of formulating company's foreign exchange risk management programme. The starting point in such a programme relates to decide the exactly amount of the assets which are under risk. Exposure Management techniques are classified into internal and external techniques according to their basic origin. Internal techniques are mainly used as a part of company's regulatory financial management & aims at minimizing its exposure to exchange risk. These basically aim at reducing or preventing an exposed position from arising. The external techniques are used to provide protection against the possibility that exchange losses will result from the foreign exchange risk exposure which the internal measures have not been able to eliminate. These consist of basically the contractual measures to provide protection against an exchange loss which may arise from an existing translation or exposed position.

This paper attempts to evaluate the various alternatives available to the Indian corporate for hedging financial risks. Hedging is a risk management technique, done to protect the foreign exchange exposures against the volatility of exchange rates, by using various internal and external techniques. Managing foreign exchange risk is a fundamental component in the safe and sound management of all institutions that have exposures in foreign currencies. It involves prudently managing foreign currency positions in order to control, within set parameters, the impact of changes in exchange rates on the financial position of the corporate. The major parts of earnings of information technology come through exports in US dollars. The value of US dollar is fluctuating day by day which is, in turn, reducing the quantum of exports and profit margin of such companies. Every company that has exposure to foreign exchange risk must prudently manage & control its exposure together with management of other risks

Keywords—Forex risk management, hedging, Foreign exchange risk, internal techniques, external techniques

I. INTRODUCTION

Every company that has exposure to foreign exchange risk must prudently manage & control its exposure together with management of other risks. Foreign exchange risk implies the exposure of a company to the potential impact of movements in foreign exchange rates. The risk that is caused by adverse fluctuations in exchange rates may result in a loss to the company.

Foreign exchange risk arises mainly due to currency differences in a company's assets & liabilities and cash flow differences. Such risk continues till the foreign exchange position is settled. This risk arises because of foreign currency cash transactions, foreign exchange trading, investments denominated in foreign currencies and investments in foreign companies. The quantum of risk is derived out by multiplying the magnitude of exchange rate changes with the size and duration of the foreign currency exposure.

Globalisation of financial markets and developments in exchange markets have resulted into complicated transnational exposure management. It is complex mainly because of (a) the increasing size and variety of exposures which companies incur as they grow globally and (b) the increasing volatility & fluctuations in exchange rates of the foreign exchange markets. Due to this complexity, a logical balanced approach is required in view of formulating company's foreign exchange risk management programme. The starting point in such a programme relates to decide the exactly amount of the assets which are under risk.

At micro economic level, transnational companies face varying degrees of business structural risks. Their need for information relevant to exposure identification differs. Therefore, no single exposure system may be appropriate for all companies. The appropriate system must be firm-specific. It must take into account the size of the company and its constituent units, the exposure objectives and strategy of the company, its operating and organizational characteristics and personnel strength. There are four basic characteristics which should be included in all exposure management method : (1) the information should be anticipatory; (2) the reporting frequency must be adequate; (3) the information flow should be related to the company; (4) the rationale of the information systems.

II. METHODS OF FOREX RISK MANAGEMENT

Exposure Management techniques are classified into internal and external techniques according to their basic origin. Internal techniques are mainly used as a part of company's regulatory financial management & aims at

minimizing its exposure to exchange risk. These basically aim at reducing or preventing an exposed position from arising. The external techniques are used to provide protection against the possibility that exchange losses will result from the foreign exchange risk exposure which the internal measures have not been able to eliminate. These consist of basically the contractual measures to provide protection against an exchange loss which may arise from an existing translation or exposed position.

III. INTERNAL TECHNIQUES

A. *Netting*

Netting implies offsetting exposures in one currency with exposure in the same or another currency, where exchange rates are expected to move high in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure. It is of two types bilateral netting & multilateral netting. In bilateral netting, each pair of subsidiaries nets out their own positions with each other. Flows are reduced by the lower of each company's purchases from or sales to its netting partner.

B. *Matching*

The netting is typically used only for inter company flows arising out of groups receipts and payments. As such, it is applicable only to the operations of a multinational company rather than exporters or importers. In contrast, matching applies to both third parties as well inter-company cash flows. It can be used by the exporter/importer as well as the multinational company. It refers to the process in which a company matches its currency inflows with its currency outflows with respect to amount and timing. Receipts generated in a particular currency are used to make payments in that currency and hence, it reduces the need to hedge foreign exchange risk exposure. Hedging is required for unmatched portion of foreign currency cash flows. The aggressive company may decide to take forward cover on its currency payables and leave the currency receivables exposed to exchange risk; if forward rate looks cheaper than the expected spot rate.

In matching operation, the basic requirement is a two-way cash flow in the same foreign currency. This kind of operation is referred to as natural matching. Parallel matching is another possibility. In parallel matching, gains in one foreign currency are expected to be offset by losses in another, if the movements in two currencies are parallel. In parallel matching, there is always the risk that if the exchange rates move in opposite direction to expectations, both sides of the parallel match leads to exchange losses or gains.

C. *Leading and Lagging*

It refers to the adjustment of intercompany credit terms, leading means a prepayment of a trade obligation and lagging means a delayed payment. It is basically intercompany technique whereas netting and matching are purely defensive measures. Intercompany leading and lagging is a part of risk-minimizing strategy or an aggressive strategy that maximizes expected exchange gains. Leading and lagging requires a lot of discipline on the part of participating subsidiaries. Multinational companies which make extensive use of leading and lagging may either evaluate subsidiary performance in a pre-interest basis or include interest charges and credits to overcome evaluation problem.

Another important complicating factor in leading & lagging is the existence of local minority interests. If there are powerful local shareholders in the 'losing' subsidiary, there will be strong objections because of the added interest cost and lower profitability which results from the consequent local borrowing Government by implementing credit and exchange controls may restrict such operations.

D. *Pricing Policy*

In order to manage foreign exchange risk exposure, there are two types of pricing tactics: price variation and currency of invoicing policy. One way for companies to protect themselves against exchange risk is to increase selling prices to offset the adverse effects of exchange rate fluctuations. Selling price requires the analysis of Competitive situation, Customer credibility, Price controls and Internal delays.

E. *Trading or Financing Pattern*

Intercompany or transfer price variation refers to the arbitrary pricing of intercompany transfer of goods and services at a higher or lower rate than the market price. In establishing international transfer prices, one tries to satisfy a number of objectives. The firms want to minimize taxes and at the same time win approval from the Government of the host country. Yet, the basic objectives of profit maximization and performance evaluation are also significant. Often, it is not possible to satisfy all these objectives simultaneously, so a company must decide which objectives are more important. As a result, particular transfer price may be established arbitrarily do fulfill the objective involving international considerations.

For the strong currency exporter, the defensive approach is the only option available for export invoicing since the home currency is probably the strongest currency acceptable to the customer. For the weak currency exporter, however, there may be significant gains from an aggressive currency-of-invoicing policy. In such circumstances foreign currency invoicing may be attractive to the exporter in expectation that the home currency equivalent sales proceeds would be changed by a foreign currency appreciation over the credit period. However, there are risks involved in switching from a weak currency to a stronger one. The relative strengths of the two currencies could reverse themselves in the future and hence currency of invoicing cannot be changed regularly. Price list adjustment & loss of customers credibility are hindrances in changing currency of billing.

F. Asset and Liability Management

This technique can be used to manage balance sheet, income statement and cash flow exposures. It can also be used aggressively or defensively. The aggressive approach reflects to increase exposed assets, revenues, and cash inflows denominated in strong currencies and to increase exposed liabilities, expenses, and cash outflows in weak currencies. The defensive firm will seek to minimize foreign exchange gains and losses by matching the currency denomination of assets/liabilities, revenues/expenses and cash inflows/outflows, irrespective of the distinction between strong and weak currencies. To archive these objectives, variables are grouped. Operating variables includes trade receivables and payables, inventory & fixed assets and financial variables cash, short-term investments and debt.

The currency denomination of operating variables is determined by intrinsic business conditions, production and marketing factors.

Financial variables can be used for exposure management purpose and thus corporate financial management has more discretion over currency denomination. The scarcity of currency finance is often a major problem. The parent company would borrow the weak currency for long term while the subsidiary is usually restricted to short term borrowing. This is because (a) most subsidiaries are not individually listed on a stock exchange, so that the public issue of debt instruments is very difficult, hence, the bulk of long-term loans taken out by foreign subsidiaries are private placements; (b) many foreign subsidiaries are relatively small and not well known to the local financial community; and (c) host governments may be reluctant to allow term borrowing by expatriate subsidiaries.

IV. EXTERNAL TECHNIQUES

External techniques are used by both exporters and importers as well as by multinational companies. The costs of the external exposure management methods are fixed and predetermined. The main external exposure management techniques are forward exchange contracts, short term borrowing, discounting, forfeiting & government exchange risk guarantees.

A. Forward Exchange Contracts

Forward exchange contracts refer to agreements in which two parties agree upon the exchange rate at which currencies will be exchanged on future date or within future specified duration. Forward contracts reduces exchange risk element in the foreign transactions. Price is paid for the protectionism and best-cost alternative should be chosen to reduce the cost of purchase. There is, however, some disagreement on how to calculate cost of forward cover mainly because there are two kinds of cost involved an ex-ante cost and an opportunity cost.

B. Short term Borrowing

Another alternative to hedge risks in the forward market is the short-term borrowing technique. A company can borrow either dollar or some other foreign currency or the local currency. Through short term borrowing techniques, two major difficulties of the settlement dates and the continuing stream of foreign currency are easily solved. Short-term borrowing has some advantages over forward cover. The cost of short-term borrowing cover is the home currency amount which would have been received if the exposed receivable has been measurable. The foreign currency converted into home currency at the settlement dateless spot rate is the amount which the short-term borrowing technique yielded.

C. Discounting

This technique is used to resolve the problems of continuing foreign currency exposures and uncertain settlement dates. The discounting technique for covering receivables exposures is very similar to short term borrowing. In discounting techniques, the effective discount rate less the home currency deposit rate rather than the foreign currency borrowing rate less the home currency rate as is short term borrowing techniques, is the cost. The basic aim in discounting is to convert the proceeds from the foreign currency receivable into the home currency as soon as possible.

D. Forfeiting

Forfeiting can be used as a means of covering export receivables. When the export receivable is to be settled on open account except by bill of exchange, the receivables can be assigned as collateral for selected bank financing. In forfeiting one simply sells his export receivables to the factor and receives home currency in return. The cost involved include credit risks the customers, default risk, the cost of financing if the exporter wants to receive payment before the receivable maturity date and the cost of covering the exchange risk by the forward discount or premium. Forfeiting,

therefore, tends to be expensive means of covering exposure. There may be offsetting benefits such as obtaining export finance and reducing sales accounting and credit collection costs.

E. *Government Exchange Risk Guarantee*

Government agencies in many countries provide insurance against export credit risk and introduces special export financing schemes for exporters in order to promote exports. In recent years a few of these agencies have begun to provide exchange risk insurance to their exporters and the usual export credit guarantees. The exporter pays a small premium on his export sales and for this premium the government agency absorbs all exchange losses and gains beyond a certain level.

Initially, such exchange risk guarantee schemes were introduced to aid capital goods exports where receivable exposures were of long-term nature. Government exchange risk guarantees are also given to cover foreign currency borrowing by public bodies.

All the various exposure management techniques are not available in all circumstances. This is mainly because of limitation imposed by the market-place and by regulatory authorities. Similarly, the availability of internal techniques is largely a function of the international involvement of each company.

F. *Forward Contracts*

Forward cover can be used to hedge purchases as well as sales. It may be two types namely forward purchases cover & forward sales cover. Forward purchase cover is extended to have terms and conditions related to export of goods & services. Period of delivery of currency should not be beyond seven days of the probable date of receipt as per the purchases forward cover. It can be extended for purchases of proceeds of foreign currency notes from licensed full fledged money changers, provided that the currency notes were exported through the bank, for realisation and credit to the bank's account. All other requirements related to export can be hedged by it. Forward sales cover imports of goods & services in India, where the import is permissible as per the Import Control Regulation and repayment of foreign currency loans, approval from RBI for availing such loan must have been obtained. Such approval should contain the details of currency, amount of interest and the repayment procedure. The forward contract would have to provide for repayment in accordance with settled terms & conditions. Repayment liabilities under such loans would be carried forward for several years and it would not be possible to fix the forward rate for such future dates as the market would not predict rate beyond six to seven months.

G. *Options*

Options are rights & not obligations to make buy and sell decision. An option is a contract between two parties known as the buyer and the seller or writer. The buyer pays a price or premium to the seller for the right but not the obligation to buy or sell a certain amount of a specified quantity of one currency in exchange at a fixed price for a specified period of time. The right to buy is a call option and the right to sell is a put option.

H. *Futures*

Futures are contracts to buy or sell financial instruments, for forward delivery or settlement on standardized terms and conditions. Future contracts are similar to forward contracts but are more liquid as these are traded on recognized exchanges.

I. *SWAPS*

Swaps refer to a contract between two parties, termed as counter-parties, who exchange payments between them for an agreed period of time according to certain specified rules. It is defined as a financial transaction involving two counter-parties who agreed terms to exchange streams of payments or cash flows overtime on the basis of agreed at the beginning of the contract. Swap is like a series of forward contracts. Swaps involve a series of exchanges at specific futures dates between counter parties.

V. CONCLUSIONS AND SUGGESTIONS

Derivatives used for mitigating risk must increase due to the increased global linkages and volatile exchange rates. Firms must focus at development of sound risk management system and also need to formulate their hedging strategy. Foreign exchange risk management must be conducted in the context of a comprehensive business plan. Hedging should also be done without speculation. Further, in-correct application of hedging strategies along with no trade off between uncertainties associated with exchange rate and opportunity loss, makes a hedging foreign exchange risk itself a risk. In order to reduce the cost of hedging, it is suggested that the Government of India should revise its regulations wherein corporates should be allowed directly to deal in foreign currency derivative market in place of the banks which have so far been allowed to deal in foreign exchange market. In order to avoid delay in the implementation of hedging decisions, it is suggested that the corporates should be equipped with latest methods of technical analysis together with the introduction of statistical packages for better and accurate forecasting and timely action. Rupee- Dollar

futures should be introduced in Indian stock exchanges as a new product of derivatives so as to provide an another route for hedging forex risk.

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