

Forex Risk Management: Needs & Approaches

Introduction:

Globalization facilitates the fluid movement of products and services around the globe, and the trend has continued without interruption since the end of World War II. It provides better utilization of natural resources, increased availability of human resources, and ease to access modern and advanced technology and other developments that are helping many Asian, European, South American and African nations achieve quick economic growth. The global economy offers an opportunity to traders / investors worldwide to profit from an expanded market and their economic growth. Currencies of emerging world economies are also becoming popular among forex traders, and becoming liquid and profitable.

After abolishment of the Bretton Woods system of administering fixed foreign exchange rates in 1971, a new system was introduced in favour of market-determination of foreign exchange rates; a regime of fluctuating exchange rates. The market determinant nature of currency consists many of risk as exchange risk, market risk, interest rate risk, economy risk, exposure risk, and liquidity risk etc and a lot of volatility in other markets around the world owing to increased inflation, the oil shock and so on. Corporates struggled to cope with the uncertainty in profits, cash flows and future costs and therefore, incurred losses. A large number of losses are marked to market basis. Marked to market is a concept under which financial instruments are valued at market rate.

Necessity of managing foreign exchange risk:

Beside the above, many firms evade active management of their foreign exchange exposure, even though they understand that exchange rate fluctuations can affect their earnings and value. They make this decision for a number of reasons.

First, management considers any use of risk management tools, such as forwards, futures and options, as speculative, or argues that such financial manipulations lie outside the firm's field of expertise. Second, they claim that exposure cannot be measured. Third, they state that the firm is hedged in all transactions such as imports or exports are covered, and foreign subsidiaries finance in local currencies. This ignores the fact that the bulk of the firm's value comes from transactions not yet completed, so that transactions' hedging is an incomplete strategy. Fourth, they say that the firm does not have any exchange risk because it does all its business in dollars (or yen, or home currency). If a German company invoices an Indian company in terms of dollars, when the mark drops, your price will have to adjust and you will be undercut by the local company. Finally, they assert that the balance sheet is hedged on an accounting basis – especially when the "functional currency" is held to be the dollar.

Currency fluctuations affect the value of the firm's operating cash flows, income statement, and competitive position, hence market share and stock price. Currency fluctuations also affect a firm's balance sheet by changing the value of the firm's assets and liabilities, accounts payable, accounts receivables, inventory, loans in foreign currency. This implies the necessity of managing the foreign exchange risk in firms.

Foreign Exchange Risk Management Framework:

Before deploying the resources to manage the foreign exchange risk, first step is to identify all of the risks in business are likely to be exposed to foreign exchange risk arising from volatility in the currency markets. Once risks are identified, a measure of the Value at Risk (VaR) and the prob-

ability of this risk should be ascertained and market-specific problems should be taken into account.

At a given exposures and the risk estimates, the firm has to set its limits for handling foreign exchange exposure and has to decide whether to manage its exposures on a cost centre or profit centre basis. A cost centre approach is a defensive one and the main aim is ensure that cash flows of a firm are not adversely affected beyond the benchmark as per company policy. A profit centre approach on the other hand is a more aggressive approach where the firm decides to generate a net profit on its exposure over time.

Develop a strategy:

Based on the limits which a firm set for itself to manage exposure, the firm then decides an appropriate hedging strategy on the basis of their attitude to risk, view on the currency markets, preparedness to pay the premiums and a host of other factors, will adopt a portfolio approach. There are various financial instruments available for the firm to choose by using a combination of spot, futures, forwards, options, swap, and foreign debt (money market instrument).

Hedging Strategies/Instruments:

A derivative is a financial contract whose value is derived from the value of some other financial asset, such as a stock price, a commodity price, an exchange rate, an interest rate, or even an index of prices. The main role of derivatives is that they reallocate risk among financial market participants, help to make financial markets more complete. The hedging strategies using derivatives with foreign exchange being the only risk assumed.

Forwards: A forward is a made-to-measure agreement between two parties to buy/sell a specified amount of a currency at a specified rate on a par-

ticular date in the future. The depreciation of the receivable currency is hedged against by selling a currency forward. If the risk is that of a currency appreciation (if the firm has to buy that currency in future, say for import), it can hedge by buying the currency forward.

Futures: A futures contract is similar to the forward contract but is more liquid because it is traded in an organized exchange i.e. the futures market. Depreciation of a currency can be hedged by selling futures and appreciation can be hedged by buying futures. Advantages of futures are that there is a central market for futures which eliminates the problem of double coincidence. Futures require a small initial outlay (a proportion of the value of the future) with which significant amounts of money can be gained or lost with the actual forwards price fluctuations. This provides a sort of leverage.

Options: A currency option is a contract giving the right, not the obligation, to buy or sell a specific quantity of one foreign currency in exchange for another at a fixed price; called the Exercise Price or Strike Price. The fixed nature of the exercise price reduces the uncertainty of exchange rate changes and limits the losses of open currency positions. Op-

tions are particularly suited as a hedging tool for contingent cash flows, as is the case in bidding processes. Call Options are used if the risk is an upward trend in price (of the currency), while Put Options are used if the risk is a downward trend.

Swaps: A swap is a foreign currency contract whereby the buyer and seller exchange equal initial principal amounts of two different currencies at the spot rate. The buyer and seller exchange fixed or floating rate interest payments in their respective swapped currencies over the term of the contract. At maturity, the principal amount is effectively re-swapped at a predetermined exchange rate so that the parties end up with their original currencies. The advantages of swaps are that firms with limited appetite for exchange rate risk may move to a partially or completely hedged position through the mechanism of foreign currency swaps, while leaving the underlying borrowing intact. Apart from covering the exchange rate risk, swaps also allow firms to hedge the floating interest rate risk.

Foreign Debt: Foreign debt can be used to hedge foreign exchange exposure by taking advantage of the International Fischer Effect relationship. This is demonstrated with the example of an exporter who has to receive a

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fixed amount of dollars in a few months from present. The exporter stands to lose if the domestic currency appreciates against that currency in the meanwhile so far, to hedge this foreign exchange risk, he could take a loan in the foreign currency for the same time period and convert the same into domestic currency at the current exchange rate.

Use of derivative for hedging is increase only due to the increased global linkages and volatile exchange rates. Firms need to look at instituting a sound risk management system and also need to formulate their hedging strategy that suits their specific firm characteristics and exposures.

The above hedging technique can be understood by the following table. ■

	To hedge payables	To hedge receivables
Futures hedge	Purchase currency futures contracts	Sell currency futures contract
Forward hedge	Negotiate to buy forward contract	Negotiate to sell forward contract
Money market hedge	Borrow local currency. Convert to foreign currency. Invest till needed	Borrow foreign currency. Convert to local currency. Invest till needed
Currency option hedge	Purchase currency call options	Purchase currency put options