CA BUSINESS SCHOOL
POSTGRADUATE DIPLOMA IN BUSINESS & FINANCE

SEMESTER 3: Financial Strategy

Managing FOREX

Foreign Exchange Risk Management

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Introduction

The **Foreign Exchange Market/FOREX/FX/Currency Market** is a form of exchange for the global decentralized trading of international currencies. Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock.

In a typical foreign exchange transaction, one party purchases some quantities of one currency by paying some quantities of another currency to the other party. (pre agreed by either party)

The foreign exchange market assists international trade and investment by enabling currency conversion. For example, it permits a business in the United States to import goods from the European Union member states (especially Eurozone members) and pay Euros, even though its income is in United States Dollars.

Foreign Exchange Markets

- Foreign exchange market is worldwide.
- FOREX market expands rapidly.
- Main players are financial institutions (banks).
- Banks – Customers | Banks – Government | Banks – Banks.
- Exporter – sell to bank | Importer – buys from bank.
- Most of the foreign exchange rates are change rapidly. Not fixed.
- FOREX rate usually determined through market indicators. (floating)
- Central bank and government is also intervene in rate setting. (fixed)
- FOREX rate is generally quoted in terms of the local currency.
- Central bank will be published daily (end-of-day) rates.
- There are two rates: Offer (buying) (low) and Bid (selling) (high).
- The gap will be called as Spread which represents dealers' costs/profit.

Foreign Exchange Rates

In finance, an **exchange rate/foreign-exchange rate/FOREX rate/FX rate** between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another country's currency.

Exchange rates are determined in the foreign exchange market which is open to a wide range of different types of buyers and sellers where currency trading is continuous 24 hours a day except weekends.

Buying and selling rates are the major two categories of rates in FOREX. The buying rate is the rate at which money dealers will buy foreign currency and the selling rate is the rate at which they will sell the currency.

Direct quote : the amount of domestic currency for one unit of foreign currency. Mostly used.

Indirect quote : the amount of foreign currency for one unit of domestic currency.

Foreign Exchange Exposure

Foreign exchange exposure /exchange rate risk /currency risk is a **financial risk** posed by an exposure (prone to risk) to unanticipated changes in the exchange rates between two currencies.

Investors who are making foreign investments and multinational businesses who are engaged in export or import goods/services throughout the global economy are faced with an exchange rate risk which can have severe financial consequences if not managed appropriately.

- **Transaction Exposure** : when an entity has contractual cash flows (receivables and payables) and those values are subject to unanticipated changes in exchange rates due to a contract being denominated in a foreign currency.
- **Economic Exposure** : the degree that entity's market value is influenced (fluctuated)by unexpected fluctuation of exchange rates.
- **Translation Exposure** : the extent to which entity's financial reporting is affected by exchange rate movements. (especially when consolidating the foreign subsidiaries)

When all of the above taken together, it will be "Contingency Exposure."

Managing Foreign Exchange Exposure

Some might argue that entrepreneurship or running the business is all about accepting risk. True. But, overall business risk must obviously be minimized to an acceptable level.

While minimizing overall business risk, an entity attempts to avoid/eliminate specific nature of risk such as FOREX risk. ROREX risk is the risk arise due to changes/movements in foreign exchange rates between currencies over the given period of time.

In general, risk could be managed in following manner;

- **Pooling of risks** : please recall the memories on portfolio investments.
- **Hedging of risks** : different individuals/parties come to an agreement through which one party's risk will set-off with another party's risk.

Managing Foreign Exchange Exposure (Contd.)

It is a responsibility of the key management of an entity to make all effort/attempt being avoiding/eliminating specific nature of risk arising with respect to the currency risk and interest rate risk.

Currency risk is basically a FOREX risk which can be categorized into; transaction risk/economic risk and translation risk. (discussed before)

The transaction risk very popular/common compared to others in the business world which basically can manage in the following manner;

- Currency of invoice
- Matching receipts and payments
- Matching long term assets & liabilities
- Leads and lags

Managing Foreign Exchange Exposure (Contd.)

❑ Currency of invoice

This quite a very simple technique that either exporter or importer can practice. One party will be invoiced to the other party not by his/her domestic currency but using foreign currency of the other party. Many obstacles are involved in this mechanism.

❑ Matching receipts and payments

An entity engaged in foreign transactions can simply match his/her receipts from foreign currency as opposed with payments made in foreign currency. Maintaining a foreign currency account in a bank will serve for this. Collecting receipts in advance over payments and keep the gap at its minimum level of receipts and payments are advisable.

Managing Foreign Exchange Exposure (Contd.)

❑ Matching long term assets & liabilities

An entity is having long term assets (investments) in foreign currency might obtain borrowings in foreign currency in order to match the value deterioration of such foreign currency in the future.

Netting : this technique is quite similar to above in nature. But netting always claim between companies in the same group. This involves netting-off inter company balances. Netting can be bilateral and multilateral.

❑ Leads and lags

Lead : the known (agreed) payment which has to be made in foreign currency in the future is effected now. (pay in advance)

Lag : delay the known (agreed) payment which has to be made in foreign currency over and above stipulated time period. (delay the payment)

This basically practice with the expectation of adverse movements in foreign currency.

Forward Exchange Contracts

Forward exchange contracts should also be treated as mechanism of avoiding transaction risk in FOREX.

This allows importer/exporter to arrange sell or buy a quantity of foreign currency at a future date at a rate determined at the time contract was made through a bank.

The trader knows (in advance) the amount of local currency he/she will receive or amount which need to pay.

- Binding contract in law
- Between trader and the bank
- For the purchase/sale of agreed number of stated foreign currency
- For the performance of future obligations
- FOREX rate is determined at the time contract was signed

Money Market Hedging

It also reasonable to treat money market hedge as a mechanism of avoiding transaction risk in FOREX.

This quite similar to forward exchange contract. MMH arise when an importer obliged to pay agreed amount (in foreign currency) to the exporter in agreed future date since he/she unable to find required amount of cash at current.

Actions;

- Borrow required amount in local currency
- Convert such amount to required foreign currency immediately
- Maintain the amount in foreign currency account and earn interest
- Pay interest on loan in local currency till fully settle the loan
- When the time comes, pay exporter through foreign currency account and settle the loan in local currency fully.

Futures Contracts

You could observe that futures contracts is not purely the phenomena relate to the FOREX but in common can experience in trading of commodities.

Futures are **derivatives** which have their origins in the markets for commodities such as wheat, coffee, sugar, meat and etc. The prices of this most of the commodities are fluctuated seasonally due to various factors including strong co-relationship with PEST factors.

Hence, in order to avoid/mitigate such large variations in prices, buyers and sellers of these commodities would agree quantities and prices in advance.

In order to make it more formal, futures contracts are mainly standardized by nature of the products/quantities/delivery dates.

Derivative : is a financial security whose value is derived partly from the value and characteristics of an underline security.

Options (Contract)

Options can be identified as a right but not essentially an obligation to buy (call) or sell (put) a specific amount of pre-determined commodity at a specified price (strike price) during a specified period of time.

Each and every options contracts represents a buyer (holder) and the seller (writer).

If the option contract is exercised, the writer is responsible for fulfilling the terms of the contract where as the buyer has an option.

Arrangements by means of options essentially protect against FOREX rate movements while providing an opportunity to gain from favorable rate movements.

Options Contract (Contd.)

Key features;

- Binding contract in law
- Between two parties (buyer and seller)
- Buyer getting right but not the obligation
- To buy or sell
- Agreed quantity of identified commodity
- Price determined now by the buyer (strike price)
- Effect the contract on or before agreed future date
- Pre-determined premium required to pay at the beginning

Forwards Vs. Futures Vs. Options

Forwards	Futures	Options
Legal Contract	Legal Contract	Legal Contract
Obligation to both	Obligation to both	No obligation to the buyer
Right to both	Benefited to both	Right to the buyer
No cost	No clear transactions cost	Pay premium
Market price	Price set by both parties	Price set by the buyer
Buyer and seller	Buyer and seller	Buyer and seller
Future date	Future date	Future date
Specified amount	Specified amount	Specified amount