

International Financial Management

Student: Marinela Andreica

ID:2010777

Introduction

Exchange rate fluctuation is an everyday occurrence and in the business environment can have a major impact in the business activity. This report is evaluating the concept of foreign exchange risk and evaluates various strategies that can mitigate it.

Foreign exchange risk

Foreign exchange risk is defined as “the losses that an international financial transaction may incur due to currency fluctuations” (Investopedia, 2020). When an organisation decides to engage in financial transactions in foreign markets in a different currency from where the domestic market it can incur foreign exchange risk. This refers to the risks when the changes in the involved currencies are decreasing the relative value of the investment resulting in financial losses for the organisation. The fluctuations of the exchange rate can have a direct impact on the organisation international operations and its financial performance. The exchange rates between currencies is considered to be a major aspect to evaluate when formulating strategies to manage their exposure. Trading internationally requires a high number of resources and knowledge of the market is essential to ensure success (Allen, 2003). For example a British organisation who has business activity in Europe in countries that have the Euro as currency will have for its subsidiaries financial reports in Euro and will be exposed to foreign exchange risk. Foreign exchange risk can be caused by appreciation/depreciation of the base currency, appreciation/depreciation of the foreign currency, or a combination of the two. The currency fluctuations between the date of signing the contract and the delivery date can lead to loss for one of the parties, considering the type of the contract agreed on. There are various strategies use by organisations who activate internationally. The hedging strategies are put in place to mitigate the foreign exchange risk and can refer to various financial products such as forward contracts, options and so on (CFI, 2023).

There are three types of exchange risk such as transaction risk, translation risk and economic risk. The transaction risk refers to the situation when an organisation purchases a product from another country with different currency and the price of the product is denominated in the sellers currency. Further that the transaction risks occurs when the transaction and the settlement registers delays as the exchange rate could be different and could not be favourable for the organisation. The transaction risk can be managed by adopting forward contracts and options (Marrison, 2002).

The translation risk refers to the situation when an organisation which has subsidiaries in other countries with different currency and implicitly the financial statements being denominated in the currency used there. The translation of the financial statements of the subsidiary in the organisation currency may face financial loss. An organisation which has its headquarters in a country but has a greater portion of its assets, liabilities, or equities in a foreign country with a foreign currency has a higher translation exposure.

The economic risk known also as forecast risk refers to the situation when the market value of an organisation is exposed to unavoidable currency fluctuations continuously. The macroeconomic conditions that can have an impact on the market value of the organisation can relate to Government regulations, to the geopolitical instability. The most current tensions in Israel or the Russo-Ukrainian war are examples of impacting factors. In the United Kingdom, Brexit was a major change which affected the business activity. Globalisation is a phenomena which has been increased the economic risk in the business environment with far-reaching effects and on long term. That is why the measurement of the economic exposure is difficult to be established and mitigating the risk can be challenging. Organisations can look into have strong operational strategies with a diverse production system, with, end product markets, hedging, risk-sharing agreement, currency swaps, usage of different currencies and so on (Van Deventer et al, 2004).

Another risk which is less common is the jurisdiction risk and is specific to unstable countries.

Therefore there are various causes of foreign exchange risk regarding the fluctuations of the foreign currencies: government regulations, geopolitical instability, sovereign risk, collapse of Governments, macroeconomic factors, increase of inflation, rise of interest rates, credit risk.

The mitigation of the foreign exchange risk is an important aspect for the multinational corporations. Some authors debate if the foreign exchange risk should even be mitigated or considered to be cost of doing business in foreign countries and be accepted as it comes. The cost can be absorbed in the case of a large organisation with high number of resources (Toptal, 2023). In contrast relying on benefiting of a stable financial market rarely works and fluctuations of exchange rate are most likely to occur. There are different International Financial Management theories that are implemented to manage the exposure to foreign exchange risks and many organisations are actively managing it using various tools more simpler or more complex. Hedging Currency Risk with Exchange-Traded Funds can be suitable for a multinational corporate. There are many exchange-traded funds (ETFs) that focus on providing long (buy) and short (sell) exposures to many currencies (Investopedia, 2022).

Organisations who have a very strong position in the industry can impose the usage of own currency in doing transactions. Usually the US company practice this strategy to transact in USD even in foreign countries. With the increase of online business this strategy can be adopted by organisations which will not have to pay local taxes or salaries in the local currency (Allayannis et al, 2001).

For the organisations which run long term projects such as large infrastructure projects, usually oil companies, energy companies, mining companies the foreign currency is very significant. With contracts and business activity that will last many years it is very important to build protection regarding the currency fluctuation in order to avoid jeopardising the profitability. Contractual clauses regarding the foreign exchange will allow the organisation to have any losses recouped in established scenarios. This involves prior negotiations and agreed that the exchange risk to be passed to the supplier or the customer when is the case. This type of clauses needs strong legal relevance and clearly stated. Involvement of exchange rate clause will trigger a process to recoup the loss upon completion (IMF, 2023).

The natural foreign exchange hedge is a strategy that “occurs when a company is able to match revenues and costs in foreign currencies such that the net exposure is minimised or eliminated” (Toptal, 2023). For example a British organisation which has business operations in Europe and the financial statements are in Euro, will then look into sourcing its products in Europe to use the Euro as currency and avoid the translation risk. This strategy can be very effective as it simplifies the supply chain and can benefit the company even more regarding involved costs. For the financial department can be more complicated to keep track of the net exposures and multiple currency of financial statements.

The hedging foreign currency risk mitigated by using hedging arrangements via financial instruments are more complicated and can be realised through a forward contract or a currency option. The forward exchange contract is “the agreement under which a business agrees to buy or sell a certain amount of foreign currency on a specific future date. By entering into this contract with a third party (typically a bank or other financial institution), the business can protect itself from subsequent fluctuations in a foreign currency’s exchange rate” (Barton et al, 2002,). This way the loss can be avoided for specific transactions. Purchasing a foreign currency hedge which usually can be taken for up to 12 months will enable the organisation to lock the currency rate at a certain value at the time of sale. This action involves the payment of a fee to the third party and the payment of an amount to adjust the interest rate differential between the currencies. Hedging strategies can protect a foreign investment from currency risk for when the funds are converted back into the investor's home currency (Hakala, Wystup, 2002).

The currency options are similar to forward contracts and provide the organisation the right to trade, buy or sell a currency at a specific rate on or before a certain date. A particular element of the currency options is that the organisation is not obliged to complete the transaction at the expiration of the contract. This can be favourable to the organisation and can decide to exercise the option or it can let the option expire if the exchange rate is less. The organisation has to pay extra for the option premium to benefit of this flexibility. Hedge providers such as banks or financial institutions do not provide the same service and organisations should review the offer of financial instruments to hedge the organisation exposure. In principle the provider will ensure an evaluation of the exposure of the organisation and will set up the required service and the policy accordingly. The selection of the provider should also look into the experience in the industry, the rapidity of the service, the resources for overseeing the contracts execution, the capabilities to provide regular reporting and access to traders (IMF, 2006).

Conclusion

In conclusion operating internationally can benefit the organisations, but carefully analysis and formulation of strategies are essential regarding the exposure to foreign exchange risk.

References

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