

Module: International Financial Management

Assignment Title: Written Report

Student's Name: Yordan Stankov

Student's ID: 2021805

Submission Date: 02/04/2024

Introduction

Multinational corporations (MNCs) with overseas subsidiaries, operations or investments face significant risk from foreign exchange (FX) rate fluctuations, which can markedly impact their reported profits, net assets, and competitiveness (Shapiro, 2014). Sudden currency movements due to economic, political or disaster-related events regularly wipe hundreds of millions from large companies' balance sheets. Even day-to-day volatility creates unpredictability for managers trying to monitor performance or evaluate new overseas ventures. This report evaluates the range of FX risk management strategies relied upon by MNCs to minimise these risks.

Background on Foreign Exchange Risk

Foreign exchange risk refers to the probability that changes in FX rates will impact business costs and cashflows, contractual terms, asset values, and/or earnings stated in base or reporting currencies (Madura, 2021).

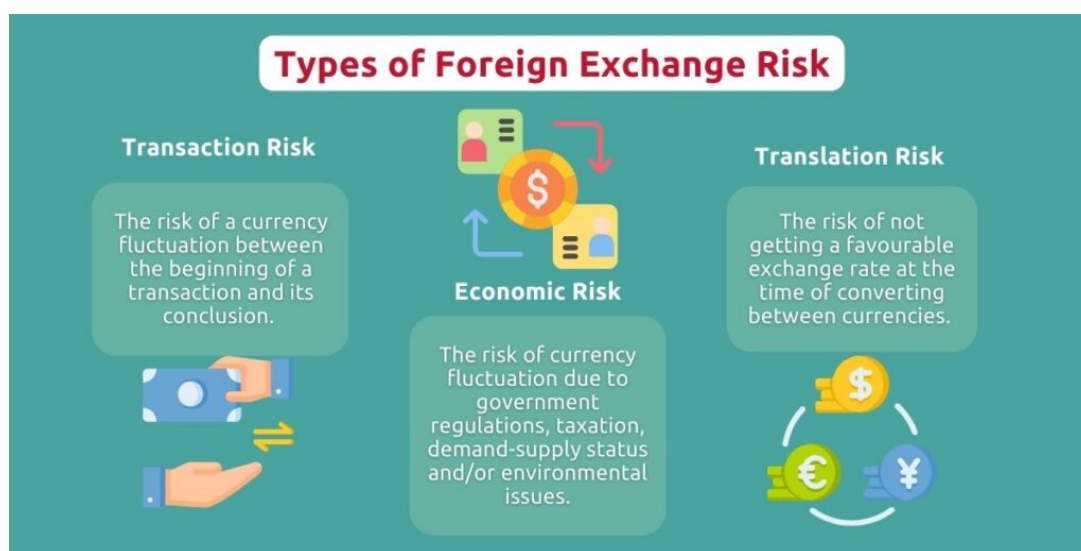


Figure1: Types of foreign exchange risks

Source: (Madura, 2021).

Several theories identify mechanisms through which exchange rate volatility transmits risk.

Transaction exposure theory argues FX volatility directly raises transaction costs and lowers margins on imports, exports and repatriations (Shapiro, 2014). Translation exposure theory notes asset values and overseas earnings fluctuate when restated into reporting currencies (Eiteman et al., 2016). Economic exposure theory highlights that exchange rate shifts affect competitiveness and long-run profitability by redirecting customer demand, changing input costs, enabling substitution effects and encouraging new market entrants (Madura, 2021).

Strategies for Managing Foreign Exchange Risks

i) Internal hedging methods

Netting: A simple but widely used approach is netting - offsetting cash inflows and outflows in the same currency to minimise net exposures (Eiteman et al. 2016). For example, Company A invoicing €500,000 of exports to Europe over the next year but also needing to pay €600,000 for imports could ask European affiliates to pay €500,000 directly to vendors first to reduce net exposure to only €100,000. Netting can effectively minimise FX costs on routine cashflows without need for derivatives or other complex arrangements (Shapiro, 2014). It provides continuous, flow-through protection tied directly to underlying operations. However, it requires tight cashflow control, financial transparency and administrative capability to track, match and settle gross inflows/outflows within entities, limiting suitability for more decentralised MNC structures (Reuer et al. 2002).

Leading and lagging - accelerating receivables and decelerating payables in currencies expected to devalue also reduces transaction risk (Madura, 2021). For example, Company B invoicing

USD imports 30 days in advance of expected payment dates could generate extra earnings if the USD then declines 10% during that period. The key benefit is leveraging natural billing cycles at little administrative cost to hedge exposures. However, opportunities may not coincide with market trends or be acceptable to all counterparties. Cashflow forecasting errors also risk over-hedging losses. So, leads/lags are more a secondary tactic than core strategy.

ii) External hedging methods

Forward contracts lock in an exchange rate today for future delivery, eliminating risk from adverse rate movements (Madura, 2021). For example, Company D worried the Japanese Yen will appreciate over the next year could secure JPY120/USD today rather than converting later at say JPY100/USD if its fears are realised. Contract simplicity and customisability to precise exposures are key benefits. Drawbacks are the need to accurately forecast net positions and lack of flexibility to participate in favourable exchange rate shifts that outperform locked-in rates (Shapiro, 2014). Misjudgements can increase costs through over-hedged losses. Forward contracts also expose MNCs to credit risks if counterparties default (Eiteman et al., 2016). These limitations motivate use of other instruments too.

Currency futures perform similar FX rate fixing while also addressing counterparty risks via exchange clearing mechanisms. However, standard contract values, maturity dates and currency pairs constraint hedging precision for specific MNC exposures (Madura et al., 2021). Futures can only hedge defined portions of risk. Exposure mismatch problems therefore still arise. Futures pricing dynamics also typically exhibit higher volatility due to leverage use among speculators, creating margin funding needs and potential losses unrelated to underlying currency risks

(Shapiro, 2014). These complexities limit corporate uptake, positioning futures more as adjunct tools than standalone solutions.

Currency options retain upside potential above strike rates while setting worst case loss floors if exercised (Madura, 2021). Company E expecting USD depreciation could buy long-dated put options locking in say JPY120/USD rates. This permits capitalising if the actual future spot rate proves lower e.g. JPY115/USD, while capping downside if say a JPY90/USD eventuates.

Options allow custom exposures, maturities and strike rates too. However, initial premium costs are high while worst case payouts still eventuate if markets move adversely (Eiteman et al., 2016). Firms accept defined known costs for undefined contingent protection. Speculators separately trading options also generates volatility undermining reliable risk calibration. Hence options mainly hedge risks that really matter rather than routine exposures.

iii) Operational techniques

Sourcing policies: Strategic local sourcing of inputs minimises imports priced in foreign currencies, while locally exporting final outputs retains revenue in domestic currencies (Madura, 2021). For example, Company G could set up Asian manufacturing to supply Asian markets using Asian materials and staff. The approach aims to set up the production and sales around the area to avoid currencies crossovers causing transaction risks (Reuer et al., 2002). Besides, it links costs and earnings to currency that will give advantage (for example, low Asian labour rate) in order to achieve market response in terms of pricing. However, it enables stability in real terms. Although focusing within a region would give rise to some efficiencies, it increases sovereign

risks, supply chain exposures and loss of core competencies (Shapiro, 2014). So, location-based production strategies include financial over managerial strategies.

Pricing Policies: MNCs can price their products and services in strong currencies to build up revenues that have the highest long-term purchasing power (Eiteman et al., 2016). For instance, Company H could price all exports in USD or Euros instead of local currencies even for the sale in the surrounding regions if monetary instability is expected. This measure utilizes the pricing latitude available in some markets to actively select invoicing currencies (Reuer et al., 2002). However, competitors may also set lower prices if they do not pass on the currency premiums. Similarly, the risk of economic exposure may still loom as the effects of the trends continue to trigger demand shifts. Thus, pricing policies make it a soft rather than a hard tool for resolving foreign exchange uncertainties.

Foreign currency debt: Foreign currency borrowings are converted into domestic currency equivalents, which are expected to depreciate over tenors – reducing effective interest costs (Madura, 2021). The company financing long-term US assets by issuing bonds in EUR that expect a weak EUR can reduce finance costs. The direct currency conversion that matches debt obligations to operating exposures is designed to have the targeted risk sharing that is based on the outlooks (Reuer et al., 2002). Nevertheless, assuming an exact match is not possible, the residual risks still exist that include performance divergences. Serious accounting complications also arise. Adverse shifts additionally exacerbate solvency pressures through escalating required payments. So foreign debt largely offsets known liabilities rather than providing generalisable solutions.

iv) Organisational approaches

Centralised treasury centres housing dedicated FX expertise permit coordinated identification, analysis, trading and risk management across diversified multinational exposures (Bartram, 2019). Company J could establish a corporate-level team to scan global operations, quantify integrated exposures, implement overlay hedges combining instruments and entities, manage counterparty relationships, and steer divisional decisions to align with enterprise risk tolerances (Reuer et al., 2002). Centralisation provides economies of scale, prevents fragmented sub-standard hedging, lowers funding costs, and enables harnessing geographic diversification through inter-affiliate netting and transfers. However, mandated standards can seem detached from divisional imperatives while added bureaucracy creates inflexibility and internal political tensions that undermine cooperation (Shapiro, 2014). Central treasuries therefore function best supporting semi-autonomous business units rather than imposing rigid policies.

Decentralised exposure management: In strongly decentralised MNCs facing difficulties coordinating central treasuries, autonomous divisions may be assigned local hedging accountabilities reflecting product/regional mandates, competencies and risk preferences (Bartram, 2019). Company K could allow regional heads to control own FX risks via forwards suitable for predictable parts, options for uncertain elements and retention of some exposures within declared volatility budgets (Reuer, 2002). This empowers entrepreneurial innovations fitting diverse environments. But localism risks inadequate resourcing, missing offsetting multi-divisional exposures and pursuing conflicting tactics like overlapped hedges and speculative positions that collectively work against MNC interests (Shapiro, 2014). Heavy headquarters

oversight is still necessary to audit practices and extract group-wide learnings. So, decentralisation does not remove, just reframes governance challenges.

Conclusion and Recommendation

In assessing appropriate combinations, large MNCs operating globally across both goods and services sectors typically need the most sophisticated multifaceted FX strategies. Their complex matrix of unpredictable short and long-term transaction, translation and economic risks often requires hybrid centralised-decentralised FX management aligning overarching risk oversight at the head office treasury level with divisionally-executed hedging reflecting industry norms and geographic considerations (Reuer, 2002). Core gross exposures are netted internally first via automated exposure aggregation tools then hedged externally through a portfolio of instruments - forwards for routine foreign purchases balanced against options for less predictable business (Shapiro, 2014). Foreign currency debt may offset specific assets/liabilities while cross-border intercompany netting reduces subsidiary exposures (Eiteman, 2016). Local sourcing and invoicing provide supplementary real risk mitigation rather than financial hedging alone. Ongoing annual reviews ensure effectiveness against evolving risk scenarios.

In terms of enhancing FX risk management, the advent of technologies enabling better currency volatility modelling, cashflow forecasting, exposure quantification and hedge performance simulation offers opportunities to lift hedging sophistication regardless of current MNC size and capabilities (Bartram, 2019). New competencies could be groomed allowing smaller firms to start accessing derivatives and portfolio solutions once sufficient analytics are available to support their disciplined usage. This helps maintain firms' competitiveness within an

environment of unrelenting exchange rate uncertainty and risk necessitating proactive financial mitigation integrated within wider corporate strategy, governance and operations.

References

- Bartram, S. (2019). Corporate hedging and speculation with derivatives. *Journal of Corporate Finance*, 57, 9-34.
- Eiteman, D., Stonehill, A., & Moffett, M. (2016). *Multinational Business Finance*. Pearson.
- Madura, J. (2021). *International Financial Management*. Cengage Learning.
- Reuer, J., & Leiblein, M. (2000). Downside risk implications of multinationality and international joint ventures. *Academy of Management Journal*, 43(2), 203-214.
- Shapiro, A. (2014). *Multinational Financial Management*. John Wiley & Sons.