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THE ROLE AND IMPACT OF CURRENCY DERIVATIVES IN MANAGING FOREIGN EXCHANGE RISKS: AN EXAMINATION OF REGULATORY FRAMEWORKS

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ABSTRACT:

A multinational corporation that has a high currency risk is likely to experience financial issues, which can interrupt the day-to-day operations of the organization. Unstable financial conditions might lead to the issue of unfavorable incentives and erode the dedication of different stakeholders. Risk and exposure to foreign currencies are key concepts in the study of international finance. It is the degree to which unforeseen fluctuations in exchange rates might affect the value of assets, liabilities, or operating revenue expressed in the native currency. If the home currency values on average in a specific way, there is exposure. When multiple currencies are involved, it also exists. The difference in the home currency value of goods resulting from unforeseen fluctuations in exchange rates is known as foreign exchange risk.

Multinational corporations employ derivative instruments including forwards, futures, and options as a hedge against their foreign exchange risk. The "Forward exchange contract" is the initial derivatives agreement in international finance. Moving forward A wellknown and conventional risk management technique for obtaining protection against unfavorable fluctuations in exchange rates is foreign exchange. Because the exchange rate is "locked in" for a particular future date, the party to the contract can more confidently plan and budget for their business expenses. Since the 1960s, the forward exchange market has served as a means of tying together global interest rates. Forward contracts, however, now need to share markets and other instruments in order to hedging and arbitrage. These more recent derivatives include swaps, options, and futures.

1. INTRODUCTION TO THE FOREIGN EXCHANGE RISK MANAGEMENT

1.1. Risk:

Risk is the possibility that the actual result from an action will deviate from the expected levels of result. The greater the magnitude of deviation and greater the probability of its occurrence, the greater is the risk.

A business has to take step to minimize the risk by adopting appropriate technique or policies. Risk management focuses on identifying and implementing these technique or policies, lest the business should be left exposed to uncertain outcomes.

1.2. Risk management:

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Risk management is a process to identify loss exposure faced by an organization and to select the most appropriate technique such exposures. Risk management tools measure potential loss and potential gain. It enables us to stay with varying degree of certainty and confidence levels, that our potential loss will not exceed a certain amount if we adopt a particular strategy. Risk management enables us to confront uncertainty head on, acknowledge its existence, try to measure its extent and finally control it.

Risk management makes sense for two reasons. One, a business entity generally wishes to reduce risks to acceptable levels. Two, a business entity is generally keen on avoiding particularly kind of risks, for it may be too great for the business to bear. For each situation where one wishes to avoid a risk- a loss by fire, for example- three is, perhaps, a counter party who may be willing such risk. For risk reduction, a business entity can adopt the following methods.

1.3. Hedging:

Hedging is a technique that enables one party to minimize the effect of adverse outcomes, in a given situation. Parties come together to minimize the effect of which risk of one party gets cancelled by the risk of another. IT is not that risk minimization is the only strategy. An entity may even choose to remain exposed, in anticipation of reaping profits from its risk taking positions.

2. FOREIGN EXCHANGE EXPOSURE

2.1. Exposure:

Exposure is defined as the possibility of a change in the assets or liabilities or both of a

company as a result in the exchange rate. Foreign exchange exposure thus refers to the possibility of loss or gain to a company that arises due to exchange rate fluctuations.

The value of a firm's assets, liabilities and operating income vary continually in response to changes in a myriad economic and financial variable such as exchange rates, interest rates, inflation rates, relative price and so forth. We can these uncertainties as macroeconomic environment risks. These risks affect all firms in the economy. However, the extent and nature of impact of even macroeconomic risks crucially depend upon the nature of firm's business. For instance, fluctuations of exchange rate will affect net importers and exporters quite differently. The impact of interest rate fluctuations will be very different from that on a manufacturing firm.

The nature of macroeconomic uncertainty can be illustrated by a number of commonly encountered situations. An appreciation of value of a foreign currency(or equivalently, a depreciation of the domestic currency), increase the domestic currency value of a firm's assets and liabilities denominated in the foreign currency-foreign currency receivables and payables, banks deposits and loans, etc. It will also change domestic currency cash flows from exports and imports. An increase in interest rates reduces the market value of a

portfolio of fixed-rate in the rate of inflation may increase value of unsold stocks, the revenue from future sales as well as the future costs of production. Thus the firms exposed to uncertain changes in a numbers of variable in its environment. These variables are sometimes called Risk Factors.

2.2. The nature of Exposure and Risk

Exposure are a measure of the sensitivity of the value of a financial items (assets, liabilities or cash flow) to changes in the relevant risk factor while risk is a measurable of the

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variability of the item attributable to the risk factor.

Corporate treasurers have become increasingly concerned about exchange rate and interest rate exposure and risk during the last ten to fifteen years or so. In the case of exchange rate risk, The increased awareness is firstly due to tremendous increase in the volume of cross border financial transactions (which create exposure) and secondly due to the significant increase in the degree of volatility in exchange rates(which, given the exposure, creates risk).

2.3.Classification of foreign exchange exposure and risk

Since the advent of floating exchange rates in 1973, firms around the world have become acutely aware of the fact that fluctuations in exchange rates expose their revenues, costs, operating cash flows and thence their market value to substantial fluctuations. Firms which have cross-border transactionsexports and imports of goods and services, foreign borrowings and lending, foreign portfolio and direst investment etc, are directly exposed: but even purely domestic firms which have absolutely no cross border transactions are also exposed because their customers, suppliers and competition are exposed. Considerably effort has since been devoted to identifying and categorizing currency exposure and developing more and more sophisticated methods to quantify it.

2.4. Foreign exchange exposure can be classified into three broad categories:

- Transaction exposure
- Translation exposure
- Operating exposure

Of these, the first and third together are sometimes called "Cash Flow Exposure" while the second is referred to as "Accounting Exposure" or Balance sheet Exposure"

2.5. Transaction exposure:

When a firm has a payable or receivable denominated in a foreign currency, a change in the exchange rate will alter the amount of local currency receivable or paid. Such a risk or exposure is referred to as transaction exposure.

2.6. Translation exposure:

Many multinational companies require that their accounts of foreign subsidiaries and branches get consolidated with those of it. For such consolidation, assets and liabilities expressed in foreign currencies have to be translated into domestic currencies at the exchange rate prevailing on the consolidation dates. If the values of foreign currencies change between a two or successive consolidation dates, translation exposure will arise.

2.7. Operating exposure:

Operating exposure, like translation exposure involve an actual or potential gain or loss. While the former is specific to the transaction, the latter relates to entire investment. The essence of this operating exposure is that exchange rate changes significantly and alter the cost of firm's inputs along with price of it output and thereby influence its competitive position substantially.

3. TOOLS AND TECHNIQUES FOR THE MANAGEMENT OF FOREIGN EXCHANGE RISK

Hedging exposures, sometimes called risk management, is widely resorted to by financial directors, corporate treasurers and portfolio managers.

The practice of covering exposure is designed to reduce the volatility of a firm's profits

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and/or cash management and it presumably follows that this will reduce the volatility of the value of the firm. There are a wide range of methods available to minimize foreign exchange risks which are classified as internal and external techniques of exposure management.

3.1. INTERNAL TECHNIQUES

Internal techniques of exposure management help to resolve exposure risks through regulating the firm's financial position. Thereby, they ensure that the firm is not endangered through exposures. The fundamental stresses minimizing of not complete elimination of exchange losses those are likely to accrue as a result of exposure.

They use methods of exposure management which are a part of a firm's regulatory financial management and do not resort to special contractual relationship outside the group of companies concerned. They aim at reducing exposed position or preventing them from arising. They embrace netting, matching, leading and lagging, pricing policies and asset/liability management. Internal techniques of exposure management do not rely on 3rd party contracts to manage exposed positions. Rather, it depends on internal financial management.

3.2.EXTERNAL TECHNIQUES

These refer to the use of contractual relationship outside the group of companies so as to minimize the risk of foreign exchange losses. They insure against the possibility the exchange losses will result from an exposed position which internal measures have not been able to eliminate. They include forward contracts, borrowing short term, discounting bills receivable, factoring, and government exchange risk guarantees currency options.

External techniques of foreign exchange exposure management use contractual relationships outside the group to reduce risk of exchange rate changes. Several external techniques are available for foreign exchange management. The firm can make a choice of that technique which is most suitable to it.

4. TOOLS FOR FOREIGN EXCHANGE RISK MANAGEMNT

4.1. FORWARD EXCHANGE CONTRACT:

A forward exchange contract is a mechanism by which one can ensure the value of one currency against another by fixing the rate of exchange in advance for a transaction expected to take place at a future date.

Forward exchange rate is a tool to protect the exporters and importers against exchange risk under foreign exchange contract, two parties' one being a banker compulsorily in India, enter into a contract to buy or sell a fixed amount of foreign currency on a specific future date or future period at a predetermined rate. The forward exchange contracts are entered into between a banker and a customer or between two bankers.

Indian exporter, for instance instead of grouping in the dark or making a wild guess about what the future rate would be, enter into a contract with his banker immediately. He agrees to sell foreign exchange of specified amount and currency at a specified future date. The banker on his part agrees to buy this at a specified rate of exchange is thus assured of his price in the local currency. For example, an exporter may enter into a forward contract with the bank for 3 months deliver at Rs.49.50. This rate, as on the date of contract, is known as 3 month forward rate. When the exporter submits his bill under the contract, the banker

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would purchase it at the rate of Rs.49.50 irrespective of the spot rate then prevailing.

When rupee was devaluated by about 18% in July 1991, many importers found their liabilities had increased overnight. The devaluation of the rupee had effect of appreciation of foreign currency in terms of rupees. The importers who had booked forward contracts to cover their imports were a happy lot.

DATE OF DELIVERY

According to Rule 7 of FEDAI, a forward contract is deliverable at a future date, duration of the contract being computed from the spot value date of the transaction. Thus, if a 3 months forward contract is booked on 12th February, the period of two months should commence from 14th February and contract will fall on 14th April.

FIXED AND OPTION FORWARD CONTRACTS

The forward contract under which the delivery of foreign exchange should take place on a specified future date is known as 'Fixed Forward Contract'. For instance, if on 5th March a customer enters into a three months forward contract with his bank to sell GBP 10,000, it means the customer would be presenting a bill or any other instrument on 7th June o the bank for GBP 10,000. He cannot deliver foreign exchange prior to or later than the determined date.

Forward exchange is a device by which the customer tries to cover the exchange risk. The purpose will be defeated if he is unable to deliver foreign exchange exactly on the due date. In real situations, it is not possible for any exporter to determine in advance the precise date. On which he is able to complete shipment and present document to the bank. At the most, the exporter can only estimate the probably date around which he would able to complete his commitment. With a view to eliminate the difficulty in fixing the exact date of delivery of foreign exchange, the customer may be given a choice of delivery the foreign exchange during a given period of days.

An arrangement whereby the customer can sell or buy from the bank foreign exchange on any day during a given period of time at a predetermined rate of exchange is known as 'Option Forward Contract'. The rate at which the deal takes place is the option forward sale contract with the bank with option over November. It means the customer can sell foreign exchange to the bank on any day between 1s to 30th November is known as the 'Option Period'.

Forward contract is an effective ad easily available tool for covering exchange risk. New instruments like options, futures and swaps can also be used to cover exchange risks. These instruments are called financial derivatives as their value is derived from the value of some other financial contract or asset.

When there instrument are bought or sold for covering exchange risk they are used for 'hedging' the exchange risk. When they are dealt in with a view to derive profit from unexpected movements in their prices or other changes in the exchange market, they are being used for speculative purposes. The scope of using these instruments for speculative purposes is very much limited in India.

Some other Strategies may also be adapted to avoid exchange risk. These consist in deciding on the currency of invoicing, maintaining in foreign currency and deciding on the setting the debt.

5. NEED AND IMPORTANCE OF THE STUDY The world nations are increasingly becoming more interrelated global trade, and global investment. These international result in

cross country flow of world nations. Countries hold currencies of other countries and that a market, dealing of foreign exchange results. Foreign exchange means reserves of foreign currencies. More aptly, foreign exchange refers to claim to foreign money balances. Foreign exchange gives resident of one country a financial claim on other country or countries. All deposits, credits and balances payable in foreign currency and any drafts, travelers' cheques, letters of credit and bills of exchange payable in foreign currency constitute foreign exchange. Foreign exchange market is the market where money denominated in one currency is bought and sold with money denominated in another currency. Transactions in currencies of countries, parties to these transactions, rates at which one currency is exchanged for other or others, ramifications in these rates, derivatives to the currencies and dealing in them and related aspects constitute the foreign exchange (in short, forex) market.

Foreign exchange transactions take place whenever a country imports goods and services, people of a country undertake visits to other counties, citizens of a country remit money abroad for whatever purpose, business units set up foreign subsidiaries and so on. In all these cases the nation concerned buys relevant and required foreign exchange, in exchange of its currency, or draws from foreign exchange reserves built. On the other hand, when a country exports goods and services to another country, when people of other countries visit the country, when citizens of the country settled abroad remit money homewards, when foreign citizens, firms and institutions invest in the country and when the country or its business community raises funds from abroad, the country's currency is bought by others, giving foreign exchange, in exchange.

Multinational firms operate in more than one country and their operations involve multiple foreign currencies. Their operations are influenced by politics and the laws of the counties where they operate. Thus, they face higher degree of risk as compared to domestic firms. A matter of great concern for the international firms is to analyze the implications of the changes in interest rates, inflation rates and exchange rates on their decisions and minimize the foreign exchange risk. The importance of the study is to know the features of foreign exchange and the factors creating risk in foreign exchange transactions and the techniques used for managing that risk.

6. OBJECTIVES OF THE STUDY

- To study and understand the foreign exchange.
- To study and analyze the revenues of the company when the exchange rates fluctuate.
- To analyze income statement and find out the revenues when the dollars are converted into Indian rupees.
- To study the different types of foreign exchange exposure including risk and risk management techniques which the company is used to minimize the risk.
- To present the findings and conclusions of the company in respect of foreign exchange risk management

7. RESEARCH AND METHODOLOGY

7.1. SAMPLING SIZE:

In this study the sample size is taken in the form of income statement of company for the year march 2016-17.

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7.2.SOURCES OF DATA

The data has been collected from various secondary sources like books and internet. The data has been collected inline with the objectives of the study. The presentations of study of the IT Company provide an insight in knowing the foreign exchange risk policies adopted by them. This data has been collected from the 2016-2017 annual reports of the companies. Conclusions have been drawn after the detailed study of the risk management policies of the IT Company as to know what are the most widely used hedging instruments for minimizing foreign exchange risk.

8. DATA ANLAYSIS AND INTREPRETATION HCL

Table:1 CURRENCY EXCHANGE BETWEEN TWO RATES

PROFIT&LOSS A/C FOR THE FINANCIALYEAR ENDED 2017

Particulars	(Rs.in crores)	Income and Expenses@ 60% from foreign (In dollars)		
		Average Exchange rate @Rs.41	If the Exchange rate@41	If the Exchange rate@40
INCOME				
Net operating Income	3768.62	2261.17	2261.17	2206.02
EXPENSES				
Material consumption	0	0.00	0.00	0.00
Manufacturing expenses	577.24	346.34	346.34	337.89
Personal expenses	1322.59	793.55	793.55	774.20
Selling Expenses	17.82	10.69	10.69	10.43
Administrative Expenses	913.89	365.55	365.55	356.63
Capitalized Expenses	0	0.00	0.00	0.00
Cost of Sales	2831.54	1516.14	1516.14	1479.16
Reported PBDIT	937.08	745.03	745.03	726.86
Other recurring income	16.07		9.64	9.40
Adjusted PBDIT	953.15		754.67	736.26
Depreciation	178.21		106.93	104.31
Other write offs	0		0.00	0.00
Adjusted PBIT	774.94		647.75	631.95
Financial expenses	20.6		12.36	12.06
Adjusted PBT	754.34		635.39	619.89
Tax Charges	75.87		45.52	44.41
Adjusted PAT	678.47		589.87	584.26
Non recurring-items	423.35		254.01	247.81
Other non cash Adjustments	0		0.00	0.00
Reported PAT	1101.82		843.88	823.30

INTERPRETATION: This above table showing total revenues are alteration together, total revenues are decreased Rs.2261.17 crores to 2206.02, and gross profit also decreased Rs.745.03 to 726.86.simultaneously all these values are changing the net income. If the Exchange rate had fixed @ Rs.41, the revenues would have been same.

HCLDATA ANALYSIS

Table:2 CURRENCY EXCHANGE BETWEEN TWO RATES

PROFIT&LOSS A/C FOR THE FINANCIAL YEARYEAR ENDED 2017-18

Particulars	(Rs.in crores)	Income and Expenses@ 60% from foreign (In dollars)		
		Average Exchange rate @Rs.41	If the Exchange rate@41	If the Exchange rate@39
INCOME				
Net operating Income	3768.62	2261.17	2261.17	2150.87
EXPENSES				
Material consumption	0	0.00	0.00	0.00
Manufacturing expenses	577.24	346.34	346.34	329.45
Personal expenses	1322.59	793.55	793.55	754.84
Selling Expenses	17.82	10.69	10.69	10.17
Administrative Expenses	913.89	365.55	365.55	347.72
Capitalized Expenses	0	0.00	0.00	0.00
Cost of Sales	2831.54	1516.14	1516.14	1484.99
Reported PBDIT	937.08	745.03	745.03	708.69
Other recurring income	16.07		9.64	9.17
Adjusted PBDIT	953.15		754.67	717.86
Depreciation	178.21		106.93	101.71
Other write offs	0		0.00	0.00
Adjusted PBIT	774.94		647.75	616.15
Financial expenses	20.6		12.36	11.76
Adjusted PBT	754.34		635.39	604.40
Tax Charges	75.87		45.52	43.30
Adjusted PAT	678.47		589.87	561.10
Non recurring-items	423.35		254.01	241.62
Other non cash Adjustments	0		0.00	0.00
Reported PAT	1101.82		843.88	802.72

INTERPRETATION: From the above table it is found that total revenues are alteration together, total revenues are decreased Rs.2261.17 to 2150.87, and gross profit also decreased Rs.745.03 to 708.69.simultaneously all these values are changing the net income. If the Exchange rate had fixed @ Rs.41, the revenues would have been same.

HCL DATA ANALYSIS

Table:3 CURRENCY EXCHANGE BETWEEN TWO RATES

PROFIT&LOSS A/C FOR THE FINANCIAL YEAR ENDED 2017-18

Particulars	(Rs.in crores)	Income and Expenses@ 60% from foreign (In dollars)		
		Average Exchange rate @Rs.41	If the Exchange rate@41	If the Exchange rate@42
INCOME				
Net operating Income	3768.62	2261.17	2261.17	2316.32
EXPENSES				
Material consumption	0	0.00	0.00	0.00
Manufacturing expenses	577.24	346.34	346.34	354.79
Personal expenses	1322.59	793.55	793.55	812.90
Selling Expenses	17.82	10.69	10.69	10.95
Administrative Expenses	913.89	365.55	365.55	374.47
Capitalized Expenses	0	0.00	0.00	0.00
Cost of Sales	2831.54	1516.14	1516.14	1553.12
Reported PBDIT	937.08	745.03	745.03	763.20
Other recurring income	16.07		9.64	9.88
Adjusted PBDIT	953.15		754.67	773.08
Depreciation	178.21		106.93	109.54
Other write offs	0		0.00	0.00
Adjusted PBIT	774.94		647.75	663.55
Financial expenses	20.6		12.36	12.66
Adjusted PBT	754.34		635.39	650.89
Tax Charges	75.87		45.52	46.63
Adjusted PAT	678.47		589.87	24774.71
Non recurring-items	423.35		254.01	260.21
Other non cash Adjustments	0		0.00	0.00
Reported PAT	1101.82		843.88	864.46

INTERPRETATION: From the table it is found that total revenues are alteration together, total revenues are increased Rs.2261.17 crores to 2316.3, and gross profit also decreased Rs.745.03 to

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763.20.simultaneously all these values are changing the net income. If the Exchange rate had fixed @ Rs.41, the revenues would have been same.

HCLDATA ANALYSIS

Table:4 CURRENCY EXCHANGE BETWEEN TWO RATES

PROFIT&LOSS A/C FOR THE FINANCIAL YEAR ENDED 2017-18

Particulars	(Rs.in crores)	Income and Expenses@ 60% from foreign (In dollars)		
		Average Exchange rate @Rs.41	If the Exchange rate@41	If the Exchange rate@43
INCOME				
Net operating Income	3768.62	2261.17	2261.17	2371.47
EXPENSES				
Material consumption	0	0.00	0.00	0.00
Manufacturing expenses	577.24	346.34	346.34	363.23
Personal expenses	1322.59	793.55	793.55	832.26
Selling Expenses	17.82	10.69	10.69	11.21
Administrative Expenses	913.89	365.55	365.55	383.38
Capitalized Expenses	0	0.00	0.00	0.00
Cost of Sales	2831.54	1516.14	1516.14	1590.10
Reported PBDIT	937.08	745.03	745.03	781.37
Other recurring income	16.07		9.64	10.11
Adjusted PBDIT	953.15		754.67	791.48
Depreciation	178.21		106.93	112.15
Other write offs	0		0.00	0.00
Adjusted PBIT	774.94		647.75	679.35
Financial expenses	20.6		12.36	12.96
Adjusted PBT	754.34		635.39	666.38
Tax Charges	75.87		45.52	47.74
Adjusted PAT	678.47		589.87	618.64
Non recurring-items	423.35		254.01	266.40
Other non cash Adjustments	0		0.00	0.00
Reported PAT	1101.82		843.88	885.04

INTERPRETATION: From the table it is found that total revenues are alteration together, total revenues are increased Rs.2261.17 crores to 2371.47, and gross profit also decreased Rs.745.03 to 781.37.simultaneously all these values are changing the net income. If the Exchange rate had fixed @ Rs.41, the revenues would have been same.

9. FINDINGS OF THE STUDY

The company has to hammer out its approach to risk management taking into account its specific circumstances. Here is brief description of company in India have fashioned its strategy towards foreign exchange risk management.

As its operations in many countries, the company is exposed to currency risk. Here is the description:

1. They transact a major portion of their business in USD and the lesser extent other currencies and is thus exposed to currency risk, The Company manages risk on account of foreign currency fluctuations through treasury operations.

2. To mitigate the risk of changes in foreign exchange rates on cash flows denominated in USD, HCL technologies purchases foreign exchange forward contracts and the company does not speculate the currency exchange.

3. Foreign exchange transactions of their revenues were generally in USD. The average exchange rate of INR to USD in fiscal 2017 was Rs.41 against Rs.44 in fiscal 2016. The above description of risk management in HCL is based on the information provided in the annual report of HCL for the year 2017.

10. CONCLUSIONS OF THE STUDY

In order to thrive in the market, businesses must look beyond BPO services to next generation services like value added services, software development, and enhancement, even in the face of market expansion.

The only way for software firms to survive in today's worldwide economy, where economic stability is truly in jeopardy, is to increase their adaptability to shifting conditions.

For their services to be accepted globally, businesses must build them to the benchmark level or global standards.

The adversely high cost structure is the root of many exporters' problems, not the rupee's volatility. Only when foreign exchange revenues are turned into an increasing amount of rupees are exporters viable. Exporters must reduce aggregate rupee costs and be efficient and productive in order to increase rupee viability and maintain profits.

Hedging will not solve poor viability. To demonstrate profit, an inefficient exporter necessitates an exchange rate of Rs. 45 to

break even. It will dazzle for more than Rs. 45. At any exchange rate of less than Rs. 45, it will fade.

in the event of a forward contract. The exporter's conversion of dollar revenues to rupee revenues is locked in by the forward contract at the market forward price of Rs. 41 per dollar. Even with the ideal hedge, the market will undoubtedly not buy the exporters' dollars at Rs. 41, making them completely ineffective and putting them in significant danger.

Viability won't be resolved until exporters' breakeven point drops to Rs. 41 per dollar. On the other hand, the hedge can benefit an inefficient exporter that makes sense at Rs. 41 per peer dollar.

Exporters' dollar profitability will be substantially preserved by the implicit dollar technique. Paying exporting companies implicitly in dollars will go to their management and staff. The business will pay a dollar-for-dollar price. However, the payment will be made at current exchange rates and in rupees. If the value of the dollar declines, the costs of managers and employees will be paid in rupees at, say, RS.39; if the value of the dollar increases, the costs of managers and employees will be paid in rupees at, say, RS. 43.

Even with high tax rates, exporters should implement strong governance by providing superior social, human, and corporate infrastructure in order to address these issues. Both the operating and total costs of running business are reduced by good governance.

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