REGULATORY FRAMEWORKS AND THE ROLE OF CURRENCY DERIVATIVES IN FOREIGN EXCHANGE RISK MANAGEMENT

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ABSTRACT:

Financial problems are likely to arise for a multinational enterprise with a significant currency risk, which could disrupt the company's daily operations. Unstable financial situations might undermine the commitment of many stakeholders and result in the problem of negative incentives. Two of the most important ideas in the study of international finance are risk and exposure to foreign currencies. It is the extent to which the value of assets, liabilities, or operating revenue expressed in the local currency may be impacted by unanticipated changes in exchange rates. There is exposure if the average value of the home currency is in a particular range. It also exists when there are several currencies involved. Foreign exchange risk is the variation in the home currency value of products brought on by unanticipated changes in exchange rates. Derivative instruments such as forwards, futures, and options are used by multinational firms to protect themselves from foreign exchange risk. In international finance, the "Forward exchange contract" is the first derivatives contract. Going forward, foreign exchange is a well-known and traditional risk management strategy for gaining protection against adverse changes in exchange rates. The party to the contract can more securely plan and budget for their company expenses because the exchange rate is "locked in" for a specific future date. The forward exchange market has been used to link worldwide interest rates since the 1960s. However, in order to hedging and arbitrage, forward contracts now need to share markets and other instruments. Futures, options, and swaps are some of these more modern derivatives.

1. INTRODUCTION TO THE FOREIGN EXCHANGE RISK MANAGEMENT

1.1. Risk:

Risk is the chance that an action's actual outcome will differ from its anticipated levels of outcome. The danger increases with the magnitude of the deviation and the likelihood that it will occur.

A company must take action to reduce risk by implementing suitable procedures or guidelines. The goal of risk management is to identify and put into practice these strategies or policies so that the company is not exposed to unforeseen consequences.

1.2. Risk control:

The process of identifying an organization's loss exposure and choosing the best strategy for those exposures is known as risk management. Tools for risk management quantify possible gains and losses. It allows us to maintain a range of levels of confidence and certainty that, should we choose a specific course of action, our possible loss will not surpass a specific threshold. Through risk management, we can face uncertainty head-on, accept its presence, attempt to gauge its magnitude, and ultimately exert control over it. There are two reasons why risk management makes sense. In general, a business entity wants to lower risks to manageable levels. Second, a company is usually careful to avoid some dangers since they can be too big for the

company to handle. There may be a counterparty who is willing to take a risk in any scenario where one wants to avoid one—for instance, a loss due to fire. A business entity can use the following strategies to lower risk.

1.3. Hedging

Hedging is a strategy that allows one party to lessen the impact of unfavorable results in a certain circumstance. The parties work cooperatively to reduce the impact of one party's risk being offset by another's risk. It is not the case that risk reduction is the exclusive tactic. In order to profit from its risk-taking positions, a business may even decide to stay exposed.

2. Exposure to foreign exchange

2.1. Exposure

Exposure is the potential for a change in a company's assets, liabilities, or both due to fluctuations in the exchange rate. Therefore, foreign exchange exposure describes the potential for a business to lose money or make money as a result of changes in exchange rates.

A company's assets, liabilities, and operating income all fluctuate constantly in reaction to shifts in a wide range of financial and economic factors, including relative prices, interest rates, inflation rates, and exchange rates. These uncertainties are hazards associated with the macroeconomic situation. All businesses in the economy are impacted by these risks. However, the nature of the firm's activity greatly influences the magnitude and type of impact of even macroeconomic threats. For example, net importers and exporters will be impacted by exchange rate variations in quite different ways. Interest rate changes will have a substantially different effect on a manufacturing company.

Several scenarios that are frequently encountered can be used to illustrate the nature of macroeconomic uncertainty. When a foreign currency appreciates in value (or the domestic currency depreciates), it raises the value of a company's foreign currency-denominated assets and liabilities, such as bank deposits and loans, foreign currency receivables and payables, etc. Additionally, it will alter the cash flows from imports and exports in home currency. An increase in interest rates lowers the market value of a fixed-rate portfolio, while inflation may raise the value of unsold stocks, future sales income, and production expenses. As a result, businesses are subject to unpredictable shifts in a variety of environmental variables. Risk factors are another name for these variables.

2.2. The characteristics of risk and exposure

While risk is a quantifiable indicator of the variability of the item attributed to the risk factor, exposure is a measure of how sensitive the value of a financial item (assets, liabilities, or cash flow) is to changes in the relevant risk factor.

Over the past ten to fifteen years or more, corporate treasurers have grown more concerned about the exposure and risk of interest rates and currency rates. The first reason for the increased awareness of exchange rate risk is the enormous rise in cross-border financial transactions, which exposes people, and the second is the notable rise in exchange rate volatility, which also exposes people to risk.

2.3. Categorization of risk and exposure to foreign exchange

Businesses worldwide have been painfully aware since the introduction of floating exchange rates in 1973 that exchange rate swings expose their operating cash flows, costs, revenues, and, consequently, their market value to significant fluctuations. Businesses that engage in cross-border activities, such as exporting and importing goods and services, borrowing and lending from overseas, investing in foreign portfolios, etc., are directly exposed. However, even domestic businesses that do not engage in cross-border activities are also vulnerable because their suppliers, customers, and competitors are. Since then, a lot of work has gone into determining and classifying currency exposure as well as creating increasingly complex techniques to measure it.

2.4. Three major categories can be used to classify foreign exchange exposure:

Exposure to transactions
- Exposure to translation
- Exposure to operations

While the second is known as "Accounting Exposure" or "Balance sheet Exposure," the first and third together are occasionally referred to as "Cash Flow Exposure."

2.5. Exposure to transactions:

A shift in the exchange rate will affect the amount of local currency that is paid or receivable when a company has payables or receivables denominated in a foreign currency. Transaction exposure is the term used to describe such a risk or exposure.

2.6. Exposure to translation:

Many multinational corporations demand that their accounts be combined with those of their overseas branches and subsidiaries. In order to accomplish this, foreign-currency assets and liabilities must be converted into domestic currencies using the exchange rate in effect on the consolidation dates. Translation risk will occur if foreign exchange rates fluctuate between two or more consecutive consolidation dates.

2.7. Exposure to operations:

Similar to translation exposure, operating exposure entails a real or possible benefit or loss. The latter pertains to the entire investment, whereas the former is transaction-specific. The fundamental aspect of this operating risk is that fluctuations in the exchange rate have a large impact on the firm's competitive position by affecting both the price of its output and the cost of its inputs.

3. METHODS AND TOOLS FOR FOREIGN EXCHANGE RISK MANAGEMENT

Financial directors, corporate treasurers, and portfolio managers frequently use hedging exposures, also known as risk management.

The goal of covering exposure is to lessen the volatility of a company's cash management and/or profitability, which should therefore lessen the volatility of the company's value. There are many different ways to reduce foreign exchange risks, and they can be divided into internal and external exposure management strategies.

3.1. INTERNAL METHODS

By controlling the company's financial situation, internal exposure management strategies assist in mitigating exposure risks. As a result, they guarantee that exposes won't damage the company. The basic emphasis is on reducing, rather than totally eliminating, exchange losses that are likely to occur as a result of exposure.

They don't use unique contractual relationships with companies outside of the group in question; instead, they use exposure management techniques that are a component of a firm's regulatory financial management. Their goal is to minimize exposed positions or stop them from occurring. They support asset/liability management, netting, matching, leading and lagging, and pricing rules. Contracts with third parties are not necessary for managing exposed positions when using internal exposure management strategies. Instead, internal finance management is responsible.

3.2. OUTSIDE METHODS

In order to reduce the risk of foreign exchange losses, these refer to the utilization of contractual relationships outside the group of enterprises. They provide insurance against the potential for exchange losses to arise from an exposed position that cannot be eliminated by internal procedures. These consist of government exchange risk guarantees currency options, factoring, short-term borrowing, discounting bills receivable, and forward contracts.

Contractual relationships outside the organization are used in external foreign exchange exposure management strategies to lower the risk of exchange rate fluctuations. There are numerous outside methods for managing foreign exchange. The company is free to select the approach that best suits its needs.

4. FOREIGN EXCHANGE RISK MANAGEMENT TOOLS

4.1. CONTRACT FOR FORWARD EXCHANGE:

By determining the exchange rate in advance for a transaction anticipated to occur at a later time, a forward exchange contract allows one to guarantee the value of one currency against another.

Under a foreign exchange contract, two parties—one of whom is a banker who is required to be in India—enter into an agreement to buy or sell a fixed amount of foreign currency at a predetermined rate on a

specific future date or period. The forward exchange rate is a tool to protect importers and exporters against exchange risk. The forward exchange contracts are made between two bankers or between a banker and a client.

For example, an Indian exporter would instantly get into a contract with his banks rather than speculating or grouping in the dark about the future rate. He commits to selling foreign exchange at a given future date in a given amount and currency. By agreeing to purchase something at a specific exchange rate, the banker guarantees his price in local currency. An exporter might, for instance, sign a forward contract with the bank for delivery at Rs. 49.50 for three months. This rate is referred to as the three-month forward rate as of the contract date. Regardless of the spot rate in effect at the time, the banker would buy the exporter's bill at Rs. 49.50 when he submitted it in accordance with the contract.

Many importers discovered that their liabilities had doubled overnight when the rupee depreciated by roughly 18% in July 1991. Foreign currencies appreciated in value relative to rupees as a result of the rupee's devaluation. A contented group of importers had secured advance contracts to cover their goods.

DELIVERY DATE

A forward contract is deliverable at a later date, as per Rule 7 of the FEDAI, with the contract's term calculated from the transaction's spot value date. Therefore, if a three-month forward contract is scheduled for February 12th, the two-month period should start on February 14th, and the contract will expire on April 14th.

OPTION FORWARD AND FIXED CONTRACTS

"Fixed Forward Contract" refers to a forward contract wherein the delivery of foreign exchange is scheduled for a specific future date. For example, if a customer signs a three-month forward contract with his bank on March 5th to sell GBP 10,000, the consumer will deliver a bill or other document to the bank on June 7th for GBP 10,000. He is unable to deliver foreign currency before or after the specified date.

The customer uses forward exchange as a tool to try to mitigate the exchange risk. If he fails to supply foreign exchange precisely on the due day, the goal will be lost. Under actual circumstances, no exporter can predict the exact date in advance. which enables him to finish the shipment and deliver the paperwork to the bank. The exporter is limited to estimating the likely date that he will be able to fulfill his agreement. The customer may be offered the option to receive the foreign exchange within a specified time frame in order to remove the challenge of determining the precise date of delivery.

An "Option Forward Contract" is a contract that allows the customer to purchase or sell foreign exchange from the bank at a predefined rate on any day within a certain time frame. The option forward selling contract with the bank with the option over November is the rate at which the transaction occurs. It indicates that the consumer has the "Option Period," which is any day between November 1 and November 30, to sell foreign exchange to the bank.

An efficient and accessible instrument for mitigating exchange risk is the forward contract. Exchange risks can also be covered by new instruments like swaps, futures, and options. Since the value of these instruments is based on the value of another financial contract or asset, they are known as financial derivatives. These instruments are used to "hedge" the exchange risk when they are purchased or sold to cover it. They are utilized for speculative reasons when they are dealt in with the intention of making money off of unforeseen changes in their values or other shifts in the exchange market. In India, the use of these instruments for speculation is severely restricted.

To prevent exchange risk, some additional strategies might also be modified. These include choosing the invoice currency, keeping it in a foreign currency, and determining the debt amount.

5. The study's necessity and significance stem from the growing interdependence of states in international trade and investment. World states move across borders as a result of these international relations. Countries own other nations' currencies, which leads to a foreign

exchange market. Reserves of foreign currencies are referred to as foreign exchange. The term "foreign exchange" more accurately describes the claim to foreign currency reserves. Residents of one nation have a financial claim on one or more other nations through foreign exchange. Foreign exchange includes all deposits, credits, and balances payable in foreign currencies as well as drafts, traveler's checks, letters of credit, and bills of exchange payable in foreign currencies. The market where money denominated in one currency is bought and sold with money denominated in another is known as the foreign exchange market. The foreign exchange (or forex) market is made up of transactions in different nations' currencies, the parties involved, the rates at which one currency is exchanged for another or for other currencies, the consequences of these rates, currency derivatives and dealing in them, and other related issues.

Every time a nation imports goods and services, its inhabitants travel abroad, its nationals send money overseas for any reason, its corporate units establish overseas subsidiaries, and so on, foreign exchange transactions occur. In each of these situations, the country in question either purchases the necessary and pertinent foreign currency in return for its own currency or takes money out of its established foreign exchange reserves. In contrast, a nation's currency is purchased by others, providing foreign exchange, when it exports goods and services to other nations, when foreigners visit the nation, when its citizens who have relocated abroad send money home, when foreign individuals, businesses, and institutions invest in the nation, and when the nation or its business community raises money from overseas.

Multinational corporations conduct business in numerous nations and deal with a variety of foreign currencies. Politics and the legislation of the counties in which they operate have an impact on their operations. As a result, they are more vulnerable than domestic companies. Analyzing how changes in interest rates, inflation rates, and currency rates affect business choices and reducing foreign exchange risk are major concerns for multinational corporations. Understanding the characteristics of foreign exchange, the elements that contribute to risk in foreign currency transactions, and the strategies employed to mitigate that risk are the key components of the study.

6. GOALS FOR THE STUDY

To research and comprehend foreign exchange.

To examine and assess the company's earnings in the event of exchange rate fluctuations.

To examine the income statement and determine the revenues after converting the dollars into Indian rupees.

To research the many forms of foreign exchange exposure, including risk and the risk management strategies the business employs to reduce it.

Presenting the company's findings and conclusions about 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.

7.2.SOURCES OF DATA

The information was gathered from a variety of secondary sources, including the internet and books. The information was gathered in accordance with the study's goals. An understanding of the IT company's foreign exchange risk policies can be gained from the study's presentations. This information was gathered from the firms' 2016–2017 annual reports. Following a thorough analysis of the IT company's risk management procedures, conclusions have been made regarding the most popular hedging tools for reducing 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 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 business must develop a risk management strategy that takes into consideration its unique situation. This is a synopsis of how an Indian company has developed its foreign exchange risk management strategy.

The business is subject to currency risk because it operates in numerous nations. The description is as follows:

1. They are subject to currency risk since they do a significant amount of their business in US dollars and to a lesser extent in other currencies. The company uses treasury operations to manage risk related to changes in foreign currencies.
2. HCL Technologies buys foreign exchange forward contracts and refrains from currency speculation in order to reduce the risk of fluctuations in foreign exchange rates on cash flows denominated in USD.
3. The majority of their foreign exchange operations were in US dollars. In fiscal 2017, the average INR to USD exchange rate was Rs. 41, compared to Rs. 44 in fiscal 2016. The facts in HCL's 2017 annual report served as the basis for the explanation of risk management in HCL given above.

10. RESULTS OF THE STUDY

Despite market expansion, companies need to go beyond BPO services to next-generation services like software development, refinement, and value-added services if they want to succeed in the industry.

at today's global economy, where economic stability is genuinely at danger, software companies can only thrive by becoming more adaptive to changing circumstances.

Businesses must develop their services to the benchmark level or international standards in order for them to be recognized worldwide.

Many exporters' issues stem not from the volatility of the rupee but rather from the unfavorably high cost structure. Exporters are only viable when their foreign exchange earnings are converted into a growing quantity of rupees. To boost rupee viability and sustain profits, exporters must lower their overall rupee costs and be effective and productive.

Poor viability cannot be resolved by hedging. An inefficient exporter needs an exchange rate of Rs. 45 to break even in order to show profit. It will sparkle for around forty-five rupees. It will wane at any exchange rate below Rs. 45.

if a forward contract is in place. The forward contract locks in the exporter's conversion of dollar revenues to rupee revenues at the going rate of Rs. 41 per dollar. The market will surely not purchase the exporters' dollars at Rs. 41, even with the perfect hedge, rendering them utterly useless and putting them in grave risk.

Until exporters' breakeven point falls to Rs. 41 per dollar, viability will not be addressed. However, an inefficient exporter can profit from the hedging, which makes sense at Rs. 41 per peer dollar.

The implicit dollar strategy will significantly protect exporters' dollar earnings. The management and employees of exporting enterprises will get implicit dollar payments. A dollar-for-dollar price will be paid by the firm. Nonetheless, the payment will be paid in rupees and at the current currency rate. In the event that the dollar's value drops, managers' and employees' expenses will be paid in rupees at, say, RS. 39; if the dollar's value rises, they will be paid.

Exporters should solve these difficulties by implementing good governance through the provision of superior corporate, human, and social infrastructure, even in the face of high tax rates. Good governance lowers the operating and overall costs of running a corporation.

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