Foreign Exchange Management

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What Is Forex?

- Foreign exchange or **Forex** is the conversion of one country's currency into that of another.
- A country's currency is valued according to factors of supply and demand
- A currency's value can be pegged to another country's currency, such as the U.S. dollar, or even to a basket of currencies

What is Currency?

- Currency refers to the physical aspects of a nation’s money supply.
- “Currency notes" means and includes cash in the form of coins and bank notes. (Section 2(i) FEMA).
- "Indian currency" means currency which is expressed or drawn in Indian rupees but does not include special bank notes and special one rupee notes issued under section 28A of Reserve Bank of India Act, 1934 (these are issued on special occasions like Gandhi centenary etc.). (Section 2(q) FEMA)

Number of Currencies in the World

Out of the 193 countries, there are about 182 official currencies in the world

What is Forex Market?

- Is an over the counter market.
- Through it we can convert one country's currency into another.
- Forex markets are quite decentralized.
- Participants like market makers, brokers, corporate and individual customers are physically separated from each other.

What is Forex Market?

The foreign exchange market refers to the network of individuals, banks and organized financial exchanges that trade global currencies.

Forex Market

- Global
- 24 hours (Never sleeps)
- Through telex, telephone, fax, computer networks
- Simultaneous trading in all currencies

Features

- Risks similar to any commodity
- Profits from exchange rates
- Exchange exposure/funds position

Elements Of Forex Market

1. It is part of management science .
2. It refers to generation of Forex.
3. It pertains to use of Forex
4. It covers storage of Forex

History of Forex Market

- The creation of the gold standard monetary system in 1875 marks one of the most important events in the history of the forex market.
- Before the gold standard was implemented, countries would commonly use gold and silver as means of international payment.
- The main issue with using gold and silver for payment is that their value is affected by external supply and demand.

International Monetary System

- **International monetary systems** are sets of internationally agreed rules, conventions and supporting institutions that facilitate
  - international trade,
  - cross border investment and
  - generally the reallocation of capital between nation states.

- They provide means of payment acceptable between buyers and sellers of different nationality, including deferred payment.

International Monetary System

- To operate successfully, they need to inspire confidence, to provide sufficient liquidity for fluctuating levels of trade and to provide means by which global imbalances can be corrected.
- The systems can grow organically as the collective result of numerous individual agreements between international economic actors spread over several decades.
- Alternatively, they can arise from a single architectural vision as happened at **Bretton Woods** in 1944.

Bretton Woods System

- During World War II, the Allied nations believed a need to set up a monetary system to fill the void left by abandoning the gold standard system.
- In July 1944, more than 700 representatives from the Allies convened at Bretton Woods, New Hampshire, to deliberate over the system of international monetary management.
- It established the rules for commercial and financial relations among the world's major industrial states in the mid-20th century.
- The first example of a fully negotiated monetary order intended to govern monetary relations among independent nation-states.

Bretton Woods System

- On August 15, 1971, the United States unilaterally terminated convertibility of the dollar to gold. As a result, the Bretton Woods system officially ended and the dollar became fully 'fiat currency.
- Bretton Woods led to the formation of the following:
  - A method of fixed exchange rates
  - The U.S. dollar replacing the gold standard to become a primary reserve currency.
  - The creation of three international agencies to oversee economic activity: the International Monetary Fund (IMF), International Bank for Reconstruction and Development, and the General Agreement on Tariffs and Trade (GATT).

Fact File

The most commonly traded currency pairs are the U.S. Dollar and the Japanese Yen, the U.S. Dollar and the Euro, and the U.S. Dollar and the Swiss Franc.

Forex Market Players

- Commercial Banks
- Central Banks
- Corporates
- Individuals

Major Forex Currencies

• USD	:	US Dollar
• EUR	:	EURO
• GBP	:	British Pound
• JPY	:	Japanese Yen
• CHF	:	Swiss Franc
• AUD	:	Australian Dollar
• CAD	:	Canadian Dollar

Fact File

According to the Wall Street Journal Europe, the most commonly traded currencies on the Forex market are the U.S. Dollar (USD), the Japanese Yen (JPY), the Euro (EUR), the British Pound (GPB), the Canadian Dollar (CAD), the Australian Dollar (AUD), and the Swiss Franc (CHF).

Top 10 currency traders

1	Deutsche Bank
2	Barclays Capital
3	UBS AG
4	Citi
5	JPMorgan
6	HSBC
7	Royal Bank of Scotland
8	Credit Suisse
9	Goldman Sachs
10	Morgan Stanley

Foreign Exchange Markets

- Spot markets
- Forward markets
- Futures markets (In India, yet not permissible)
- Options markets
- Swaps markets

World Forex Markets

- They are mostly centered around organized markets like New York, Tokyo, London, Zurich, Hong Kong, Singapore etc.
- Daily trade runs to hundreds of billions of dollars worth of currencies of the world.
- Forex market is an abstract concept as there is no single location, say like the Mumbai stock exchange.
- It is merely an over the counter market.

Futures, Options and Swaps

are called

Derivatives

*because they derive their value from the **underlying exchange rates.***

Forex Market in India

- The economic liberalization provided the economic rationale for the introduction of FX derivatives.
- According to data compiled by Switzerland-based Bank for International Settlement (BIS) India has the fastest increase in market share in comparison with other countries in the world.

Role of RBI

- Management of money Supply / inflation
- Management of exchange rates
- Ensuring orderly markets

Factors Effecting Rates, Short Term

- Time scale in forex
- Supply/demand position
- Movement of funds
- Entry of a large Banks / Corporates
- Political crises, wars, oil price
- Central Bank intervention

Factors Effecting Rates, Long Term

- Economic fundamentals/data
- Balance of payments
- Govt.'s economic policies
- Interest rate changes
- Capital movements
- Technical/psychological factors
- Purchase power parity
- Interest rate parity

Determination of Exchange Rates

- Balance of payments
- Demand and supply
- Purchasing power parity
- Interest rate
- Relative income levels
- Market expectations

Forward Exchange Rates

- The forward rate is a price quotation to deliver the currency in future.
- The exchange rate is determined at the time of concluding the contract,
- But payment and delivery are not required till maturity.
- Foreign exchange dealers and Banks give the forward rate quotations for delivery in future according to the requirement of their clients.

Foreign exchange Reserves

- Foreign exchange held by a nation is one way to measure a country's economic power.
- As on December 2011 –
  - **China stood No 1 with FE** reserves: $3,181,100 millions
  - **Japan** stood at No 2 with FE reserves: $1,295,840 millions
  - **Saudi Arabia** stood at No 3 with FE reserves: $541,091 millions

- **India** stood at No 9 with FE reserves: $296,688 millions
- **The United States** stood at 17 with FE reserves: $149,541 millions

Foreign Exchange Risks

- Transaction Risk
- Translation Risk
- Economic Risk

Transaction Risk

- The risk of changes in the expected value of a contract between its signing and its execution as a result of unexpected changes in foreign exchange rates.
- Whoever makes a contract denominated in a foreign currency bears transaction risk.
- Ocean Drilling has transaction risk if it borrows money in French francs or Japanese yen, and Hintz-Kessels-Kohl has transaction risk if it agrees to accept future payments for its vehicles in U.S. dollars.

Translation Risk

- Gains or losses from exchange rate changes that occur as a result of converting financial statements from one currency to another in order to consolidate them.
- Every company having at least one subsidiary using a different functional currency bears translation risk.
- MSDI has translation risk from having a subsidiary, MSDI Alcala de Henares, whose financial statements are kept in Spanish pesetas and not in U.S. dollars.

Economic Risk

- Changes in competitive position as a result of permanent changes in exchange rates.
- Every company buying or selling abroad or even just competing with foreign companies has economic risk.
- Maybach has economic risk from manufacturing its automobiles in Germany for export to the United States, where it competes with Rolls Royces manufactured in England.

Other Classifications of Forex Risks

- Exchange risk
- Credit risk
- Liquidity risk
- Settlement risk
- Operational risk
- Compliance Risk

Fact File

Forex is the most liquid market in the world, thus making it easy to trade most currencies.

Forex Management

- Effective forex management minimizes the economic risks, while providing cash flow to meet everyday expenses and improve earnings.
- Foreign exchange management requires its participants to enter the market to deliver and accept currencies at fluctuating exchange rates.

Forex Management

- From there, individuals may either hold foreign currency in reserve to make payments or return overseas profits back home in the form of domestic banknotes.
- Proper foreign exchange management accounts for these transactions, while anticipating shifts in currency valuations that affect the bottom line

Managing Forex is all about……..

- Foreign Exchange Management requires you to follow current events that translate into fluctuating exchange rates for a particular country.
  – Savers prefer to do business in nations that feature stable governments and strong economies.

Managing Forex is all about……..

- Investors may liquidate overseas holdings in the case of economic recession and political instability that is attributable to a particular country.
  - For example, businesses would quickly sell assets and retreat from a nation that is undergoing military coup where the new regime is hostile to foreign investors.

Managing Forex is all about……..

- Identifying the distinct risks of transacting global business.
- Foreign exchange management analyzes the economic records of prospective countries---in order to uncover and buy undervalued currencies.
  – The goal is to hold these notes until exchange rates improve to mirror favorable developments, such as strong national employment reports and falling budget deficits. Successful currency trading increases profitability and buying power.

Managing Forex is all about……..

- Foreign exchange management may use diversification and currency derivatives to manage risks and preserve profits.
  - Currency derivatives are bought to establish predetermined exchange rates for set periods.
  - These derivatives include futures, options and forwards.
  - Currency futures and options trade on organized exchanges, such as the Chicago Mercantile Exchange.
  - Forwards, however, are customized agreements between two parties to negotiate future exchange rates between themselves.

Managing Forex is all about……..

- Smaller investors may elect to diversify with mutual funds according to geography, instead. For example, high commodity costs may lead Japan into economic recession, while mutual funds investing in resource-rich Russia are making money.

Identifying, Measuring, Monitoring & Managing Risks

Derivatives

- Use of Derivatives in Risk Management
  - Derivatives are contracts whose values are to be derived from the assets covered by them
  - Exchange Rate Risk : Forwards, Options, Futures, Range forwards (Floors, Collars, Caps)
  - Interest Rate Risk : FRAs, Options, Futures, IRS
  - Liquidity/Currency Risks : Currency Swaps/ Swaptions,

Foreign Exchange Derivative Contracts

- 'Foreign exchange derivative contract' means
  - a financial transaction or
  - an arrangement
  - in whatever form and
  - by whatever name called,
  - whose value is derived
  - from price movement
  - in one or more underlying assets, and includes,
  - (a) a transaction which involves at least one foreign currency other than currency of Nepal or Bhutan, or
  - (b) a transaction which involves at least one interest rate applicable to a foreign currency not being a currency of Nepal or Bhutan, or
  - (c) a forward contract, but does not include foreign exchange transaction for Cash or Tom or Spot deliveries.

Foreign Exchange Derivative Contracts

- Derivative contracts are governed by the **Foreign Exchange Derivative Contracts Regulations, 2000 (Notification No. FEMA 25/2000-RB).** No person in India can enter into a foreign exchange derivative contract or currency futures without the prior permission of the Reserve Bank.

Permission to enter into a Foreign Exchange Derivative contract

- A person resident in India can enter into a foreign exchange derivative contract to hedge an exposure to risk in respect of a transaction permissible under the Act.
- This should be in accordance with the provisions contained in Schedule I.

Types of Foreign Exchange Derivative Instruments in India

- Foreign Exchange Forwards
- Foreign Currency Rupee Swap
- Foreign Currency Rupee Options
- Cross-Currency Options
- Cross-Currency Swaps

Forward/Future Rate Agreement

- Cash settled forward contracts on notional amounts
- A mechanism to cover against adverse interest rate movements
- Available in all major currencies
- Flexibility of amount and period
- Fine spreads available on quotes

Options

- A stipulated privilege to receive/deliver a security commodity / currency, at a given price, with in /on a specified date.
- Confers a right with no obligation whereby the buyer can demand a purchase or sale by the writer of a specified amount of currency / number of bonds / shares, commodities
- Call option gives a right to purchase and a put option, to sell
- Premium paid on spot basis (2 days).
- Terminology: strike price, maturity date, premium,
- American / European options

Options

- Price dependent on:
  i. Difference between the strike and the market price
  ii. Interest rate differential
  iii. Term of the option
  iv. Volatility of the currency

Engineered Options / FRAs

- Cap: Insurance against rise in currency price or short term interests on liabilities
- Floor: For protection of income on an asset against fall in interest rates or currency prices.
- Collar: -A range product, where simultaneously a cap is bought and a floor is sold on a liability and vice-versa on an asset/currency

Interest Rate Swaps

- Helps create the right mix of short term and long term assets and liabilities, while controlling the interest rates attached to them
- No exchange of principal but only interest difference on a notional amount
- Interest rate risk can be shifted, by converting a floating rate to fixed rate or vice-versa
- Interest payments made in the same currency

Currency Swaps

- Currency swaps help hedge currency risk and companies can freely change the currencies in which they pay and receive
- Liabilities and assets can be restructured
- Balance sheet transaction risks can be hedged
- Surplus in one currency can be used to take care of funding in another currency
-
- Interest payments are made in two currencies
- Currencies and principal are exchanged at a pre-fixed rate at the beginning and end, of the contract period.

Swaptions

- An arrangement/right to call on the counter party to enter into a swap at a pre-agreed rate and for an agreed period

- An asset swap can improve yield on bonds and avoid its selling.

Futures

- An agreement to buy or sell a standard quantity of an asset at a future date at a price agreed through an open cry on the Futures exchange.
- Quantity, quality, date of delivery, units of price, minimum change in price, location for settlement are standardized
- American and European style

Forex Risk Mitigation

- Multi currency budgeting
- Cash and funds flow projections
- Multi currency pricing and invoicing
- Asset- liability management in a multi currency environment
- Dynamics of a multi currency balance sheet
- Appetite for risk

Managing risks

in

foreign exchange markets

is

***NOT** easy!*

But………

Interesting

&

Rewarding!!!!

About the Author

- CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.

- In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.

- Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.

- He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.

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About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

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