EFFECTIVE FX RISK MANAGEMENT

by Hee-Seong Kim

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The won-dollar exchange rate closed at 877.70 won on March 12. This was up 3.10 won from the previous day and marked the sixth straight daily rise since March 4, when the exchange rate was 863.60 won. The exchange rate actually even once soared to 878.70 won during the trading session on March 12. The won-dollar exchange rate has been rising sharply, largely due to the speculative buying of US dollars by the corporate sector. On the other hand, the Korean won has gained sharply against the Japanese yen, which is weakening the international competitiveness of major Korean export items such as steel, automobiles and electronics goods relative to the corresponding Japanese-made products. The won has gained 4.2% against the yen since the beginning of this year, reaching 697.23 won per 100 yen as of January 21. It is the first time in four years that the won-yen exchange rate has fallen to below 700 won per 100 yen. The volatility of exchange rates to which corporations are being exposed is increasing day by day. In other words, corporations' foreign exchange (FX) risks are increasing.

Why Manage Risk?

Risk management helps to fulfill three important needs: 1) the need to protect your business from financial shocks (e.g., the exchange rate soaring); 2) the need for greater predictability in future cash flows; 3) the need for long-term resilience in business.

The benefits for a company which adopts a risk management program are multiple. A higher market rating is given to corporations with stability of cash flow—the share price impact is likely to be positive. Such a stable cash flow enhances creditworthiness, leading to greater borrowing capacity. Long-term risk management also focuses on long-term opportunities. Investment in R&D and capital expenditure can be better managed. A firm can enjoy the freedom to focus on areas where the firm has a comparative advantage and a distinctive competence. For example, airlines can concentrate on the development and growth of their passenger/freight business rather than the management of fuel prices and foreign debt's foreign exchange exposure. Others also benefit from a risk management policy. Banks have a fixed call on cash flow. If cash flow is more secure, then banks are happy. Shareholders may—and usually do—have higher risk appetites than banks. They may also have conflicting requirements of the management of one company. By engaging in risk management the signal is clear—the riskiness of the business will not be increased at the expense of the bankers. This should enhance the company's ability to borrow more money over longer periods of time. Customers are concerned with the appetite of the enterprise for financial risk. If cash-flow volatility is reflected in retail pricing, this could be a cause for concern. Commodity suppliers who can offer fixed-price contracts are more innovative than those who just wait and see.

How About FX Risks?

A transaction exposure will often lead to trouble when there is a mismatch in revenues and expenses. For example, let us assume that one company's revenues are primarily in pounds but their payments for the imported facilities are in dollars. With a stronger dollar, this company would have to pay more pounds to make the payments on their debt. This FX transaction exposure might even contribute to sending the company into bankruptcy. Accordingly, foreign exchange transaction exposures are reflected in the firm's income statement. A parallel exposure—one that also focuses only on the direct effects of a price change—that is reflected in the company's balance sheet is referred to as a translation exposure. A translation exposure reflects the change in the value of the company as foreign assets are converted to the home currency. Most of the companies in Korea make a point of noting that they do not manage translation exposures. There is a much broader point worth noting, which is the relative competitiveness of two institutions against each other. A maker of cars in Korea selling to France is not only concerned with the value of the French franc against the Korean won, but also the values of his competitors' currencies (e.g., Japanese yen) against the French franc. If the currencies of a Korean manufacturer's competitors depreciate, then their goods become cheaper to French buyers, and thus the Korean firm's sales will suffer. There is much evidence which indicates very clearly that changes in foreign exchange rates can have a significant negative impact on a company's ability to compete. This being the case, how can these FX risks be managed? What products can be used to manage FX risks?

Products For FX Risk Management

By and large, FX risk management products are directed towards transaction risk; however, new products, such as average rate options, have been designed with translation risk in mind. Many new types of products have appeared in recent years. Most of these are not entirely new and can be briefly categorized as follows:

1) Spot Transactions

These are the most common transactions and are used to change money immediately. A spot transaction is one in which the rate of exchange between two currencies is agreed upon that day and the funds exchanged two business days later.

2) Forward Transactions

These are used to lock-in the cost of another currency, or to convert expected receipts in a foreign currency into a domestic currency at a guaranteed rate. The rate for exchanging two currencies is agreed upon that day, but the physical transfer of the funds does not take place until a future business day, for example, three months later. Forward rates are derived from the interest rate differential between the two currencies and the spot rate.

3) Foreign Exchange Swaps

These are essentially a substitute for money market deals, or for currency borrowing. A currency spot can be purchased simultaneously with the sale of the currency forward. Swaps are used to temporarily transfer funds into another currency to offset cost or to increase yields.

4) Currency Swaps

Currency swaps are used for transforming a term borrowing from one currency to another.

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These are a kind of interest rate swaps, whereby payments are exchanged between two parties in different currencies. There is an exchange of principal at the end of the agreement.

5) Currency Options

Options can be regarded as an insurance policy; in return for a premium the user is protected against adverse events. Currency options allow option buyers to fix an exchange rate but do not obligate them to deal at the rate if the prevailing market rate is not in the option buyers' favor.

Exchange rate management products can be classified into short-term and long-term. Options, forward FX contracts, and FX swaps can be categorized as short-term products. Long-dated forwards and currency swaps can be used for long-term risk management.

Control of FX Dealing Operation Procedure

There are many steps—measurement of risk, FX forecasting, setting up the required system and organization, etc.—which need to be taken before managing FX risks. In this report, these steps were passed over. Assuming that the preconditional steps above have been taken, let us go over the FX dealing control procedure instead. In order to make sure that the FX operations are being properly conducted, it is essential for a bank and a company to have some kind of internal audit unit. This unit and management must pay particular attention to the following areas: 1) the danger of too much emphasis being placed on dealers making high profits; 2) keeping processing areas (backup) entirely separate from the dealing area; 3) the importance of checking deal confirmations to and from counterparties.

The importance of separating the dealing areas from the backup areas cannot be overemphasized. This is probably the single most important element in keeping the ongoing dealing operation under control. Dealers must clearly understand and acknowledge what their individual limits are within the overall figures assigned to the dealing operation. It is the responsibility of the dealing manager/chief dealer to make sure that this is done. In return, management should not expect too much of dealers by way of profit. This can lead to risky positions being taken to boost profits, with the inherent possibility of substantial loss. At regular intervals foreign currency holdings must be revalued.

Conclusion

Foreign exchange does not involve only trade. The foreign exchange markets today are dominated by movements of international capital seeking the most profitable home for the shortest term. The late 1980s have seen large fluctuations in exchange rates as capital flows have been liberalized. Although changes in exchange rates are usually gradual, changes that used to take place over a matter of weeks can now take place in minutes.

In order to manage FX risks, companies especially need to have a professional department which consists of experienced dealers and is a well controlled operation. It is essential that internal infrastructure such as risk measurement, control, and management computer systems have been arranged. Most of all, management must understand clearly how important FX risk management is and what its benefits are. VIP