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A Study of Foreign Exchange Risk Management within Banks

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ABSTRACT

After the whole liberalization and globalization, the Indian economy has become well connected to the world outside its boundaries. This connection leads to various market risks. In order to hedge these risks Indian market takes various precautions. In this study we are going to look at the various risks a banking industry faces in the Indian market related to foreign exchange. We will also look at the various ways that they hedge these risks. This study will mainly focus on the banking sector and their risk management techniques. The information gathered for this report is secondary in nature which means they are collected from various published documents or the banking sector. It is found that even though there are several ways to hedge the foreign exchange risks the banks go for one maybe two policies to hedge their risks. This is mainly because they are still sceptical about the foreign markets. They prefer the RBI rules and various cushions that prevent them from incurring too much of losses due to foreign exchange exposures.

keywords: Foreign Exchange, Exposure, Risk

INTRODUCTION

Foreign exchange in simple term means the exchange of one currency to another. It also means the Global Market where you go to trade in foreign currencies. This exchange ca range from a person converting currency for an International tour or a company paying its suppliers abroad.

India after the liberalization in 1999 became very well connected with the rest of the world. This connection leads to various foreign exchange transactions and risks. Before this the Indian market was quite rigid and also quite safe. It had set boundaries and very less interaction with the outside world. With globalization and the opening up of borders the Indian market has not only flourished but also gained some supporters and some risks. The breaking of these trade rules and barriers meant that the markets got new suppliers for various products and also funds. In turn they could export their goods to other countries for foreign currency or gold. They got to know about other borrowing techniques and debt markets which broadened the scope of better finances.

As also said above with these openings various risks were associated and to hedge these risks steps needed to be taken. In India there is always a search for the most cost effective way to hedge a risk. To try and maintain a good rupee value and to incur lesser losses many hedging techniques are currently used. Any dynamic exchange market provides a wide range of hedging techniques to its businesses. As India becomes more involved in global transactions it is becoming more important to have the best hedging policies in effect.

Till recently the exchange rate stability made everyone feel safe. The importers felt that the rupee value decline if happens will be stopped in time by RBI and exporters thought that the currency rate was great and didn’t need to appreciate. This has kept businesses from properly hedging for a long time. Although the scenario is changing, the current fluctuations has given rise to the need of good hedging policy and implementing those policies.

The businesses are becoming more active in risk management. The full information on how much successful they are may not be available but it can be said that with more involvement in foreign trades and foreign currencies the businesses need to strategically think and find the best hedging policy for themselves.

OBJECTIVES OF THE STUDY

- To ascertain the FERM policies and product usage of Indian banks.
- To ascertain the organisation structure, policy making, and control process adopted by banks in managing foreign exchange exposure.

METHODOLOGY

The study is majorly an exploratory one. It mainly has information collected from variety of sources like publications in RBI sites about bank policies and bank websites. Some of the information is collected from the bank annual reports and journals published. A little bit of literature review in the area of foreign exchange risk management will also help with collecting information on the various techniques used.

DATA ANALYSIS

When it comes to foreign exchange risks there are two types of risks that can happen. These are called foreign exchange exposures. They are Translation Exposure and Economic Exposure.

Translation exposure is a type of accounting exposure, where the financial statements of an international partner or subsidiary needs to be converted into the domestic currency. This is very sensitive to the exchange rates and thus fluctuates regularly.

Economic exposure is an exposure where a firm’s or company’s market value fluctuates due to the instability of the changes in foreign currency. One type of economic exposure is transaction exposure where fixed price contract in an atmosphere of exchange-rate volatility.

Foreign exchange is not predictable. There are various factors which keep affecting it and continuously changing it. Even researches into the exchange rate changes have discovered that even though exchange rates can be determined by looking at historic data, there is no guarantee that it will be exactly that. It can easily turn out to be something different. Therefore what most companies do is hedge these risks. Hedge means try and minimize their risk factor due to dealing in foreign markets. There are different techniques to hedge risks like forwards, futures, swaps or options.

When we start talking about foreign exchange the Indian economy or the Indian banking system, we can still see a lot of ignorance. The idea of using derivatives or hedging is either unknown to them or scarcely used. If there were no rules set by RBI there is a possibility that the banks might not hedge their foreign exchange risks.

There are various reasons for this like not knowing which technique to use for which risk. Finding the right technique is very important to be able to hedge a risk properly but little to no knowledge of which risk requires which king of hedging can have the opposite effect of helping. There is a general fear of hedging. Not knowing what will happen in the future scares banks as much as it scares a normal person. Therefore they have trust issues and fear the instability of exchange rates. Sometimes even costs play a role in the use of hedging policy. The banks don’t find the costs involved worth the risks and therefore feel they are doing just fine without hedging.

After a thorough search through the several published works of RBI and other banks we found that they have various techniques in place to hedge the exchange risks both internally and externally. Although the banks have the freedom to choose the best hedging option suitable for them. Most banks published that they preferred Multi- currency billing systems and price adjustment as their internal hedging technique and for external they prefer forwards and futures as they feel these are more secure.

The banks depend a lot on the RBI policies when it comes to foreign exchange. Like the firms in India even they are careful in dealing with foreign exchange. But having international branches and clients the need to have foreign exchange and thus depend on RBI guideline to overcome the risks.

CONCLUSION

After the whole globalization and liberalization there has been many changes. Most of them relating to foreign market and foreign exchange. India as an economy is trying its best to overcome the challenges that come with dealing with foreign exchange. The indian banks maybe slow on the take in managing foreign exchange but they have become more active in the recent years due the various fluctuations and their effects on Indian economy. We can expect that in the future they will gain better knowledge and will have a better way of handling the foreign exchange risks.

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