

# Assignment – international financial management flashcard



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This report contains a brief understanding about the foreign exchange risk and the various techniques used for hedging against these risks which is very important for International Financial Management in the current market scenario.

The problem stated in the assignment about a US firm which is due to receive 500mn Mexican Pesos in 6 months time is a real time situation provided to us. It gives us an opportunity to think as analysts, evaluate the situation, perform calculations and suggest the firm to take the most profitable hedging approach. It also gives an opportunity to understand and explain the various hedging techniques available in the market. Further study of the report makes us familiar with the features of fixed contracts and option contracts. Extracting information on these topics has been very informative and productive in terms of gaining knowledge.

Purpose of Hedging Foreign Exchange Risk Hedging is a technique for risk management, performed to safeguard foreign exchange vulnerabilities against the unpredictability of exchange rates. Hedging can be performed using techniques like Currency Futures, Forward Contracts, Currency Swaps, Money Markets, Currency Options, etc. by acquiring neutralizing positions against the underlying asset. To create stability between risk opportunity loss and uncertainty is a demanding act in hedging. Hedging is a risk in itself, and could be destructive if utilized inaccurately and with the desire of doing speculation. Hedging refers to a situation; where a company or an individual can safeguard the price of their financial investment at a future date by taking an opposite position in the present date.

When 2 companies from 2 different countries do business with each other, they exchange currencies. When one company receives payments from the other company and vice versa, they have to consider the exchange rates of the countries. Foreign exchange risk refers to the risk that the exchange rates will change before the currency is paid or received. There are different types of foreign exchange exposures: Transaction, Economic and Translation exposures. Transaction exposure: measures the change in the value of financial liabilities obtained prior to the change in exchange rates but to be paid-off after the change in the rates. Economic exposure: measures the change in the present value of the company caused due to any change in the expected future operating cash flows which is caused by unpredictable changes in exchange rates. Translation exposure: measures the probable gains or losses that appear on the consolidated financial statements due to varying exchange rates.

Alternative Hedging Techniques Hedging with Options - Currency options can be defined as an arrangement between 2 parties where the buyer of the option has the right but does not have any compulsion to buy or sell currency at a defined exchange rate, on or before a specified date, from the seller of the option. There are two types of options - Call options - buyer possesses the right to buy currency at a defined exchange rate on or before a specific date. Put options - the buyer possesses the right to sell currency at a defined exchange rate on or before a specific date. Seller of the option is rewarded with a premium of the option in the event a buyer utilizes the right. Thus in such a situation it is obligatory for the seller to receive the premium of the option.

Hedging with Futures - Currency futures is traded in the futures market. Reduction in the value of currency can be hedged by selling futures and increase in the value of currency can be hedged by buying futures. Futures contract is a legal agreement to buy or sell a currency in exchange of another currency (only standard quantity exchanged) at a defined exchange rate and in a specific period. Price fluctuation in the futures market determines the change in exchange rate of the currencies. For example, a buyer acquires the contract to buy wheat in September. The price to be paid is figured out by the demand and supply on the futures market trading floor, if in case the crops are destroyed due to weather conditions the price for wheat rises. In this scenario, buyer of the contract can either trade within a defined period or can hold it until the contract expires.

Hedging with Swap - Currency swap is an arrangement between 2 parties exchanging currencies at defined exchange rate at specified time in future. For example, Company A requires Dollars in the future and Company B requires Pounds, both companies arrange to swap currencies at defined exchange rates at a specified date in the future. This reduces the risk occurring due to fluctuation in currency exchange rates, hence proving beneficial for both the parties. Currency swap deals with the exchange of principal amount and interest of a currency in exchange of another currency, known as foreign exchange transaction.

Hedging with Forward Contracts - Forward contracts can be used to fix exchange rates up to a year ahead. For companies it is ideal if they are importing goods, as the sale price is usually agreed few months before the goods are shipped. Although, the exchange rate could fluctuate the  
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advantage of forward contract is that the company knows the exact standard cost of the goods as soon as the rate is agreed. This protects the company from adverse exchange rate fluctuations. Another advantage is that the company needs to pay a small amount between 5% - 15% as deposit when the rate is finalized, while the rest of the amount can be paid on the agreed future payment date. For example, a farmer produces 2million lbs apples every year.

The price of apple fluctuates, sometimes goes to 30pence per lbs after the harvest and the farmer makes good amount of profits and sometimes the price falls to 10pence per lbs and the farmer is unable to cover his costs. On the other hand, an Apple Pie Chain who buys apples every year from the farmer, if they buy it for 10pence per lbs they make huge amounts of profits and if they buy it for 30pence per lbs they make very negligible profits. The farmer and the apple pie chain can setup a contract before harvesting, where the pie chain would agree to buy 2 million lbs apples for a price of 20pence per lbs. This helps to take out the unpredictability of the market fluctuations and both parties can benefit from this contract.

Hedging with Money Markets - Money Market Hedge is a process of borrowing and lending in multiple currencies to eliminate currency risk by locking in the value of a foreign currency transaction in one's own country's currency. For example, if company XYZ is due to receive \$10million in 3months time, Spot rates (\$/£) (1. 5384 - 1. 5426), Interest rates in US (5. 2% - 5. 8%), Interest rates in UK (3. 6% - 3. 9%). XYZ would borrow \$10mn @ 1. 45% so the present value is now \$9. 86mn. XYX would convert \$9.

86mn to UK £'s at the current spot rate of 1. 5426% and get £6. 392mn. XYX  
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would now deposit £6.392mn for 3 months @ 0.9% and get £6.97mn. XYZ would now convert £6.97mn with the spot rate of 1.5384% and get \$10.7mn. Hence XYZ had to receive \$10mn and it received \$10.7mn making a profit in excess of \$700k.