Awareness and Use of Various Hedging Tools by IT Sector Undertakings In Pune For Effectively Managing the Foreign Exchange Risk

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Abstract

Financial markets across the globe have been in turmoil with currency markets displaying high degree of volatility. The Indian Rupee has witnessed sharp depreciation and increased volatility during the recent past, driven by both global and domestic factors. The event began Post 2008 financial crisis, the advanced economies slipped into recession and faced prolonged slowdown in their growth. Sovereign Debt crisis of Euro Zone countries, which subsequently followed, also hampered the world growth. After the historic downgrade of USA by S&P in August 2011 that triggered heightened risk aversion and a selloff of assets in emerging economies including India by the Foreign Institutional Investors (FIIs). Risk aversion was further heightened on escalating euro-zone concerns, falling global growth and recent apprehensions over the US Federal Reserve tapering its bond purchase programme. While authorities across the globe have taken actions to stabilize the markets and support growth, India has grappled with unique domestic considerations.

Keywords: Risk management, Hedging, IT, Finance

I. INTRODUCTION

Historically, the Indian rupee, which was at par with the American currency at the time of our Independence in 1947, hit an all-time low of 68.79 to the dollar, but has partly recovered since then. Major reasons for such a drastic fall include: l. Continued Global uncertainty, Continued global uncertainties have led to pressure on most currencies against the US Dollar. 2. Moderation in capital inflows. 3. Moderation in Gross Domestic Product growth and decline in prospects of the economy. 4. High inflation rate. 5. Wide fiscal deficit. Major positive steps being undertaken and recent stability, the long term outlook for the Indian economy remains positive due to strong domestic demand spurred by rising incomes and aspirations, a skilled workforce, significant household savings and a young demographic profile. In recent days the positive outlook has been clouded by growth concerns, approaching elections, expanding current account deficit and persistent infrastructure bottlenecks. It is in such a challenging environment that Indian corporates seek to continue with their normal business activities and generate higher returns. With exchange rates in a state of flux it is increasingly difficult for business entities to make optimal decisions without the benefit of hindsight. It is imperative that all business entities explicitly understand and measure currency risks associated with their business. In the Indian market a large number of derivative instruments are available for corporates to effective manage their currency risks. The derivative products chosen should be consistent with the corporates' business, financial operations, skill and sophistication, internal policies as well as risk appetite.

Though the RBI has imposed the responsibility for due diligence and appropriateness of a derivative contract on the banks, the end-user corporates do have a greater responsibility in this regard. Identification, measurement and management of risks should be an integral part of the corporate governance structure.

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II- FOREX RISK MANAGEMENT

Before venturing onto describing the hedging avenues, I would like to quote Mr. V. K. Sharma, former Executive Director, Reserve Bank of India: "Risk Management is not about eliminating, or which is the same thing as completely hedging out risk but about first determining, like one's pain threshold, risk tolerance threshold and then aligning an entity's existing risk, be it currency, interest rate or commodity price risk, with its risk tolerance threshold. Having said that, it would also be in order to have a sense of how risk itself is defined and measured." The availability of hedging instruments such as forwards, swaps and options has never been a major concern for the Indian forex markets. Currency Futures have also been well received by the market. While presence of an underlying exposure is an essential requirement in the Over the Counter (OTC) segment, no such requirement is in place for the exchange traded derivatives segment. Liquidity has been ample in the spot USD/INR markets with the volumes increasing manifold over the past decade. The finer pricing and depth of the market reflects the substantial increase in trade flows.

The forward markets in India are also quite liquid up to one year. The Long Term Foreign Exchange (LTFX) market is evolving and exposure for longer tenures can be managed by entering into Long Term Forward contracts. Thus, it is in the interest of corporate to avail the various instruments and look to hedge their forex exposures. This would allow them to manage the currency risks in volatile markets.

III - FOREIGN EXCHANGE VOLATILITY:

Table No. 1

Financial YEAR	USD/INR HIGH	USD/INR LOW	RANGE
2015-16	68.79	62.04	6.75
2014-15	63.89	58.33	5.56
2013-14	68.83	53.81	15.02
2012-13	57.15	50.72	6.43
2011-12	53.72	44.07	9.65
2010-11	47.69	44.11	3.58
2009-10	50.52	44.92	5.6

Source: RBI

Foreign exchange (FX) is a risk factor that is often overlooked by small and medium enterprises (SMEs) that wish to enter, grow, and succeed in the global markets. There is a spectrum of opinions regarding foreign exchange hedging. Some firms feel hedging techniques are speculative or do not fall in their area of expertise and hence do not enter into hedging practices. Other firms are unaware of being exposed to foreign exchange risks. There are a set of firms who only hedge some of their risks, while others are aware of the various risks they face, but are unaware of the methods to guard the firm against the risk. There is yet another set of companies who believe shareholder value cannot be increased by hedging the firm's foreign exchange risks as shareholders can themselves individually hedge themselves against the same using instruments like forward contracts available in the market or diversify such risks out by manipulating their portfolio. They need to understand that the volatile nature of the FX market, which may cause significantly damaging financial losses from otherwise profitable export sales. The primary objective of FX risk management is to minimize potential currency losses, not to make a profit from FX rate.

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IV- WHAT IS FOREIGN EXCHANGE RISK?

Foreign exchange risk is the risk that a business's financial performance or position will be affected by fluctuations in the exchange rates between currencies. The risk is most acute for businesses that deal in more than one currency (for example, they export to another country and the customer pays in its own currency). However, other businesses are indirectly exposed to foreign exchange risk if, for example, their business relies on imported products and services. Foreign exchange risk should be managed where fluctuations in exchange rates impact on the business's profitability. In a business where the core operations are other than financial services, the risk should be managed in such a way that the focus of the business is on providing the core goods or services without exposing the business to financial risks. Sources of foreign exchange risk.

Foreign exchange risk for a business can arise from a number of sources, including:

- where the business imports or exports
- where other costs, such as capital expenditure, are denominated in foreign currency
- where revenue from exports is received in foreign currency
- where other income, such as royalties, interest, dividends etc, is received in foreign currency
- where the business's loans are denominated (and therefore payable) in foreign currency
- where the business has offshore assets such as operations or subsidiaries that are valued in a foreign currency, or foreign currency deposits

V - ROLE OF PUNE/MUMBAI INTO IT/ITES EXPORTS

India's Top two states in Software Exports:-

Figure-1 (Rs Cr)

State	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Karnataka	70375	67100	70241	82110	95048	1.03L
Maharashtra	42980	45709	49874	46262	49796	55420
India	2.02L	2.05L	2.15L	2.27L	2.51L	2.73L

**Source: STPI, Maharashtra's share is 20% of the country's, second after Karnataka. TNN,Oct 6 , 2015 "Maharashtra seeks to be India's top software exporter" – Chittranjan Tembhekar*

VI- MAHARASHTRA'S CONTRIBUTION TO INDIA'S SOFTWARE EXPORTS

The city's IT growth story is only getting better, with a rapid proliferation of companies in the IT and ITeS sectors. Numbers shared by the Software Technology Parks of India (STPI), Ministry of Communications and Information Technology, show that Pune is only second in terms of software exports in the country. According to STPI Maharashtra centre, an export of Rs 63,000 crore was recorded in the last financial year, which is a 10% growth from the previous year. "Pune's software exports are seen to be rapidly growing and the city is also now emerging as the most lucrative hub for startups, just after Bengaluru.

Bangalore STPI center recorded Rs 1,00,000 crore exports, added Rai. In Maharashtra, Pune recorded the highest software exports, with Mumbai at second place, followed by Nagpur and Nasik. "In Maharashtra, various smaller cities are emerging as promising IT hubs such as - Nasik, Kolhapur and Aurangabad," said Sanjay Gupta, director, STPI-Maharashtra and Goa.

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Source of Data of IT Sector Companies:

MCCIA – Mahratta Chamber of Commerce Industry & Agriculture Pune. Industrial Directory.8th edition. Published in 2012-13 - Total 444 Regd. Members / 129 software exporters.

SEAP–Software Exporter Association of Pune(http://www.softexpune.org) -89 Reg. Members.

NASSCOM - The National Association of Software and Services Companies (http://www.nasscom.in) - 135 Reg. Members-STPI – Software Technology Parks of India-Maharashtra (http://www.mah.stpi.in) - Total 435 / 233-Pune Reg. Members.

VII- SCOPE & LIMITATIONS :

We are talking about mostly SME IT sector companies where the export sales turnover would be upto INR 100 cr per annum. Though the SME IT companies agree that while appreciation of risk is fairly ingrained at the operating managers level there was scope for better appreciation of risk at the Management level. A stronger organizational risk management culture and greater support from the senior management are perceived to be the major areas of improvement for better risk management. Although companies today attach larger importance to risk management in financial decision making, the approach still leaves much to be desired. While the focus on risk management has increased since the global financial crisis of 2008, market views still dominate risk management decisions rather than the risk profile and the risk appetite of the organization. Volatility and uncertainty in the markets during the last ten years has brought about a greater focus on market risk by the management. While there is no disagreement with the fact that corporate needs to manage Foreign exchange risk effectively, the approach to be adopted differs from sector to sector and is often influenced by policies being followed by the peer group.

The dilemma of how much amount to hedge and for what tenure challenges most SME's and these companies do not want to lose out to competition in future because their portfolios are aggressively hedged nor do they want to miss out on the current opportunity of locking in profits on their foreign exchange exposures. This is particularly true of companies dealing with commodities and those in the IT/ITEs sectors.

VIII- SIGNIFICANCE OF STUDY:

There are multiple risks faced by companies in the course of its business. Some are internal and some are external. Additionally, the corporate is actually in the business of taking some risks that it may be more competent to manage i.e. business risks, strategic risks, operational risks etc. The process of risk management starts with completely understanding the interplay between these various risks and accepting the fact that risks are not really eliminated but just transformed from one form to another using certain hedging tools. Typically a corporate is competing with many competitors (both domestic and international) in its line of business. Any Foreign Exchange hedges taken by it have to start with a projection of its expected FX exposures into the future. These projections are based upon certain assumptions about the state of its business performance in future.

A decision taken by the corporate to hedge its complete Foreign Exchange exposures for the foreseeable future (say next 2 years) could leave it in an under/over hedged position depending on how its business actually performs v/s the projections and market movements. This under/over hedging could itself pose risks to the corporate. In other words, managing the FX risks, has actually transformed the risks into a business risk. Most companies so far have been approaching FX risk management as a view based approach i.e. take hedges when their view on market indicates that the market could move against their underlying exposure.

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This strategy may work in a stable market environment but in today's event driven market environment, is likely to be quite un-predictable and hence risky. Hence, for most companies it would be prudent to follow a more scientific and systematic approach. The key to achieve right hedging strategy is a function of available tools and its sensible mix. There is no single product that can take care of all Fx hedging needs. While generally, foreign exchange forwards and options have been considered to be good instruments for hedging short term trade exposures (exports and imports) and cross currency swaps for hedging longer duration loan exposures, we have seen this change with times. In present times of volatile currency movements, use of Fx options is clearly a desirable solution. Buying options is like buying insurance cover to protect your business from Fx risks. Hence any prudent Fx risk management solution should look at embedding some amount of insurance ie use of bought option (be it vanilla bought options or bought option spreads). By paying a premium that is known up-front, the corporate can price it into their respective business models and protect it from future uncertainties. While nobody wants to be brave enough to call the top in the US dollar nor would one like to hazard a guess here while working on a risk containment strategy. Hence for an exporter, instead of locking in a particular rate through a forward contract, a mix of forward and bought options would be a more prudent strategy. And we have seen immense benefits of this strategy in the last couple of years. We are also seeing corporate clients, taking advantage of the listed currency futures and options on the local exchanges. However, given the low position limits and lack of liquidity on longer tenor contracts clearly exchanges cannot entirely fulfill, but definitely supplement, the hedging needs of the corporate. Using a combination of available tools in a disciplined approach to hedge all the identified FX exposures can place the corporate treasury in good stead.

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