Foreign Exchange Risk Management in Indian Commercial Banks: Perspectives of Bankers and Customers

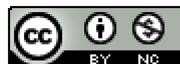
Madhuchandrika N.
Senior Faculty, MLI vertical, I-nurture Education Solutions Pvt Ltd. India
E-Mail: mchandrika4@gmail.com

Type of the Paper: Editorial Research Proposal.
Type of Review: Peer Reviewed.
Indexed in: OpenAIRE.
DOI: http://doi.org/10.5281/zenodo.3240234.
Google Scholar Citation: IJMTS

How to Cite this Paper:
Madhuchandrika, N. (2019). Foreign Exchange Risk Management in Indian Commercial Banks: Perspectives of Bankers and Customers. *International Journal of Management, Technology, and Social Sciences (IJMTS), 4*(1), 78-82.
DOI: http://doi.org/10.5281/zenodo.3240234.

International Journal of Management, Technology, and Social Sciences (IJMTS)
A Refereed International Journal of Srinivas University, India.
IFSIJ Journal Impact Factor for 2018 = 4.764

© With Author.



This work is licensed under a Creative Commons Attribution-Non Commercial 4.0 International License subject to proper citation to the publication source of the work.
Disclaimer: The scholarly papers as reviewed and published by the Srinivas Publications (S.P.), India are the views and opinions of their respective authors and are not the views or opinions of the SP. The SP disclaims of any harm or loss caused due to the published content to any party.

Foreign Exchange Risk Management in Indian Commercial Banks: Perspectives of Bankers and Customers

Madhuchandrika N.
Senior Faculty, MLI vertical, I-nurture Education Solutions Pvt Ltd. India
E-Mail: mchandrika4@gmail.com

ABSTRACT
A study regarding the foreign exchange risk management in Indian Commercial Banks is proposed to be conducted in Bengaluru city. The main objective of the study will be to examine the foreign exchange risks faced by Banks and their customers, to understand the different instruments used to hedge those risks and the efficacy of those measures in managing the risks. The study will be considering the scenario from a banker and customer perspective. The research will be entirely quantitative in nature and data will be collected through structured questionnaires. The data so collected will be analysed using various statistical techniques and financial ratios. The proposed study is expected to further the cause of forex risk management.

Keywords: Commercial Bank, Risk Management, Foreign Exchange, forex.

1. INTRODUCTION :

Indian Banks are showing considerable enthusiasm in foreign exchange business which is evident by their increasing concentration on forex products. Although foreign exchange business has emerged as a profitable business prospect, they also expose Banks to considerable risk (Bredin, 2004) [1]. Forex risk arises in cases where Banks hold assets or liabilities in foreign currency and the exchange rates fluctuate. This risk puts the earnings and capital of bank at stake (Kanchu and Kumar, 2014 [6]; Raghavan, 2003) [8]. Further, as exchange rates are generally unpredictable and prone to occasional extreme movements, there is always a threat to the earnings and capital of Banks in the backdrop of vulnerable economic conditions (Limo, 2014) [7]. The forex risk of a commercial bank can originate from both trade and non-trade services and those risks will be either transactional or translational (Sabri, 2014). While the transactional risk, originates from the impact of exchange rate fluctuations on foreign transactions, translational risk originates when the exchange rate impacts the held in foreign currency by way of reducing its value (Rampini et al., 2017).

Over the previous decade, the interest income of Indian Banks has been diminishing owing to persistent economic slowdown, non-performing assets, etc. As a result, Banks are now exploring potential areas of business for income generation and foreign exchange market is one such prospective avenue (Dutta, 2008) [4]. However, fluctuating exchange rates have made it quite challenging for Indian Banks to expand their forex business without getting exposed to huge risks. Further, customers, such as importers and exporters, dealing with the overseas market through Banks are also exposed to similar risk (Raghavendra, 2018) [9].

Banks face a variety of foreign risks, such as the open position risk, cash balance risk, maturity mismatches risk, credit risk, country risk, over-trading risk, fraud risk, and operational risks. Owing to the wide range of risks, Banks need to be extra vigilant while dealing with the foreign market. Although the foreign currency transactions of customers will not affect the bank, it puts the reputation of the bank at stake as customers would expect their bank to offer support.

Banks adopt hedging techniques to manage forex risks, wherein their risk exposure will be either eliminated or minimised. A hedge is a

contract Banks enter into, which involves Banks taking an offsetting position to reduce the risk of adverse exchange rate movements, such as the futures contract (Chugh et al., 2017 [3]; Soni, 2018) [12]. It is similar to getting the transactions insured so that exchange rate volatility does not impact the profits of the Banks. There are different hedging techniques that Banks employ, such as foreign currency asset and liability matching, where Banks match their foreign currency assets and liabilities; foreign currency derivatives, such as foreign currency futures, swap, options and forward contracts, of which forward contracts are most popular for hedging through diversification of the foreign asset-liability portfolio (Brown, 2017) [2].
Although Banks used the above mentioned safeguards against the exchange rate fluctuations, the extent to which those mechanisms effectively offset forex risk is unclear (Limo, 2014) [7]. Further, as avenues of forex risks are expanding in the wake of economic and geopolitical developments worldwide, it is high time that the Indian Banks constantly evaluate their forex risk management strategies.

2. NEED FOR THE STUDY :

Owing to global economic turmoil and a persistent slowdown in the growth of economies across the world, global exchange rates are expected to remain volatile for a relatively long period. As a result, organizations involved in international business are exposed to forex risk as their profits depend on the stability of exchange rates. Indian Banks investing in the foreign market and helping customers' overseas transactions are also hard hit by the fluctuating exchange rates, which put their profits at stake and affects their reputation in the local and global markets. Therefore, it is necessary to analyse the bank mechanisms for managing forex and extent to which these mechanisms are useful.

3. REVIEW OF LITERATURE :

Foreign exchange and risks associated with it have caught the academic interest of a number of research scholars for a long time. As the proposed study intends to obtain a fresh perspective on forex risk from a banking point of view, the findings of the previous research endeavours have been reviewed in this section to arrive at the aspects that need to be explored further.
Sabri (2011) [11] studied the forex risk management techniques employed by Pakistani commercial Banks and found that while most of the Banks employ derivatives hedging to avoid forex risks and associated losses, these techniques do not have an impact on the foreign exchange business of those Banks.
Kanchu and Kumar (2013) [6] undertook an empirical study of the risk management strategies adopted in the Indian banking sector. The study opined that forex fluctuations expose Banks to considerable financial losses and therefore Banks should take measures to predict and hedge foreign exchange risks in order to gain competitive advantage.
Limo (2014) [7] conducted a study of the impact of forex risk management techniques on the financial performance of Kenyan commercial Banks. The author opined that the forex risk hedging techniques followed by Banks, such as forward contracts, options, cross currency swaps, price adjustments and leading and lagging have a direct positive impact on the return on assets (RoA) of the Banks.
Chugh et al (2017) [3] examined the forex risk management techniques employed by small and medium enterprises and other unlisted firms of India. The study opined that irrespective of the country they belong to, all the firms involved in foreign currency transactions need to carryout forex risk hedging in order to survive in the foreign market.
Denga and Jain (2017) [5] studied the forex risk management techniques used by multinational organisations in India and Ukraine. It was found in the course of the study that monitoring forex risk efficiently protects companies from losses emanating from volatile exchange value. Further, the study also found that derivatives trading has not been very profitable in India and Ukraine.
Rampini et al (2017) [10] explored the interest rate and interest risk management mechanisms

employed by financial institutions, wherein it was found that institutions that suffer losses due to exchange rate risks tend to reduce their forex business and hedging activities.

Raghavendra (2018) [9] undertook a study of the forex risk management using financial derivatives with regard to the Indian IT industry. The author opined that as Indian IT firms develop software and their incomes depend on exports, they are required to measure and manage exchange rate risk efficiently. The paper concluded that anintelligent use of hedging through derivatives is the only solution for foreign exchange risk faced by the Indian firms.

Tripathi (2018) [13] studied the risks emanating from the foreign currency exposure of small and medium enterprises and their effect on the commercial Banks of India. The study found that the small corporates are the most vulnerable to foreign exchange fluctuation and their unhedged exposures in the foreign market has a negative impact on Banks and the entire economy.

A review of previous literature revealed that although foreign exchange risks and associated risks have been examined objectively in the past, how Banks manage the negative impact of forex fluctuations relating to their overseas business has not been given due focus. Further, there is also a limitation of studies that look into the problem of foreign exchange risks from an Indian banking perspective.

As Indian Banks open up to global investment and foreign markets, they are exposed to the risk originating from changes in exchange rates. Although Banks have a variety of risk management techniques, there is always the danger of extreme exchange rate fluctuations surpassing the most secure risk management mechanism. While it is important that the Banks' and the customers funds in the overseas be secure, it is also essential that the Banks should expand their foreign exchange business in the wake of dwindling interest income. Therefore, it is necessary to develop new effective means to manage foreign exchange risks of Banks and their customers along with evaluating the efficiency of the existing forex risk management techniques.

4. OBJECTIVES OF THE STUDY :

1. To ascertain the macro- and micro-economic factors that expose Banks to foreign exchange risk.
2. To understand the hedging techniques through which Banks manage forex risk.
3. To analyse the effectiveness of forex risk management techniques thus employed by the Banks.
4. To delineate the role and challenges of Banks as money changers.
5. To map the consumer profile that deals with forex market through Banks.

5. RESEARCH METHODOLOGY :

The proposed study will adopt a mix of exploratory and descriptive research approaches, wherein the forex risk management techniques of Banks will be defined and the effectiveness of those techniques in containing forex risk will be explored. Further, the study will be entirely based on quantitative data, which will be collected through questionnaires. A deductive research method will be employed to understand the scenario of forex risk management in Indian Banks and customers.

6. SOURCE OF DATA :

Primary data: The primary data will be collected from the Bengaluru city based bankers and their customers carrying out forex transactions. Two different structured questionnaires will developed –one for bankers and one for customers. Likert scale type questions will be used which will be developed on the basis of an extensive literature review.

Secondary data: Secondary data will be collected from journal articles, theses, white papers, publications, books, occasional papers with RBI, Banks and other websites.

7. SAMPLING PROCEDURE :

A simple random sampling technique will be followed to select the respondents for the present study. The study will involve two kinds of respondents, i.e., bankers and customers and therefore two populations. A sample of 50 respondents each will be drawn randomly from the population of bankers and customers.

8. PLAN OF ANALYSIS :

The data collected through questionnaires will be analysed using the software SPSS. The demographic data will be analysed using descriptive statistics, such as mean, standard deviation, and tools like linear regression, correlation, chi-square test, etc. will be used. Financial ratios and percentages will be used wherever required. Further, the theoretical framework will be tested using Statistical tools.

9. CRITIQUE OF THE STUDY :

Although the study provides a fresh perspective of managing forex risk in the banking parlance, it is not without limitations. As the study will be conducted involving the bankers and customers of Bengaluru city, the findings of the study may not be applicable to Banks functioning elsewhere. Further, the study exclusively deals with the management of Banks/Customer`s risks associated with their foreign exchange transaction.

10. CONCLUSION :

The proposed study will contribute to the limited literature available on how Banks manage risks emanating out of foreign exchange transactions. Apart from describing the forex risk management strategies, the study will also examine the advantages of the tools and techniques used by Banks to manage forex risks. The study will be particularly important as Indian Banks' forex exposure is evergreen. Findings will be of considerable significance to bankers and customers in evolving their forex risk management policies.

REFERENCES :

[1] Bredin, D., & Hyde, S. (2004). FOREX Risk: Measurement and evaluation using value at risk. *Journal of Business Finance & Accounting, 31*(9-10), 1389-1417.

[2] Brown, G. W. (2001). Managing foreign exchange risk with derivatives. *Journal of Financial Economics*, *60*(2), 401-448.

[3] Chugh, A., Sharma, R., & Mehta, K. (2017). Forex Risk Management by SMEs and Unlisted Non-financial Firms: A Literature Survey.

[4] Dutta, D. (2008). Risk management in the Indian financial market. Doctoral Dissertation, Jadhavpur University.

[5] Denga, S., & Jain, A. (2017). Forex risk management for multinationals: internal and external hedging techniques. In *София* (Vol. 280, pp. 51-61).

[6] Kanchu, T., & Kumar, M. M. (2013). Risk Management in Banking Sector–an Empirical Study. *International Journal of Marketing, Financial Services & Management Research, 2*(2), 145-158.

[7] Limo, D. (2014). The effect of foreign exchange risk management on the financial performance of commercial Banks in Kenya. *Master's Thesis*, University of Nairobi.

[8] Raghavan, R. S. "Risk management in Banks." *CHARTERED ACCOUNTANT-NEW DELHI-* 51, no. 8 (2003): 841-851.

[9] Raghavendra, R. H. (2018). Managing forex risk by using financial derivatives: A study on Indian IT firms. *ZENITH International Journal of Business Economics & Management Research, 8*(1), 32-45.

[10] Rampini, A. A., Viswanathan, S., & Vuillemey, G. (2017). Risk management in financial institutions.

[11] Sabri, M.H. (2011). Foreign exchange risk management in commercial Banks in Pakistan. *Master's Thesis*, University of Lahore.

[12] Soni, R. (2018). Does Firms Have Impact of Currency Appreciation and Currency Volatility on Market Shares?—Study of Selected Financial and Non-Financial Firms of India. *Theoretical Economics Letters, 8*(05), 1004.

[13] Tripathi, D. (2018). A Study on Risks from Foreign Currency Exposure of Small and Medium Enterprises (SMEs) and Their Impact on Banks.

****