MANAGING TRANSACTION EXPOSURE

Transaction Exposure

Transaction exposure exists when the anticipated future cash transactions of a firm are affected by exchange rate fluctuations. A Kenyan firm that purchases Ugandan goods may need Ushs to buy the goods. Though it may know exactly how many Ushs it will need, it doesn’t know how many Kshs will be needed to be exchanged for those Ushs. This uncertainty occurs because the exchange rate between Ushs and Kshs fluctuates over time. A Kenyan-based MNC that will be receiving a foreign currency is exposed because it does not know how many Kshs it will obtain when it exchanges the foreign currency for Kshs.

If transaction exposure exists, the firm faces three major tasks. First, it must identify its degree of transaction exposure. Second, it must decide whether to hedge this exposure. Finally, if it decides to hedge part or all of the exposure, it must choose among the various hedging techniques available. Each of these tasks is discussed in turn.

1. Identifying Net Transaction Exposure

Before an MNC makes any decisions related to hedging, it should identify the individual **net transaction exposure** on a currency-by-currency basis. The term *net* here refers to the consolidation of all expected inflows and outflows for a particular time and currency. The management at each subsidiary plays a vital role in reporting it’s expected inflows and outflows. Then a centralized group consolidates the subsidiary reports to identify, for the MNC as a whole, the expected net positions in each foreign currency during several upcoming periods. (Refer to earlier notes on this)

1. Adjusting the Invoice Policy to Manage Exposure

In some circumstances, the Kenyan firm may be able to modify its pricing policy to hedge against transaction exposure. That is, the firm may be able to invoice (price) its exports in the same currency that will be needed to pay for imports. Because the matching of inflows and outflows in foreign currencies does have its limitations, an MNC will normally be exposed to some degree of exchange rate risk and, therefore, should consider the various hedging techniques identified next.

1. Hedging Exposure to Payables

An MNC may decide to hedge part or all of its known payables transactions so that it is insulated from possible appreciation of the currency. It may select from the following hedging techniques to hedge its payables:

• Futures hedge

• Forward hedge

• Money market hedge

• Currency option hedge

Before selecting a hedging technique, MNCs normally compare the cash flows that would be expected from each technique. The proper hedging technique can vary over time, as the relative advantages of the various techniques may change over time. Each technique is discussed in turn, with examples provided. The techniques can be compared to determine the appropriate technique to hedge a particular position.

Forward or Futures Hedge on Payables

Forward contracts and futures contracts allow an MNC to lock in a specific exchange rate at which it can purchase or sell a specific currency and, therefore, allow it to hedge payables denominated in a foreign currency. A forward contract is negotiated between the firm and a financial institution such as a commercial bank and, therefore, can be tailored to meet the specific needs of the firm. The contract will specify the:

• Currency that the firm will pay

• Currency that the firm will receive

• Amount of currency to be received by the firm

• Rate at which the MNC will exchange currencies (called the forward rate)

• Future date at which the exchange of currencies will occur

Nyeri Co. is a Kenya-based MNC that will need 100,000 Ushs in one year. It could obtain a forward contract to purchase the Ushs in one year. The one-year forward rate is Ush 25, the same rate as currency futures contracts on Ushs. If Nyeri purchases Ushs one year forward, its Ksh cost in one year is:

Cost in Ksh = Payables x Forward rate

100,000 Ushs x 1/25 = 4,000

The same process would apply if futures contracts were used instead of forward contracts. The futures rate is normally very similar to the forward rate, so the main difference would be that the futures contracts are standardized and would be purchased on an exchange, while the forward contract would be negotiated between the MNC and a commercial bank. Forward contracts are commonly used by large corporations that desire to hedge.

Money Market Hedge on Payables

A money market hedge involves taking a money market position to cover a future payables or receivables position. If a firm has excess cash, it can create a simplified money market hedge.

In the example above, the company needs 100,000 Ushs in one year. If it has cash, it could convert Kshs into Ushs and deposit them in a bank for one year. Assuming that it could earn 5 percent on this deposit, it would need to deposit Ushs today, as shown here:

Convert that into Ksh. Assuming an exchange rate of Ksh 1 to Ush. 25.

In many cases, MNCs prefer to hedge payables without using their cash balances. A money market hedge can still be used in this situation, but it requires two money market positions: (1) borrowed funds in the home currency and (2) a short-term investment in the foreign currency.

If the company did not have cash available, it could borrow the funds that it needs. Assuming that the company can borrow Kshs at an interest rate of 8 percent, it would borrow the funds needed to make the deposit, and at the end of the year it would repay the loan: