International Business
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Lecture - 36
Exposure Management Theory, Hedging, FERA & FEMA, RBI and its Power

Welcome friends once again to our course on International Business. So, in the last lecture we discussed about Foreign Exchange Exposure. So, the types of exposure the three types basically we discussed, the first is the Translation exposure where we talked about that it does not have actual any impact, but it is only to reflect on the books of accounts because nothing is liquidated, nothing is sold or purchased there. Second we talked about the Transaction exposure where there is a difference between the cost you know the receivables or the payable due to the change in the exchange rate in a short term period maybe 1 month.

So, suppose let us say we have sold something and we are we are about to receive some payment and in between the exchange rate change changes. So, we will get less or more due to the exchange rate change, right. The third we said is the Economic or Operating exposure which is a long term view and this has a larger impact on when you know when it is connected with the pricing of the product, change in the price of the products or it is the company's location changes. So, it has a long-term view basically and we understood that economic exposure also has an effect on the cash you know operating cash flow right of any company.

So, today we will talk about the Exposure Management Strategy, right. So, how does a company who we all have understood for example an Indian company if we have understood that there is a change in the, the currency value, so the exporter and importers would feel the pain right. Either they will be in a gain, so they will be happy or there will be in a loss, they will be in a pain right. So, we have understood also how it affects, correct. So, it becomes very important for all the firms and especially the firms who are in a large number of countries, they are operating in a large number of countries to take care of this exposure management and control it. So, that as you saw in the case of BMW a company, the company was doing everything fine, but because they were not able to understand and properly control the exposure management, they could not do it. They were making a loss of 2.4 billion Euro's in between 2005 and 9.

So, this should not be happening to any company. So, today we will discuss we will start with the Exposure Management Strategy.

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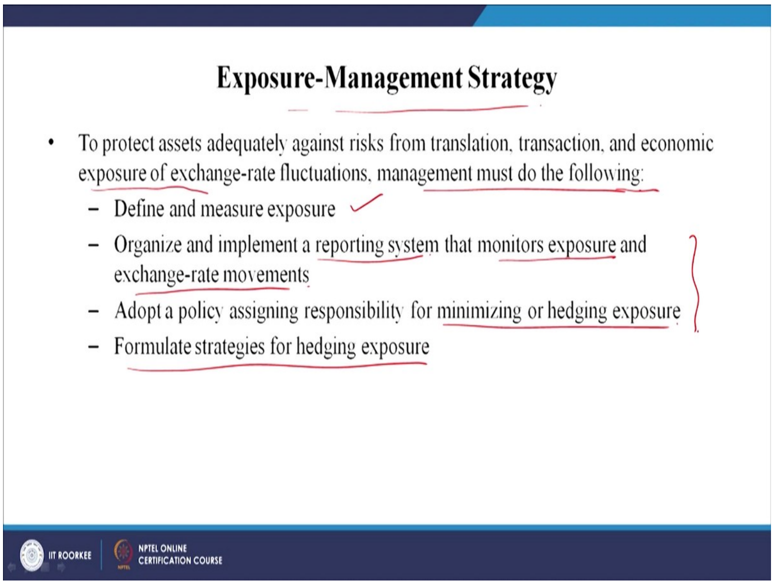

So, what it says is to protect assets adequately against risks from translation transaction and economic exposure of exchange rate fluctuations management must do something, right. So, they have to do the following. So, what they have to do? The first point is define and measure the exposure. So, first you have to define the exposure and measure it. That means how much of exposure is there right, what is the magnitude of the exposure, how much exposed we are. That means how much of transactions are we doing with a particular currency.

Let us say are we doing too much of trading with a particular country and with a particular currency, then we are more exposed to that particular currency. So, any volatility in that will have a major effect on our profitability. Similarly organize and implement a reporting system. A proper reporting system is required that monitors the exposure and exchange rate movements, ok. The third is adopt a policy assigning responsibility for minimizing or hedging. So, these two are connected. So, you have to monitor the exposure and also try to minimize or hedge the exposure. Hedging means to reduce right control it, formulate strategies for hedging.

So, what are the different strategies? Are we said one of the strategies which BMW had adopted was to get into different countries and produce there, so that they and they would buy the products source, the products in the from the local market. So, they have a long good supply chain establishment and thus they can hedge their exposure, ok.

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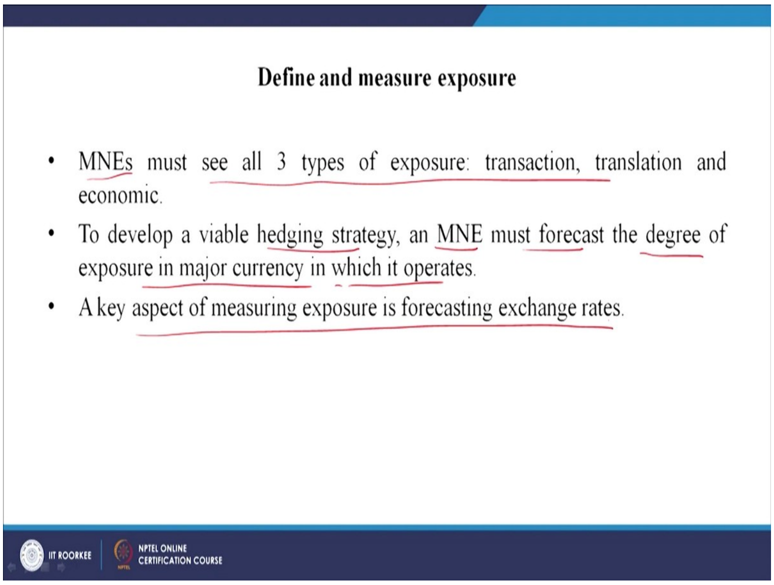

Define and measure exposure. So, MNEs Multinationals must see all three types of exposure, right. To develop a viable hedging strategy a multinational enterprise must forecast the degree of exposure in major currency in which it operates. So, it is not that simple. It is a very complicated task that you need to forecast. How much of business we are going to do with which country, right and what is the currency of that country and what is going to be the change in the currency of that particular country in the maybe future in the coming 10 months or 12 months or 1-3 years whatever it is during the time duration.

So that also has to be kept in mind; because suppose you are trying to do business with let us say today with Iran. Let us say an Iran is in with a fight with US. So, the Iran's Iran's Iran's political condition is going to change and because of the change, there has to be an impact on its currency also. So, now that impact on its currency because of this suppose the currency depreciates, now what is the going to be the impact on an Indian trader who is going to let us say trade with an Iranian trader right. So, because of this fall in the value of the currency there is it going to make a big impact or a negative impact?

If yes, then we need to maybe have some different strategies for that. A key aspect of measuring exposure is forecasting the exchange rates.

So, you need to forecast the exchange rate on you cannot exactly forecast, but you at least get a guess [FL]. What should be the way? We can whether it will fall, it will go up, what is the climatic condition, what is the ecological condition, what is the political condition, so what changes are happening in that country. So, accordingly we can decide that ok.

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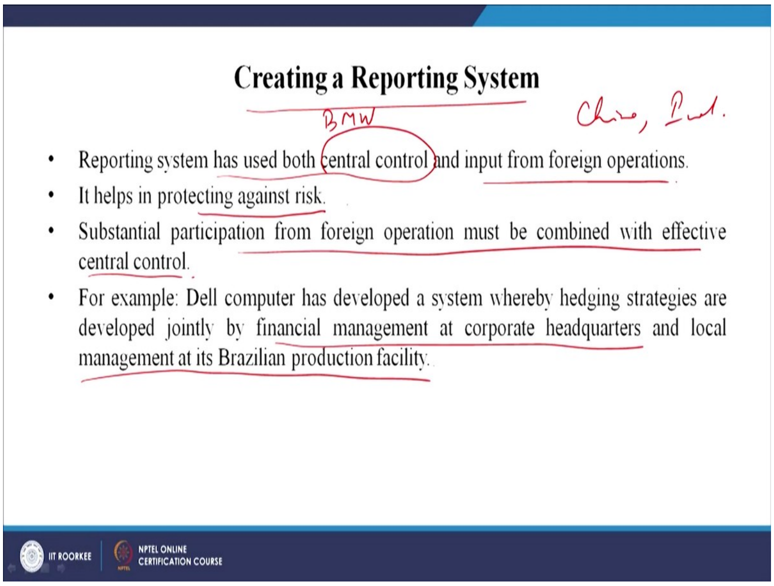

The third thing it says is create a proper reporting system. Reporting system has used both central control. That means where the country where the company resides for example we talked about BMW in Germany, right and input from the foreign operations. For example, they had operations in China, India right and they were expanding in Russia also.

So, this helps in protecting against risk ok. Substantial participation from foreign operation must be combined with effective central control. This is what we are talking of the first point. You see this example Dell computer has developed a system whereby hedging strategies are developed jointly by the financial management at corporate headquarters and local management at its Brazilian production facility.

So, Dell has adopted this strategy that they would have a joint you know collaborative effort, so that they can hedge the risk.

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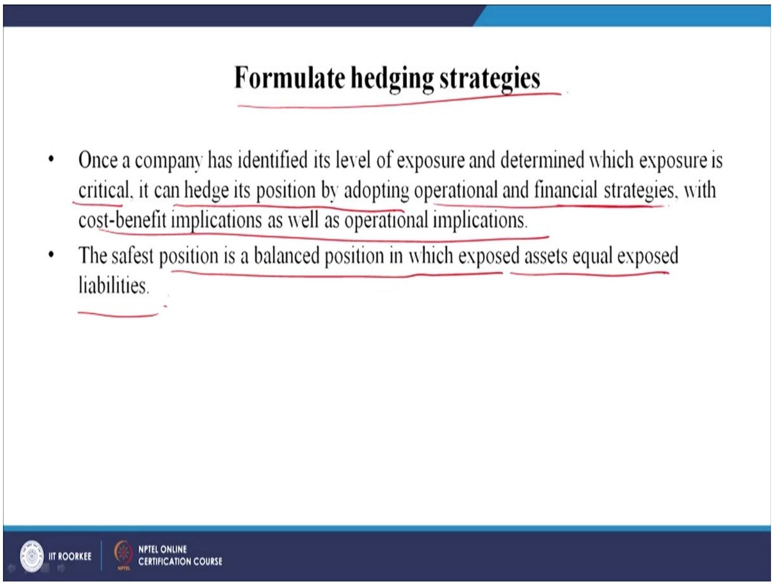

Now finally formulate the right hedging strategies. Once a company has identified its level of exposure and determine which exposure is critical, so which exposure is critical for them, it can accordingly hedge is position by adopting operational and financial strategies. So, the law, the supply chain, the local suppliers, the buying and you know amount of purchase how much which you are purchasing from the local suppliers and all this and the financial strategies like the pricing of the products and all these things.

With cost benefit implications as well as operational implications; obviously it will have an operational and cost benefit application because if you are buying it from uh from different suppliers and the suppliers where they are and what is the quality of the suppliers, all these things will matter to the entire production system.

The safest position is a balanced position in which exposed assets equal expose liabilities. So, so it says the safest portion is a balanced position, ok.

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Now currency or foreign exchange hedging. So, I am not going deep, but let us understand what is it is. Hedging refers to the avoidance of foreign exchange risk, hedging refers to the avoidance of foreign exchange risk because spot rates vary overtime. So, you know what are spot rates, right. So, we have discussed spot rates are the rates at the current at the present moment, ok. So, it provides a mechanism to guard against losses as arising from fluctuations in the exchange rates.

So, hedging helps you protects you from fluctuations in that exchange rates. The investors, traders, businesses and other market participants use forex hedges. It is meant to protect from losses not to make a profit. It is not exactly to make a profit, but it to protect from losses, right. It allows hedging to manage and minimize their exposure to any adverse exchange rate movement. Risk and reward are often professional to one another, thus reducing risk means in fact reducing profits right. So, when you are not exposed, so obviously you are if the meaning of this is very important to understand.

So, higher risk in business we say higher risk is sometimes higher profits, but also it can be higher losses also so, but when there is a reduction in risk losses also maybe reduced, but profit is also reduced, right. There is no doubt about it, but then we are more bothered about protecting (Refer Time: 09:41) from the losses.

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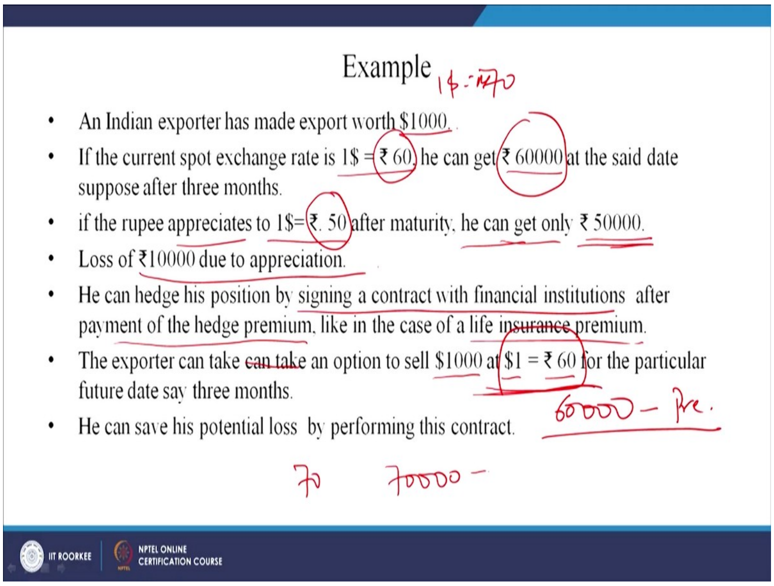

Let us see this example. An Indian exporter has made export worth 1000 dollars, right. The current spot exchange rate is 1 dollar is 60 rupees, right. So, how much will we get 60000? So, 60 into 1000 dollars at the said date suppose after 3 months. So, after 3 months, he will receive it how much? He will receive rupees 60000, but the rupee appreciates to 50. Now this is interesting when we say appreciates, that means what the rupee has become stronger and the dollar correspondingly has become weaker in front of us.

So, today earlier what you are buying with 60 rupees 1 dollar, today you can buy with 50 rupees 1, right. So, he gets now because of the appreciation what will he do, he will get only 50000 rupees. So, you see the exporter as an exporter if you think when you are exporting, so if the rupee appreciates, will you like it? No, you will never like as an you know exporter that the rupee should appreciate. You will feel that the rupee should rather depreciate, right.

So, had it depreciated to let us say 70 rupees. So, 1 dollar is equal to 70 rupees. Suppose it would have happen now how much this guy would have got? Maybe 70000 rupees, right. So, loss of rupees 10000 due to appreciation. Now he can hedge his position by signing a contract with some financial institution after payment of the hedge premium by paying a premium. So, they can make a contract. So, as you do in case of a life insurance that something if goes wrong, the company will insure me right. The exporter can take an option. So, this is a repeat an option to sell 1000 dollar at 1 dollar is equal to rupees 60 for the particular future date say 3 months and he pays the premium for it.

So, in any case if something happens at least he will get rupees 60 rupees 60, but as I said had this depreciated, then what would have happened? Maybe there was a case. Just imagine now he has by he has paid a premium. So, that premium is some value and also he is getting 60000 at the end of 3 months, but suppose let us say and the premium is whatever the premium charge you have to minus it. So, the actually something less than 60000. Now the other hand in instead of appreciating had the rupee depreciated. So, now the rupee has depreciated to let us say 70.

Now, what you would have got? He would have got 70000 rupees and the premium also would have been saved because he did not had to pay the premium, but so this is an if you look at the difference now it is more than 10000 and not 60 minus 70 because it is 70 minus 60 minus the premium. So, it is a higher value. So, this is what you would have gained, but the question is we are not looking at only profits, we have to protect ourselves from the risk right and the risk can be that it can go too much, it can appreciate much higher right.

So, this is all what we discussed about the foreign exchange market. You can go in deep for a reading about these things from in the course of International Finance or somewhere because in International Business I am not going to go deep into that, right. It is a part of the International Finance which you if you want you can cover up through some other books and materials, right.

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So, now coming to the next. So, we will talk about Foreign Exchange Regulation Act and Foreign Exchange Management Act. So, this foreign exchange, the government in every country has its own regulations, right. In India also we had earlier called the FERA and FEMA.

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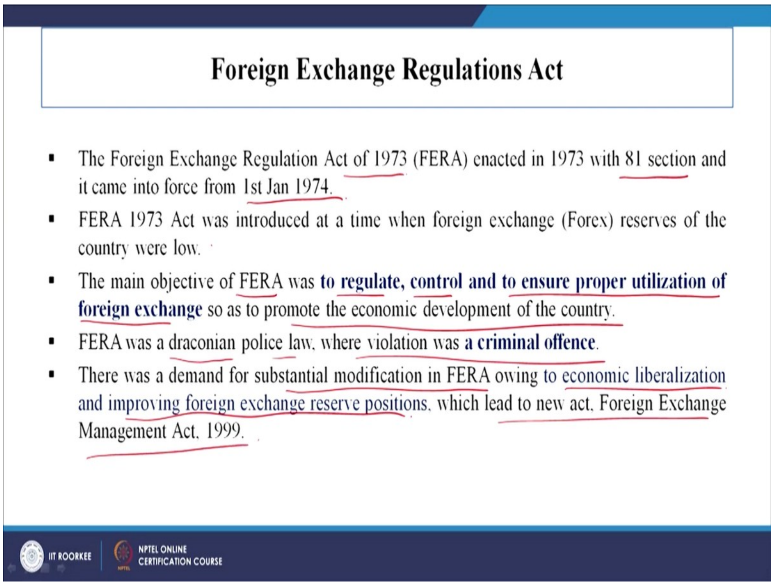

So, FERA was earlier there and which was later on changed to FEMA. So, what was this FERA act? It was the 19th act of 1973 with 81 sections and came in 1974, 1st January 1974. It was introduced at a time when foreign exchange reserves of the country were low. So, we had very less foreign reserves, right. The main objective of FERA was to regulate control and to ensure proper utilization of the foreign exchange, so as to promote the economic development of the country.

So, the government wanted to interfere and tried to regulate and protect the foreign currency, did not want you know too much of any mishandling or misutilization. So, that we because already we are running short of foreign reserves right, but it was a Draconian law where violation was a criminal offense. So, if anybody did something wrong, so they were it was a criminal offense.

There was a very popular case I do not know the if anybody you know about it you can check it ITC KL Chugh. There was a gentleman called KL Chugh who was arrested before of because of FERA violation. So, there was a demand for substantial modification in FERA because of the economic liberalization because we were opening up the market was opening and improving foreign exchange reserve positions. Our foreign exchange reserve positions also was improving which led to a new act called Foreign Exchange Management Act.

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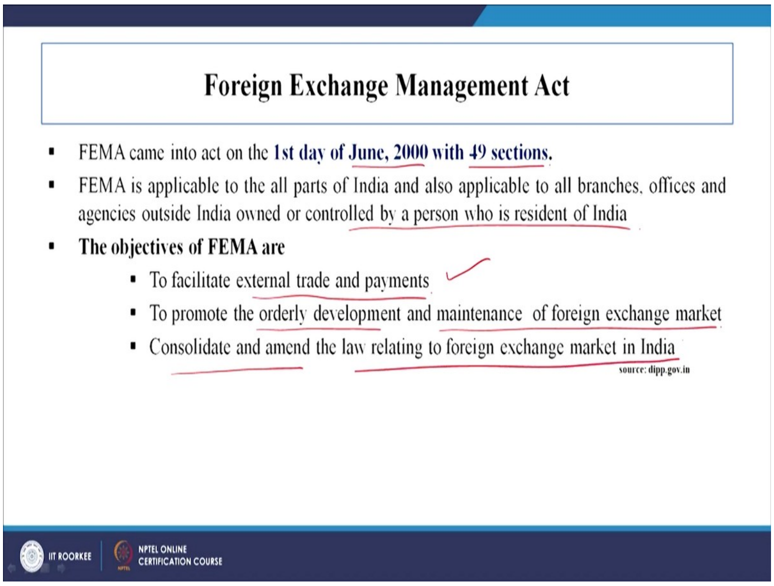

So, we will see. So, FERA moved on to become FEMA right. FEMA came on 2000, June right with 49 sections. The earlier one was 81, right if you see and in 74. So, this after 16 almost years FEMA came FEMA is applicable to all parts of India and all, also applicable to all the branches, offices and agencies outside India owned or controlled by a person who is resident of India. So, you all come under FEMA when you suppose you are resident of India you have offices in different countries that also comes under FEMA act, ok.

So, what is the objective to facilitate external trade in payments ok? Obviously it is to controlling the foreign exchange. So, trade in payments promote the orderly development and maintenance of foreign exchange market and consolidate and amend the law related to foreign exchange market in India.

So, these were the basic objectives of the FEMA. So, in nutshell if you want to understand FEMA wanted to be less you know draconian. It had it was more liberal, slightly liberal than the FERA and it, but the intention was the same to facilitate trade and to make a proper, maintain the foreign exchange market right. So, what are the regulations and management of foreign exchange let us see.

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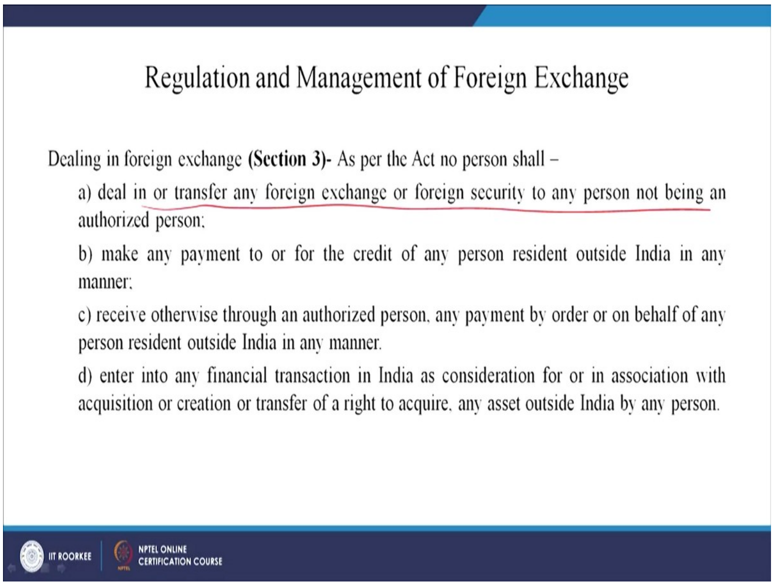

So, dealing in foreign exchange as per the act as per this FEMA act no person shall deal or in or transfer any foreign exchange or security to any person not being an authorized person, right. Now let us see what does it mean? Make any payment to or for the credit of any person resident outside India in any manner, so you are not allowed, right. Receive otherwise through an authorized person any payment by order on behalf of any person resident outside India in any manner.

So, these were the conditions right enter into, so no person right entry into any financial transactions in India as consideration for in association with acquisition or creation or transfer of a right to acquire any asset outside India by any person.

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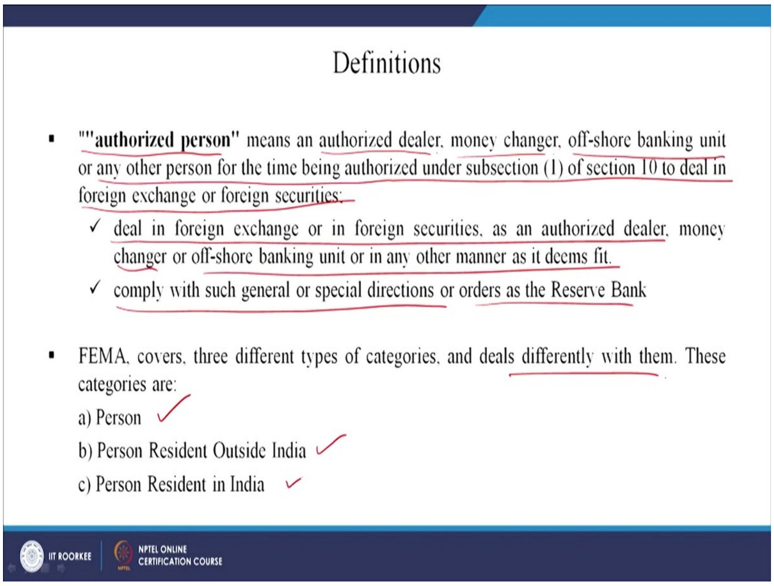

So, this is what the FEMA was said, right. The regulation now who is this authorized person? So, here you have seen authorized person, right. So, this word being used time and again authorized person means an authorized dealer, money changer, offshore banking unit or any person for the time being authorized under subsection 1 of section 10 to deal in foreign exchange or foreign securities.

So, the government has given permission to few people. So, they are the authorized people who these foreign these are the ones who deal in foreign exchange or in foreign securities as an authorized dealer, money changer or off shore banking unit in any other manner as it deems fit.

Comply with such general or specific directions or orders of the Reserve Bank of India, RBI right. FEMA covers three different type of categories and deals differently with them. These are one person in person, then person resident outside India, person resident in india.

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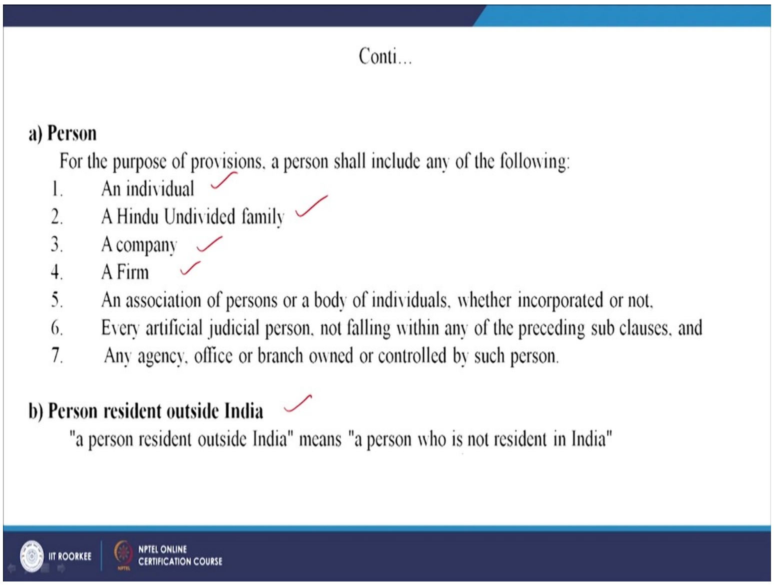

Let us see what they are. So, what is the definition of? As per FEMA person for the purpose of provisions a person shall include an individual Hindu Undivided family, a company, a firm, an association of persons or a body of individuals whether incorporated or not, every artificial judicial person not falling within any other proceedings sub clauses and any agency office or branch owned or controlled by such person right.

Person resident outside India, a person resident outside India means a person who is not resident in India, but he is a Indian right.

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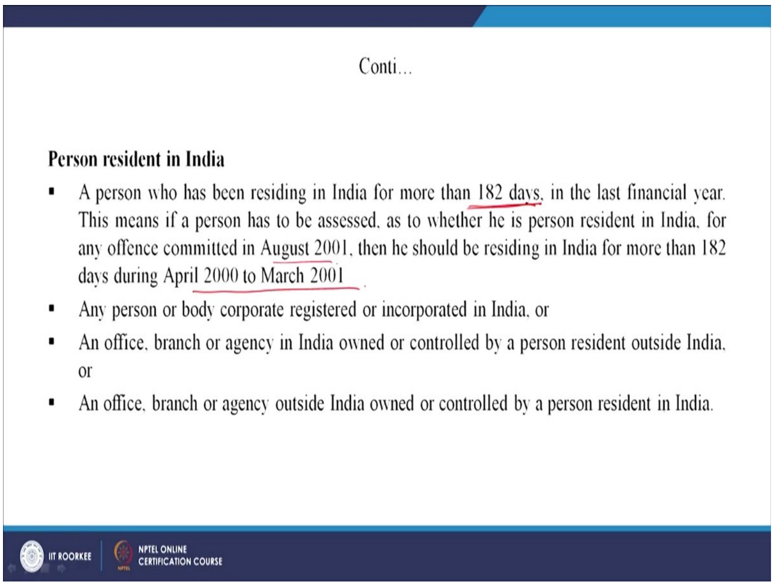

A person resident in India a person who has been residing in India for more than 182 days, right in the last financial year. So, this is the definition. This means if a person has to be assessed as to whether he is person resident in India for any offense committed in August 2001, then he should be residing in India for more than 182 days during April 2000 to March 2001.

So, this is what the definition says, right. Any person or body corporate registered or incorporated in India right or an office, branch or agency in India owned or controlled by a person resident outside India right or an office branch or agency outside India owned or controlled by a person resident in India. So, these are the conditions which FEMA has made right. So, now you have understood if you have to go it slowly to understand it and you know what it exactly means right. Now Administration of the Act, now this FEMA Act.

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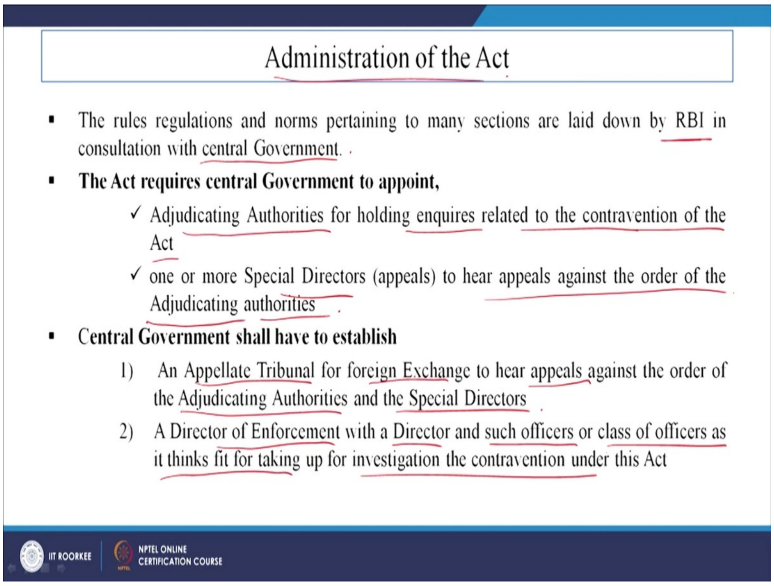

So, the rules regulations and norms pertaining to many sections are laid down by the RBI in consultation with the central government. Now what does it want? The act requires the central government to appoint adjudicating authorities for holding enquiries related to the contravention of the act. So, if there is any problem, so to hold enquires one or more special directors to hear appeals against the order of the adjudicating authorities.

The central government right shall have to establish an appellate tribunal for foreign exchange to hear these appeals against the order of the adjudicating authorities and the special directors, ok. The central government also has to establish a director of enforcement with a director and such officers or class of officers as it thinks fit for taking up the investigation. So, basically the RBI along with the central government tries to keep a control and I am sure that nobody violates this and if they violate, what would be the kind of punishment or kind of you know penalty on them, right.

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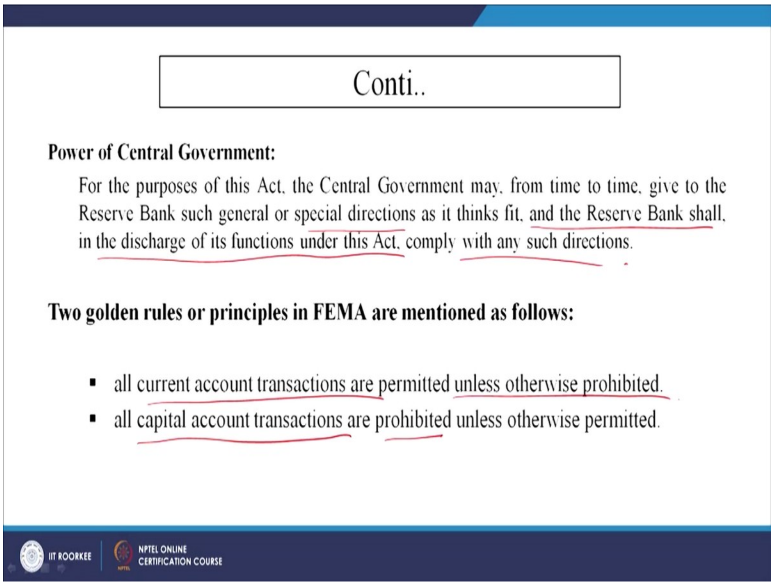

What is the power of the central government? For the purposes of this act, the central government may from time to time give to the RBI such general or special directions as it thinks fit and the RBI shall in the discharge of its functions under this act comply with any such directions, right. Two golden principles in FEMA are mentioned below. All current account transactions are permitted unless otherwise prohibited, all current account transactions are permitted unless it is prohibited, all capital account transactions are prohibited unless they are permitted.

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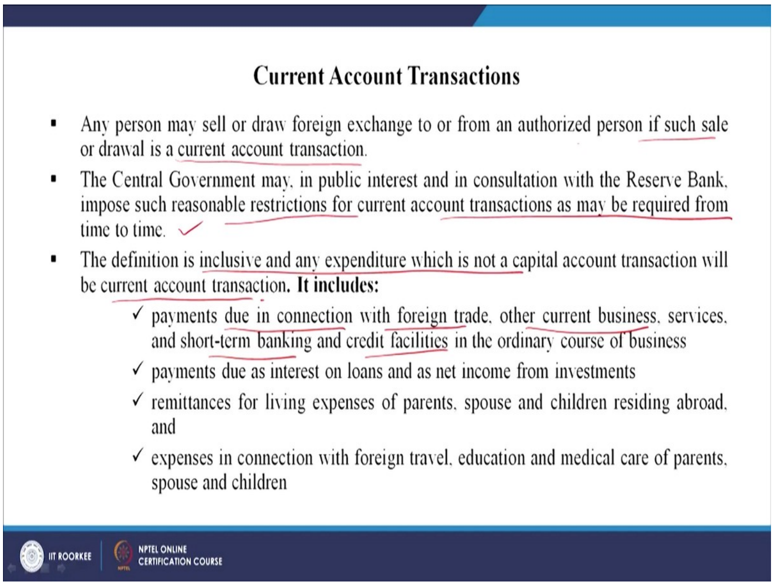

So, these are the two golden rules of the FEMA. Now current account transactions what does it say? Any person may sell or draw foreign exchange to or from an authorized person. If such sale or drawal is a withdrawal is a current account transaction, right. The central government may in public interest and in consultation with the RBI impose such reasonable restrictions for current account transactions as may be required from time to time.

So, basically these are all theories theoretical things which you have to read again and again to understand and try to understand what exactly how the RBI is trying to control it basically along with the help of the central bank, central government right.

The definition is inclusive and any expenditure which is not a capital account transaction will be current account transaction. It includes payments due in connection with foreign trade, other current, businesses services and short term banking and credit facilities, right. Payments due as interest on loan and net as net income from investments, remittances for living expenses from whoever are staying abroad or expenses in connection with foreign travel education and medical care.

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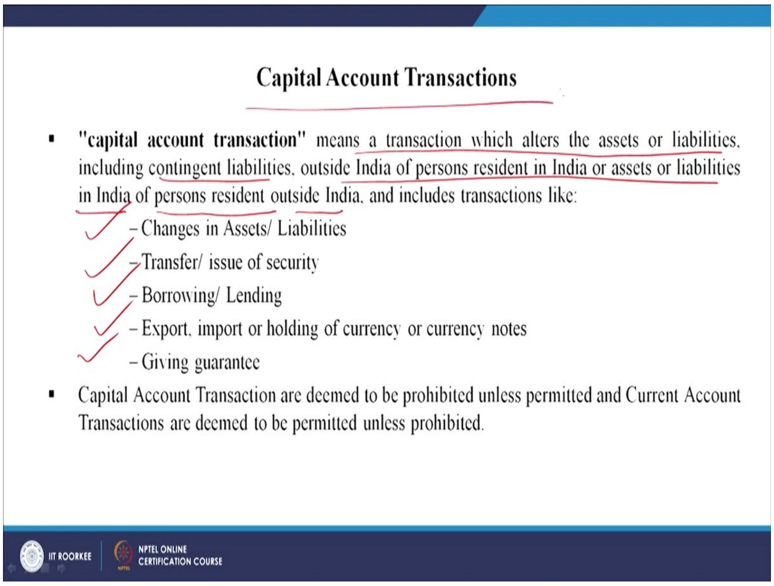

So, these are all coming under the current account transactions under capital account. If you see it means a transaction which alters the assets or liabilities. So, capital account right including contingent liabilities outside India of persons residing in India or assets or liabilities in India of persons resident outside India. And these can include things like change in assets transfer or issue of security borrowing or lending, export import of or holding of currency or currency notes and giving guarantee.

So, this come under the capital account transaction. So, this is all prohibited until and unless you take permission, but in capital account here in current account these are all permitted until and unless somebody for some reason is prohibited for some reason is prohibited, ok. So, these are the as per the golden rules you have understood, right.

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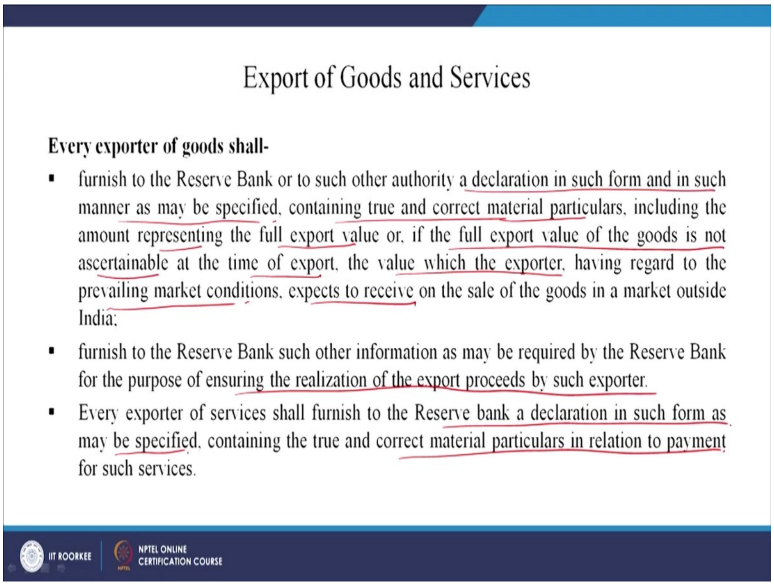

Exporter of goods and services, every exporter of good shall furnish to the bank. Now this is very important. To the Reserve Bank or to any such other authority a declaration in such form and in such manner maybe specified containing true and correct material particulars including the amount representing the full export value or if the full export value of the good is not ascertainable at the time of export, the value which the exporter having regard to the prevailing market condition expects to receive should be clearly mentioned.

Furnish to the Reserve Bank such information as may be required by the RBI for the purpose of ensuring the realization of the export proceeds by such exporter. Every exporter of services shall furnish to the RBI, a declaration in such form as may be specified containing the true and correct material particulars in relation to payment for such services. So, these are the for the export of goods and services.

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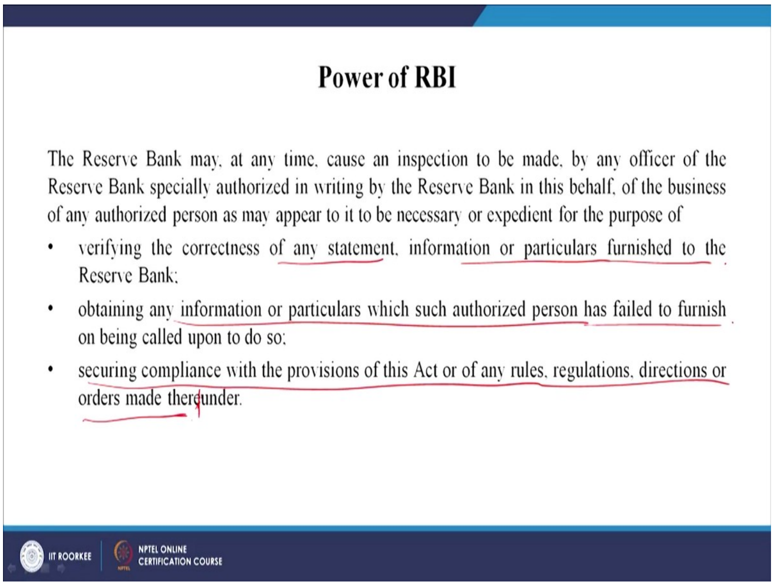

Now, what is the power of the RBI in this case. The RBI may at, any time cause an inspection to be made by any officer of the Reserve Bank specially authorized in writing by the Reserve Bank in this on this behalf of the business of any authorized person as may appear to it to be necessary for the purpose of verifying the correctness of any statement information and particulars furnished to the Reserve Bank. So if you have done something, the RBI will set up or you know under the you know have an officer to inspect it to verify the correctness of the different statements and information.

Obtain any information or particulars which authorized person has failed. This also happened this had happened with the case Vijay Mallya, right. Securing compliance with the provisions of this act or of any rules regulations, directions or orders made thereunder sorry there under. So, this is a the gap has to be given. So, these are the powers the RBI has - the power to make check, control and inspect. So, if something is wrong they can take action against it right. So, what are the penalties?

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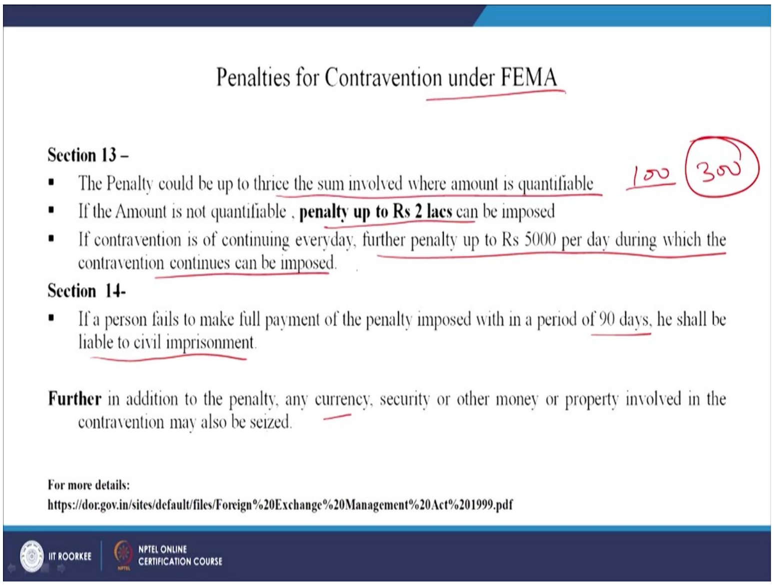

So, under FEMA the penalty could be up to thrice the sum involved where amount is quantifiable. So, if you let us say is 100 rupees say the penalty could be up to 300.

If the amount is not quantifiable, penalty up to rupees 2 lacs can be imposed,. If contravention is of continuing every day further penalty up to rupees 5000 per day during which the contravention continues can be imposed. Now as per the Section14 if a person fails to make full payment of the penalty imposed within a period of 90 days, he shall be liable to civil imprisonment, but earlier it was very different. In fact if somebody violated the FERA, he was immediately getting under criminal offense. Further in addition to the penalty, any currency, security or other money or property involved in the contravention may also be seized.

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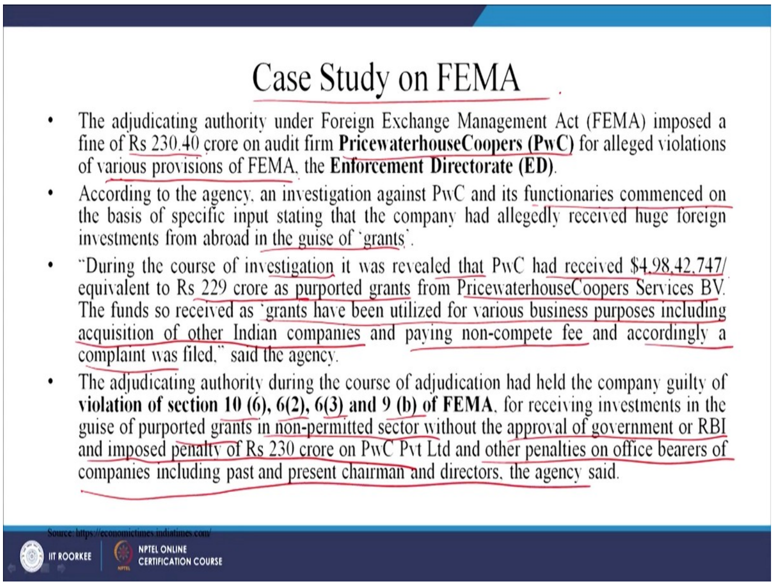

So, FEMA gives these are the penalties. So, this is one case we will discuss and I will wind up here.

So, this is a case study on FEMA right. So, this happened with PriceWaterhouse Coopers, PWC. You must have all heard. So, what happened FEMA imposed a fine of rupees 230.4 crore on the audit firm PriceWaterhouse Coopers, right for alleged violations of various provisions of FEMA right. So, as per as you have read now you can go back and also check. So, PwC had violated. So, the rules of FEMA and because of this the enforcement director had you know they had penalized it. According to the agency the investigation against PwC and its functionaries commenced on the basis of specific input stating. The company had allegedly received huge foreign investments from abroad.

So, what had happened? The as per the investigation they found that PwC had received huge foreign investments from abroad in the guise of grant. So, in the name of grant they had received huge foreign funds. Now what did they do with these funds? During the course of investigation it was revealed that PwC had received this much value equivalent to rupees 229 Indian crore Indian rupees as purported brands right from Price Waterhouse Coopers Services, right. So, from one of their own maybe related agencies the funds so received as grants have been utilized. Now this is interesting for various business purposes including acquisition of other Indian companies and paying non-compete fee and accordingly a complaint was filed said the agency.

So, what PwC was had done with this money was actually falling beside the purview of the rules as FEMAs guidelines, right. So, the adjudicating authority during the course of the education had held the company guilty of violation of section 10 6, 6 2, 6 3 and 9 b of FEMA; for receiving investments in the guise of purported grants. So, in the guise of grants because grants are generally relaxed. So, in non-permitted sector without the approval of government or RBI and imposed penalty of rupees 230 crore finally and other penalties and office bearers of the company including past and present chairman and directors.

So, you can understand, but had it been a case of FERA, it would have been much stringent and very difficult, but this was a very popular case. There are many cases. You can go and check on the internet also and this is one popular case which happened with Price Waterhouse Coopers and the FEMA of you know they penalized they had they imposed penalty and once they found guilty, they had to pay back this 230 crores back. So, this is what happened.

So, FEMA is basically nothing, but like you know the SEBI looks after the you know the Stock Exchange or the anything related to the Stock Exchange, the FEMA you know this act looks for anything related to the Foreign Exchange right. So, whenever there is a foreign exchange mismanagement or deliberate intentional you know mismanagement or something, so their investigation is done and the parties who are involved in it they may be penalized for it. So, this is all what we have for the Foreign Exchange Market and how to you can protect yourself from the foreign exchange exposure.

So, we have discussed today what is FERA and what is FEMA we have discussed. Whatever we have discussed you can go further, you can read more and maybe may have improve your clarity you can learn more, but this is a basic understanding what you have got from my lecture, right. So, this is what we have for the day.

Thank you very much.