

Foreign Exchange Risk Management of Multinational Companies

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ABSTRACT

After the 811 exchange rate reform in China, for one thing, the exchange rate formation mechanism has caused the RMB exchange rate to break through the ten-year appreciation against the dollar. For another, RMB began to fluctuate significantly. As a result of this change, Chinese foreign-related companies have suffered large exchange losses during this period of time, and their foreign exchange risk management capabilities need to be strengthened urgently. In this paper, the foreign exchange risk management strategies were analyzed through a literature review and case study of the multinational company ABB. Besides, solutions for Chinese multinational companies were provided to deal with foreign exchange risks. To strengthen the management of a company, enhancing the awareness of foreign exchange risks and building a risk management platform are recommended methods.

Keywords: *Foreign exchange, Risk management, Multinational company, Hedging instruments*

1. INTRODUCTION

In recent years, China's economy has been in a period of rapid growth. However, in China's foreign exchange market, the risk control system is not mature enough, and the concept of foreign exchange risk management in multinational companies is still limited to its traditional business model. Under this background, China's multinational enterprises also face exchange rate fluctuations, which can change the company's future cash flow and affect the long-term development of the company. With the expansion of multinational companies, global economic instability is becoming more and more obvious, and the fluctuations in exchange rates are also increasing. This will have a deeper impact on multinational companies. Enterprises will have a large amount of exchange rate gains and losses in the short term, which will directly affect the benefits of multinational companies and even eventually lead to huge losses[1]. Multinational companies have always faced a core issue, which is foreign exchange risk. Although exchange rate fluctuations are unstable, it can be avoided as much as possible through foreign exchange management. Therefore, the significance of foreign exchange risk control of multinational companies is to protect profits from loss, stabilize cash flow, and improve cash utilization rate.

Starting from the definition of foreign exchange risk and the problems faced by multinational companies, this paper will introduce the background of China's RMB exchange rate reform and its impact on multinational

companies. Then, in a case study of multinational company ABB, by analyzing its existing transaction risks, the foreign exchange risk management strategy used by ABB company will be studied. The purpose of this case study is to understand the foreign exchange risk management platform of multinational companies. Moreover, this paper proposes foreign exchange risk management measurements through the results of case studies, such as enhancing awareness of foreign exchange risk prevention and establishing a sound risk management system. Meanwhile, whether the different foreign exchange management strategies adopted by the case are reasonable will be analyzed through relevant theories and verified through the chosen case. This research is hoped to be a reference for the peers in this area.

2. REVIEW OF THE BACKGROUND

In recent years, China's economy has been in a period of rapid growth. From July 21, 2005, the People's Bank of China began to implement a managed floating exchange rate system. The RMB exchange rate will form a more flexible exchange rate mechanism, which has attracted widespread attention from countries outside China. Most people think that the RMB has entered the appreciation channel, also marking that the RMB has since entered an era of real floating exchange rates, ending the era, in which the exchange rate of RMB against that of the US dollar is stable. On August 11, 2015, the central bank officially launched

the new RMB exchange rate mid-price system, and the members of the inter-bank foreign exchange market combined the closing exchange rate of the previous day to obtain the mid-price and report it to the foreign exchange trading center. However, after the 811 exchange rate reform, in the face of more market-oriented exchange rate fluctuations, a large number of exchange rate gains and losses will directly affect the cost-effectiveness and development of multinational operating companies and even bring significant losses to enterprises.

3. RELEVANT THEORIES

3.1. Definition of Multinational Company

A multinational company is a cross-border company that establishes subsidiaries or branches abroad through direct foreign investment. Because of the need for foreign investment, multinational companies will inevitably invest and recover large amounts of foreign exchange funds worldwide, receive and pay large amounts of foreign exchange, and have huge foreign exchange debts[2]. Therefore, merged enterprises always face a very important topic and core issue, which is foreign exchange risk.

3.2. Major Foreign Exchange Risks Faced by Multinational Companies

3.2.1. The Case of Multinational company ABB

ABB company is one of the world's top 500 companies, headquartered in Switzerland, with 39 companies in China and 19,000 employees. In 2013, ABB company's sales revenue in China exceeded US\$5.6 billion, making it the second largest market in the world.

In March 2014, the People's Bank of China announced that it has increased the volatility of the RMB exchange rate, posing a huge challenge to the daily management of the company's financial management. ABB requires that all members should hedge foreign currency transactions to lock in exchange rate risk[3].

3.2.2. The Problems of Transaction Risk Prevention

According to the research result, the transaction volume of hedging business in the process of ABB company's foreign exchange transaction risk control in 2013 was about 800,000 to 1.4 million, which would incur a huge transaction fee. Such a large transaction

volume, coupled with the inability of customers to receive and pay foreign exchange on time, makes the collection time with greater uncertainty[4]. When the hedge has expired, if the enterprise cannot make the first payment or payment on time, the cost of postponing or pre-settlement of foreign exchange will be incurred. How to reduce the cost of foreign exchange transactions has become a very important problem.

4. ANALYSIS RESULT AND IMPLICATIONS

4.1. Strategies of Foreign Exchange Risk Management

To manage foreign exchange risk, both transaction risk and accounting risk can be used for ex-post risk prevention. In addition to this method, multinational companies need to perform ex-ante prevention strategically and operationally. In the theory of internal control, ex-ante control is far more effective than ex-post control. It's much better, so in order to better prevent risks, companies need to introduce more policies or guidance at the operational level, such as the localized production strategy of a multinational group's raw materials, and the process of internationalization of RMB is accelerating[5]. A multinational group is also taking advantage of this opportunity to vigorously promote the RMB calculation method.

4.2. Strengthen Awareness of Foreign Exchange Risk

Risk control is not only the work of the financial department or the risk management department. Cultivating and enhancing the awareness of foreign exchange risk among corporate employees is the first step in managing foreign exchange risk. Or to achieve targeted and appropriate control before the formation of foreign exchange risks[6]. In addition, companies should introduce corresponding foreign exchange risk management personnel. This person needs to understand the changes in the foreign exchange market and continuously adjust the company's foreign exchange risk management methods to the real-time conditions, which is especially important for large group companies. Besides, companies should set up corresponding professional departments at the headquarters to provide funds for various companies' contact services. What is more, from the perspective of the group, each member company should be helped solve the foreign exchange risk problems. Meanwhile, the consulting of the foreign exchange risk should be provided[7]. At the same time, it can also provide

helpful decision-making information to corporate decision makers.

4.3. Establishing Foreign Exchange Risk Management Systems

Whether a foreign exchange risk management platform is effective can be judged based on whether the company is able to improve the effectiveness of foreign exchange risk management greatly with the help of this platform. It can also perform detection and control of foreign exchange risk management anytime, anywhere, respond to problems in a timely manner, and actively solve problems. Large-scale enterprises can build a comprehensive foreign exchange risk management platform, but when setting up the platform, they must also consider the benefits of scale, whether the input and output are equal, or whether the input and output are in the best state. The layer attaches great importance to foreign exchange risk management and builds an overly strict and verbose management platform, which ultimately makes the risk management platform not effectively used. Nor can it be too simple to implement or use the platform, fail to achieve the desired management results, and to effectively manage foreign exchange risk[8].

5. CONCLUSION

Under the premise of introducing the relevant risk theory, this article focuses on the analysis and research of ABB company's foreign exchange risk management cases in the Chinese market and expounds on the countermeasures of foreign exchange risk management. From the perspective of enterprise management and specific operation, it introduces the measures that multinational companies can take to prevent risk management. To strengthen the management of a company, enhancing the awareness of foreign exchange risks as well as building a risk management platform are recommended methods. Since only one case was analyzed, the examples are relatively incomplete, and the author hopes to gradually improve the comprehensiveness of the cases in future research.

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