Sources of Risk in Financial Markets and Minimisation Strategies

Jerek Joseph

What we need to know

Here are all the topics this PowerPoint aims to cover from the BME Y12 Syllabus.

- sources of financial risk in export markets, including:
  - currency fluctuations
  - non-payment of monies
- strategies for minimising financial risk in export markets, including:
  - documentation
  - insurance
  - hedging

Risk – Currency Fluctuation

The measure of value of a country's currency, expressed in terms of one or more other foreign currencies, is defined as an **exchange rate**. These exchange rates are typically determined by the strengths or weaknesses of the underlying countries' economies and as such cause changes (fluctuation) in these rates, causing risk.

Solutions to Risk Factors:

- Hedging (forward contract) – see later slides
- Quoting prices in the firm's home currency. i.e. Australian firm quotes in Australian Dollars

Risk Factors

- Demand elasticity fluctuates – The measure of how sensitive the quantity of goods demanded to its price is. Some products have a greater fall in demanded quantity when prices increase more than others
- Weaker currency can stimulate exports and make imports more expensive – this could however decrease a country's trade deficit (debt) but increase its surplus over time
- Impacts cost of sales as changes can occur to the cost of imported products causing these costs to fluctuate as well
- Impacts international competitiveness of exports
- Whole economies of countries can be affected through the impact currency fluctuation has on Net Imports

Appreciation and Depreciation of Currencies

Appreciation – Prices rise due to reduced demand, supply increases and **importers** benefit

Depreciation – Prices fall due to increased demand, supply falls and **exporters** benefit

Appreciation of Australian Dollar	Depreciation of Australian Dollar
EXPORTING – Falling demand - Exports that are priced in Australian dollars become more expensive due to decreased demand - Export prices in foreign markets are priced with less Australian dollars to match the new exchange rate	DEMAND increasing - Exports priced in Australian dollars become cheaper for foreigners due to increased demand - Export prices in foreign markets are priced with **more** Australian dollars to match new exchange rate
IMPORTING – Increased supply - Imports are cheaper which generally leads to more purchased at the result of less profit for Australian businesses - Reduces inflation and the negative effects from inflation on firms	SUPPLY falling - Imports are dearer (more expensive) resulting in typically increased inflationary pressure for firms

Risk – Non-payment of Monies

A non payment is defined as the failure to meet the obligation to pay a sum or money that you owe. These non payments are classified as **bad debts** to a firm, and if a firm suspects a non payment is imminent (coming soon) it's classified as a **doubtful debt**.

This is a great financial risk for global firms as it is harder to hold customers accountable for their debts when they are in different countries. Legal fees associated with taking customers to court are often expensive and don't always guarantee favourable outcomes.

Domestic customers typically pay quicker than foreign customers, this delay is also applicable for delivery and transporting goods. All these delays increase the risk of firms incurring non-payment of monies which have a negative impact on cash flow.

Non-payment of Monies and Prepayments

- Prepayments or Cash payments can be made electronically into a firm’s bank account by the importer prior to the good arriving. A prepayment is an accounting term defined as “the settlement of a debt or instalment loan in advance of its official due date”
- It can be the settlement of a bill, operating expense, or non-operating expense that closes an account before its due date
- This is typically high risk for importers as they have to believe the firm exporting is doing this in good faith
- Very safe for the exporter as they have received the payment ahead of sending the goods

Strategy to Reduce Risk - Documentation

A contract that outlines the evidence of a transaction between the buyer and seller **for the transport** of the goods and **insurance** during the transportation journey.
These contracts should outline:

- Where the goods will be delivered
- Who arranges transport
- Who is responsible for insuring the goods
- Who pays for insurance
- What currency will the payment be made in

Strategy to Reduce Risk – Documentation (Continued)

There is also the option for a **documentary credit** as a form of documentation. This is when a customer arranges a letter of credit from the bank that agrees to pay the exporter (seller) once all the proper documentation is received.

- This is commonly used as all risk is insured by the importer’s (buyer’s) bank
- Banks typically take high fees for the risk as a result

A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. This letter determines all criteria that must be met before the bank issues the payment.

Should an importer lack funds, the bank will still make the payment then collect debts from the customer after.

Strategy to Reduce Risk - Insurance

An agreement between two parties to provide a guarantee of compensation for specified losses, damages, illness or death in return for payment of a specified premium.

Firms often offer generous credit terms to their customers to encourage sales. i.e. Harvey Norman's 60 months interest free). By having some form of insurance, a firm mitigates (reduces) the risk they face in missing/late payments.

It is harder to follow up on a customer internationally than domestically in this regard, which is where insurance helps.

Strategy to Reduce Risk – Insurance (Continued)

Product Liability Insurance (PLI)	Credit Insurance	Political Risk Insurance (PRI)
- Product liability is an area of business law which allows consumers injured by a purchased product to sue its manufacturer, retailer or distributor for any liability they may have - A court can deem the manufacturer, retailer or distributor firm responsible on grounds such as: failure to warn, inadequate user instructions, defective products - PLI protects a firm from the costs that are associated with ligations (lawsuits etc) and can protect them from paying compensation for up to the amount specified in the insurance policy	- Covers the risk of lenders that lend to a firm by guaranteeing that the lender(s) will be repaid should a firm be unable to pay their debts due to insolvency/bankruptcy - These insurance policies can typically offer up to 80-90% of what was owed to the lenders - The premium (the payment for the insurance, can be periodically) for these insurance policies is typically negotiated on the basis of a percentage of what the firm's expected turnover (income from sales, **not sales or profit**) is at the beginning of the year	- Political risk is the risk of foreign and/or domestic governments interfering or intervening in a firm's investments. This could be the goods exported or any assets or business conducted - This form of insurance policy covers various possibilities such as: expropriation (confiscation of property by government, political violence (i.e. insurrection), inability to convert local currency and send it abroad, and even terrorism or war - PRI covers the losses foregone by these possibilities

Strategy to Reduce Risk – Insurance (Continued)

Export Credit Insurance (ECI)	Transit or Shipping Insurance
- ECI protects any exporter of products and services against the risk of non-payment of monies by a foreign buyer - The process is typically that a firm agrees to the terms of sale with a buyer, exports the product and then sends an invoice. The firm then reports the shipment to the insurance firm and they pay the insurance premium. After an agreed period of time, if the buyer doesn't pay, the insurance firm does - This increases competitiveness for firms by allowing firms to negotiate ambitious credit terms with reduced risk - Improves liquidity by ensuring all receivables (debts owed to firm) are insured	- An insurance policy which covers the risks faced by goods when they are being transported from one location to another. This policy covers being transported by air, water, road or rail but certain policies may cover select methods of transport only - If goods are lost or damaged, a firm typically makes the claim with their insurance firm to get a payout as compensation which was previously agreed upon. The size of the payout depends on the worth/value of goods affected - Firms may choose to offer this to consumers as an optional charge, as if customers don't select this a firm can reduce their liability in the event goods are damaged/lost. - i.e. AusPost ExtraCover

Strategy to Reduce Risk - Hedging

In the context of currency, hedging is where firms take measures to offset potential losses that may arise due to fluctuations in interest rates. This can be achieved by using financial instruments such as forward contracts, currency swaps, options and futures. These methods typically allow fixed, predetermined exchange rates to be used to reduce risk.

- **Forward Contact** – gives a firm the ability to sell a quantity of goods at a set exchange rate at a **future date**
- **Option** – provides a buyer with the right to buy and sell a currency at a certain date. This is however not a contractual obligation to do either, so the buyer has the option to do whatever they desire to reduce risk
- **Currency Swap** – an agreement between two parties to exchange currencies at some date and exchange them back again at a future date. Usually the currencies exchanged are of same or similar equivalence