FOREIGN EXCHANGE RISK MANAGEMENT PRACTICES AND PRODUCTS USED BY AUSTRALIAN FIRMS

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Abstract. This industry-wide, cross-sectional study concentrates on recent foreign exchange risk management practice and product usage of large Australian-based firms. Results are discussed from an empirical field study of seventy-two firms operating in Australia. Based on a statistical analysis of five firm-specific variables with six management-practice variables, conclusions are drawn on the foreign exchange risk management practices and financial product usage of firms operating in Australia.

Recent studies by Teoh and Er [1988] in Australia, and Collier and Davis [1985], Collier et al. [1990] and Belk and Glaum [1990] raise important issues about the foreign exchange risk (FX) management behaviour of firms. These issues include:

- the extent to which industry actively manages rather than hedges FX risk,
- how the firm determines foreign exchange risk,
- what techniques are favoured by industry in its FX risk management,

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• whether there are any statistical relationships between the size, class and ownership of the firm and its risk management practices.

These issues also raise important policy implications concerning the extent of risk management regulation of the corporate sector. The purpose of this paper is to address these various issues and to assess the risk management practices of large Australian firms. An empirical field study approach is adopted, using a sample of firms with annual sales greater than Australian dollar (A$)10 million as the basis for a statistical analysis.

This study addresses a wide range of financial risk management issues and practices including internal control systems, use of computer technology and the extent of central bank (Reserve Bank of Australia) monitoring of the Australian corporate sector as part of its prudential supervision of the Australian financial sector.

Recent product innovations in the financial markets and the use of these products by the corporate sector are also examined. In addition to the traditional "physical" products, such as spot and forward exchange rates, the new "synthetic" or derivative products, including options, futures and swaps, and their use by the corporate sector are considered. These synthetic products have their market value determined by the value of a specific, underlying, physical product. The notional contractual cash flows associated with synthetic products can also be used to offset or match the risk associated with a known series of the firm’s operating cash flows.

The paper is arranged as follows. In the next section a literature review provides the historical and theoretical basis for this study. The third section describes the research method used to undertake the survey and the data sources. The empirical results are presented and discussed in the fourth section. The results reveal that many firms (70%) prefer to trade their foreign exchange exposures rather than to develop strategies to eliminate or minimise their foreign exchange risk. Also, in this Australian study, the majority of respondents (61%) who measured foreign exchange risk did so using transaction exposure.

There is also evidence of the sophistication of these Australian firms, with twenty-eight (39%) employing both short- and long-term foreign funding facilities, and with thirty-nine (54%) respondents utilising a variety of synthetic products. Statistical analysis provides some insight into which firm characteristics have a major impact upon the foreign exchange risk management practices. Firm size as measured by foreign exchange turnover has the most important effect. Size has implications for the use of computer technology and the number of foreign funding and physical activities used by the firm, though size does not affect the degree of centralisation of the firm. Also, there were no differences in management techniques between firms in different industry sectors. The final section will provide some concluding remarks on the implications of the study.