

## MANAGING RISK IN UNCERTAIN TIMES

July 29, 2008 \* New Delhi

### Background

The Indian economy operates in a dynamic and exciting environment. Although volatility in today's markets increases uncertainty around projections of business income, profits and cash flows, sophisticated markets do offer businesses greater operational and financial flexibility to cope with these uncertainties. But they also demand very robust risk management practices, which, as abundant empirical evidence shows, is sorely lacking in most companies, whether in India or, indeed, globally.

9.9 Insights hosted a briefing session on July 29, 2008 in New Delhi to highlight and discuss the need for internal corporate risk management policies in keeping with the current economic environment. The panel of eminent speakers shared their experiences and perspectives, debated some of the recent market gyrations and discussed how to prevent getting caught in the next market churn.

The panel included **Shubhashis Gangopadhyay**, Adviser to Finance Minister; **C Chandrasekhar**, Senior Vice President, Mecklai Financial; **S Mahalingam**, Chief Financial Officer and Executive Director, Tata Consultancy Services; **Sushil K Maroo**, Director, Jindal Steel & Power; **Revathy Ashok**, Director - Finance and IT, TSI Ventures; **Partha Sarathi Basu**, Chief Financial Officer, SpiceJet; **Rahul Bhasin**, Managing Partner, Baring Private Equity Partners.

### Introduction

Given the kind of volatility being observed in today's markets, there is immense interest in how one can go about '*managing risk in uncertain times*'. Several changes have been observed recently (most specifically related to the dollar-rupee fluctuations) and the past 18 months have been full of surprises. Markets are impacting the financial decisions of all companies whether small or large. Managing in such an environment requires firms to cope with all kinds of related risks.

**S Gangopadhyay** noted that while India had witnessed remarkable growth in the past 20 years, there was a significant section of the population that had been left behind. The gap between the wealthy and the poor is widening, leading to social rifts. Therefore, it is imperative that all responsible individuals and institutions work towards enabling the poor to also participate in India's economic transformation.

### Insurance in India

Building on this idea of the importance of inclusion, Mr Gangopadhyay illustrated with the example of how the insurance sector prefers to work with events of low probability (as this means the insurance companies get to keep their premiums and not pay out to the policyholders). Observing how insurance markets work overseas would lead us to expect the government to make financial provisions for the health insurance markets. However, this is not feasible in India since common diseases such as malaria, TB etc are high probability events in our environment. Such large occurrences of high probability events make the insurance business unprofitable as policy payouts seem larger than premiums paid in.

Another example he discussed was in the area of agriculture, where it is not possible for farmers to pay high premiums from their low incomes. Thus, the actual operationalisation of the insurance market becomes a huge problem and the model needs to be turned around and adapted to suit local realities. So, instead of farmers paying for insurance, the government can allow farmers to transfer their risk to retail investors who can 'buy' these risks and help the farmers access liquidity. To develop and understand such innovative trades and markets, we require institutions which will allow farmers to enter into these exclusive financial markets.

Mr Gangopadhyay continued to reveal that large amounts of money could be generated through such trading. If this can be developed, it would open a huge area of growth, although with small margins. Studies reveal that



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about 77 percent of the population earns less than Rs 20 a day. This means that approximately 150 million households are waiting to be tapped.

### **Derivatives and best risk management practices**

**C Chandrasekhar** continued to discuss how exotic financial instruments, such as derivatives, could be used to manage risk. He pointed out that while most companies use derivatives in a conscious manner to help minimise risk, they were recently subject to more aggressive selling of derivatives on the part of some banks. This led to the sale of derivatives products that were poorly structured, with minimal checks and balances. The companies that bought these derivatives were unaware of the risks they were taking as well as whether these products were actually protecting them against the risks they'd identified. When the markets began to move in an opposite direction to their assumptions, they experienced heavy losses.

As per the new accounting regulations, which many companies are now opting for, they need to prepare a document which states the risks they are insuring against and which instrument is being used to manage that risk. Mr Chandrasekhar revealed that these derivatives themselves are potentially risky, as their value is based on market movements that are uncertain and very difficult to predict. Markets are increasingly becoming more volatile and historical experience is no longer sufficient to make any judgements about the present or immediate future.

#### **Liquidity Risk**

Mr Chandrasekhar moved on to emphasise how liquidity risk, which arises when a party is unable to pay the interest rate demanded by the market, needs to be factored in to the company's risk management practices as well. Additionally, foreign exchange risk, the source of exchange rate volatility, has resulted in astounding volatility in the market. This has resulted in the rupee moving in both directions and experiencing wider spreads, which has not happened before.

Another distinction that companies fail to make is the one between revenue exposure and balance sheet exposure. Certain risks have an impact on the P&L of the current year while others affect the balance sheet over 5-7 years. Therefore, these two have to be approached separately.

#### **Exchange Risk**

In a multi-product company that participates in international trade, transfer pricing can affect the performance of various departments differently. The export department may achieve 100% targets in terms of export performance, but when converted to rupees, they may be falling short of the target or exceeding it. So the performance gets under- or over-stated in the absence of a proper transfer pricing policy that recognises exchange risks.

Another source of risk is the fair value accounting system, IFRS (International Financial Reporting Standards), which has been accepted by more than 100 countries, including India. As a result, all accounting standards will undergo changes by 2011, including the all-important derivatives accounting standards. But some Indian MNCs are already accustomed to these standards, which is a heartening development.

#### **Hedging Cost**

Mr Chandrasekhar believed that the cost of hedging should be viewed in the same manner as the cost of funding. He emphasised that the current value of the dollar is not its forward value but its forward value minus hedging cost. Companies have to consider these costs when evaluating their project costs. For instance, if a company has taken a Yen loan into its funding, it would have got 14% negative return, due to the Yen's appreciation. If this is incorporated into the project cost, then the project may not be viable.

Mr Chandrasekhar recommended that once we take this cost into account, we should minimise the hedging cost by following an appropriate hedging strategy. Proper guidance or a written down policy is required to deal with hedging requirements and monitoring its risks. If a firm is not hedging, then the investment manager must be alert to market changes, just as investors look at the market value of their open positions on a daily basis. There is also an option to limit risk through parameters such as stop-loss, in which an investor can set



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predetermined limits to curtail potential losses. Additionally, companies have a wide array of accounting procedures to choose from, including:

- Budget rate v/s Transaction rate
- Transaction v/s Portfolio Monitoring
- Gross v/s Net
- Existing v/s Projected
- Forward v/s Options v/s Structured
- Cross-currency
- Hedging period
- Risk limits

### **Balancing Market Realities with the Board's Perception of Risk: a panel discussion**

A compilation of data for 500 BSE listed companies revealed that last year, foreign exchange worth Rs 3,21,875 crores was earned by these companies and Rs 5,78,933 crores worth was spent - about 14% and 26% respectively of their total income. A 10% move in currency rate can impact their income and spends significantly as the net margin of these companies is just 7%.

Given these risks, a lot of pertinent questions come up. For instance, how does risk need to be managed today? What is the board's reaction when a company faces losses because of foreign exchange movements? Can one ensure that independent directors are comfortable with the risk management policies in a company? Should an organisation follow a well defined risk management policy that is communicated clearly to all concerned parties? What are the models adopted by leading players globally? Should we adopt the same or develop our own? These questions formed a key component of the panel's discussions.

#### ***Hedging in two industries: IT and Steel***

S Mahalingam from TCS revealed how hedging is undertaken carefully in his organisation, especially if foreign currency has to be translated in order to underline the rupee expenses. Therefore, a decision is taken in the beginning of the year on what kind of rate needs to be protected and if it can be protected at all.

Sushil K Maroo from Jindal Steel and Power discussed the role of hedging in the steel and power business, where there are a large number of transactions and significant price fluctuations in the last two years. Neither the board nor subject matter experts are fully prepared to really understand what can be done in this kind of a scenario. What is recognised is that it is most important to protect the core business, that is, primarily minimise any losses rather than maximise profits in a wildly fluctuating scenario.

If a company is taking a foreign currency loan, then a comparison with the rupee must be drawn. For instance, a company would pay 2.5% interest rate for Yen, 4% for USD, 10% for INR, and hence, savings differ. The objective is to make the effort to try and stay within this band. While the board leaves the decisions to the experts within the organisation, it normally maintains a fairly cautious view on these matters.

#### ***The perspective of the risk takers***

Rahul Bhasin, from Baring Private Equity Partners, highlighted the importance of understanding the global context in which these factors manifest themselves, and then manage the risks accordingly. If one does not have a framework of understanding the drivers of change then it is difficult to react in this environment.

In the recent past, a very large asset bubble floated from the technology sector to different sectors. This has happened in the context where very high leverage ratios have been built up in the entire Anglo-Saxon world. In the U.K, the average debt to household income is 174%. In New Zealand, this is 170% while in the US, it is 140%. This scale of leverage is highly risky, with an alarming potential for huge losses.

Mr Bhasin also believed that the cost of capital was very high in the current environment. In the 1980s, the average inflation rate of OECD countries was 15%. On that basis, the recent increase in inflation and interest rates is only the start of the cycle. With higher cost of capital, reinvestment must be managed very carefully and one has to understand the limitations of demand.



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In the energy sector (oil and gas) the scenario of high prices can be expected to continue, largely because governments around the world have captured the upside in this sector. So it is actually the government that is making supernormal profits, not the oil companies! Therefore, the reinvestment rate in the last 4 years has remained almost flat, as is visible in a cycle where energy prices have gone up the way they have. Reinvestment rates are just over USD 100 billion in real terms. As far as India is concerned, one will see labour shortages in this kind of industry, because the skill availability is not sufficient.

### ***Impact on foreign capital***

The real estate business requires day-to-day management of risk. In the last 6 weeks, Revathy Ashok revealed that TSI has been in conversation with the investment committee discussing all possible risks and all related aspects. While real estate prices have collapsed, this sector cannot be ignored as it is vital to India's continued growth.

Commodity prices have seen immense fluctuation – for instance, steel prices went up from Rs. 30,000 to Rs. 60,000 and currently, they are down to Rs. 50,000. No one knows what to expect. While TSI has to face commodity risk, foreign exchange risk, and liquidity risk in an illiquid market, it has already committed USD 4 million worth of projects in India. But only three banks have the requisite funding to help meet those commitments. Further, there is regulatory risk, since the government has said that no recourse to overseas funds can be made.

Thus, Revathy felt that although TSI is making clear its current capital commitment, it still has to manage all these risks and have a view on the markets three years hence, since that is the delivery timeframe. She explained that TSI also has an efficient mechanism for communication with the board members – the company communicates every single decision to all the partners and investment committee members. Since there is little understanding internally about foreign markets, the company has international advisors advising them.

### ***Strategies in emerging, competitive sectors***

The final speaker on the panel, Partha Sarathi Basu stated that almost any development in today's economy invariably affects the aviation industry. So airline companies face multiple risks. Spice Jet has established a strong system to enable clear communication – board meetings happen once in three months, executive committee meetings on a monthly basis, and communication between the CEO and CFO is on a monthly basis. While hedging, it is important for the management to decide what percent of the dollar or rupee should be hedged. This communication is on a real time basis.

Companies often have natural hedges within their own portfolios of businesses. He advised firms to always look at the net exposure and not the gross exposure as the transactional cost and fictional cost of the gross exposure is quite high.

Another big risk that companies face is that of access to more capital. When start-up enterprises have already exhausted their first round of funding and need to raise the second round of funds, it is important to communicate with the investors constantly. Given the current environment where inflation is at an all time high, it is very difficult to convince the investment committee to release new funds. Hence, it becomes a challenge for firms to ensure that they present the long-term view to investors to retain their interest and continue to invest.

### **Conclusion**

The panel discussion revealed that the volatility associated with financial markets is here to stay for some time. While risks have gone up, there are also many instruments available to companies to mitigate those risks. It is vital that companies take a comprehensive view of the environment they operate in and employ the appropriate measures to address the risks they face. This includes identifying the right financial products (derivatives), working with trusted partners (banks and other financial institutions) and communicating their decisions clearly and regularly to the important stakeholders (board of directors). By employing this mechanism, the negative impact of risk can be diluted significantly.