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**FOREIGN EXCHANGE RATE EXPOSURE AND DETERMINANTS OF USING
FOREIGN CURRENCY DERIVATIVES: AN EMPIRICAL STUDY ON PUBLIC
LISTED FIRMS OF MALAYSIA**



BY
ABDULLAH BIN OMAR

UUM
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**Thesis Submitted to
Othman Yeop Abdullah Graduate School of Business,
Universiti Utara Malaysia,
in Fulfillment of the Requirement for the Degree of Doctor of Philosophy**



Kolej Perniagaan
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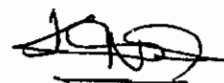
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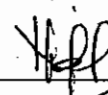
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ABSTRACT

Financial theory holds that fluctuations in exchange rate significantly influence open market firms by affecting their cash flows and firm value. Because of high market openness and fluctuations in Malaysian exchange rate, this study, therefore, aims to investigate the extent to which 224 sampled firms of Malaysia face foreign exchange risk during the period of 2008 to 2014. Similarly, the continuous improvement in derivative market structure has enabled corporations to effectively manage their foreign exchange risk by using a variety of financial hedging tools such as foreign currency derivatives (FCDs). Therefore, the second aim of this study is to investigate the extent of the influence of foreign exchange risk and other firm's characteristics on the use of FCDs. This study employs ordinary least square model and logistic regression model to achieve first and second aim of the study respectively. Results show that the fluctuations in exchange rate significantly affect Malaysian firms' value during the sample period. It is also found that hedging pattern of Malaysian firms is significantly explained by the foreign exchange risk. The findings reveal that financial distress, firm size and exposure to foreign business operations significantly affect FCDs use. However, the study finds no support for risk management committee, underinvestment theory and liquidity hypotheses in explaining derivative use. This study contributes to relevant literature by introducing two new variables: foreign exchange rate exposure and risk management committee; using new market index and estimating both total and residual exposures. The results have implications for managers by guiding them to carefully consider highly risky currencies while making international transactions. This study has also implications for investors by guiding them regarding investment decisions; for Bursa Malaysia Derivatives Berhad in relation to offering new or improve existing derivative products and for Malaysian government to formulate risk management strategies at national level.

Keywords: foreign currency derivatives; currency risk; financial hedging; Malaysian firms

ABSTRAK

Teori kewangan menegaskan bahawa fluktuasi kadar pertukaran secara signifikan mempengaruhi firma-firma dalam pasaran terbuka dengan mempengaruhi aliran tunai dan nilai firma. Oleh kerana keterbukaan pasaran yang tinggi dan fluktuasi kadar pertukaran Malaysia, kajian ini bertujuan untuk menyiasat sejauh mana firma-firma di Malaysia menghadapi risiko kadar pertukaran asing dalam tempoh 2008 hingga 2014. Begitu juga penambahbaikan berterusan struktur pasaran derivatif telah membolehkan syarikat menguruskan risiko kadar pertukaran asing secara efektif dengan menggunakan pelbagai alat lindung nilai seperti derivatif mata wang asing (FCD). Oleh itu, matlamat kedua kajian ini adalah untuk mengkaji sejauh mana pengaruh risiko pertukaran mata wang asing dan ciri-ciri lain sesebuah firma ke atas penggunaan FCD. Kajian ini menggunakan model kuasadua terkecil biasa dan model regresi logistik masing-masing bagi mencapai tujuan pertama dan kedua. Keputusan menunjukkan bahawa fluktuasi kadar pertukaran asing secara signifikan mempengaruhi nilai firma di Malaysia sepanjang tempoh kajian. Ia juga menunjukkan corak lindung nilai firma-firma di Malaysia dapat dijelaskan secara signifikan oleh risiko kadar pertukaran asing. Penemuan ini mendedahkan bahawa ketenatan kewangan, saiz firma dan pendedahan kepada operasi perniagaan asing secara signifikan mempengaruhi keputusan penggunaan FCD. Walau bagaimanapun, kajian ini tidak menyokong pembolehubah jawatankuasa pengurusan risiko, teori pelaburan dan hipotesis kecairan bagi menjelaskan kegunaan derivatif. Kajian ini menyumbang kepada literatur yang relevan dengan memperkenalkan dua pembolehubah baru iaitu pendedahan kadar pertukaran asing dan jawatankuasa pengurusan risiko; dengan menggunakan indeks pasaran baru dan menganggarkan jumlah keseluruhan dan pendedahan residual. Kajian ini memberi implikasi kepada pengurus firma dengan membimbing mereka membuat pertimbangan yang teliti terhadap risiko mata wang semasa membuat transaksi antarabangsa. Kajian ini juga memberi kesan kepada pelabur dengan membimbing mereka dalam membuat keputusan pelaburan Bursa Malaysia Derivatif Berhad dalam menawarkan produk derivatif baharu atau menambahbaik produk sedia ada dan kerajaan Malaysia untuk merangka strategi pengurusan risiko di peringkat negara.

Kata kunci: derivatif mata wang asing; risiko mata wang; lindung nilai kewangan; firma-firma Malaysia

ACKNOWLEDGEMENT

First and foremost, I would like to express my gratefulness and all thanks to almighty Allah for providing me this opportunity, the support and guidance and granting me the strength and ability to complete this work. Without HIS help and grace, I can never be able to achieve this goal or anything in my life.

I would like to strongly express my deepest gratitude, indebtedness and sincere appreciation to my both supervisors Dr. Kamarun Nisham Taufil Mohd and Dr Norzalina Ahmad. I am very grateful for their exceptional guidance, constructive comments, and, critical inputs, which assisted me to gain confidence and encouraged me to go much deeper into writing the research. I am very grateful for their immense knowledge and interest in my research area that made my thesis more interesting and significant. I appreciate their honesty, including compliments and criticisms.

The support of my family cannot be acknowledged enough and it is hard to express my thanks to my parents in words. It is impossible to describe how much I owe my father; Muhammad Umar Khan, and my mother; Soofia Umar, for their love, support, and patience. My parents suffer a lot as I am the only child of my parents who have been away for five years and could not be besides them when they needed. I will be always grateful to them as their support, courage and motivation make this achievement possible for me and their continuous struggle to make me successful in hereafter. I am very appreciative for their invaluable understanding, the faith, advises, intellectual spirit and indescribable support to me throughout my whole life.

I must say a big thank you and apology to my beloved family: my wife; Khunsa Khurram, and my both lovely sons; Muhammad Mutahir & Muhammad Talha, who have lived with every line and every page of this thesis and in our life together and much suffered from my absence. To my parents, wife and my sons I dedicate this work and to them I am forever indebted. I would like to express my special and sincerest gratitude to my wife who has always besides me and supported me spiritually with her patience and encouragement and share the burden of my postgraduate study. I sincerely apologize her for misbehave, rude and strict attitude, impolite talk, harsh words and indecorous behavior I ever did with her during study tenure. I am looking forward to many more happy and exciting years with her (In sha Allah).

Finally, I am also thankful for all my other family members, friends and colleagues that have contributed to the completion of this dissertation, whether in Malaysia or Pakistan. More importantly, I owe a debt of gratitude to my brother-in-law, Haris Khurram, for his time, support, encouragement and sacrifice specially during writing the last two chapters of this thesis. I also wish to deeply thank Saqib Ali, Atif Nawaz Baloch, Haseeb Bhatti and Muhammad Ramzan Zafar Ansari for their guidance, assistance, and coordination that they have offered to me. And last but not least, I wish to extend my sincere thanks to Mansha Yousaf for his unselfish support and generosity in a form of providing me peaceful and pin drop silence environment which become my big strength in pursuing this goal.

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LIST OF ABBREVIATIONS

AUD	Australian Dollar
CAPEX	Capital expenditures as a percentage of total sales
ECU	European currency unit
FBMEMAS	FTSE Bursa Malaysia EMAS Index
FBMKLCI	FTSE Bursa Malaysia KLCI
FCDs	Foreign currency derivatives
FSTS	Foreign sales ratio
FX	Foreign exchange
GBP	Great Britain Pound
GDP	Gross domestic product
GFC	Global Financial Crisis
IASB	International accounting standard board
IFRS	International financial reporting standard
INCOV	Interest-coverage ratio
JPY	Japanese Yen
LIQ	Liquidity
LVRG	Leverage ratio
MM	Modigliani and Miller
MTBV	Market-to-book value ratio
MYR	Malaysian Ringgit
NPV	Net present value
OLS	Ordinary least square
PER	Price-earnings ratio
RM	Return on market index
RMC	Risk management committee
SGD	Singapore Dollar
SIZE	Firm's size
TWI	Trade-weighted exchange rate index
UK	United Kingdom
US	United States
USD	US Dollar
VIF	Variance inflation factor

Chapter 1 INTRODUCTION

1.1 Background of the Study

Breakup of the Bretton Woods system during 1970s, increased globalization of businesses, intense competition, market imperfections and political uncertainties introduced several global and financial risks and challenges for corporate sector. For firms that are involved in international business activities, such as exports and imports, their cash flows and firm value are largely affected by the changes in exchange rate, that ultimately rendering the management of foreign exchange (FX hereinafter) risk as an important element of firm's objectives (Bartram, 2008). Corporate risk management is now becoming the essential part of corporate business planning. The ultimate goal of risk management is to enhance firm value and therefore, benefit shareholders. According to Thomas-Olivier (2007), risk management maximizes value creation in three ways: providing financial flexibility, supporting better decisions and enabling operational and strategic flexibility. A great number of studies, such as Panaretou (2013), Choi, Mao, and Upadhyay (2013), Sheedy (2006), and Bartram (2000) discuss risk management strategies at corporate level of different markets such as UK, Hong Kong, and Singapore under various conditions.

FX rate risk is a type of financial risk in which value of a firm is possibly affected by uncertain changes in exchange rate (Hakala & Wystup, 2002). Past studies (Hekman, 1985; Marston, 2001; Shapiro, 1975) highlight the fact that fluctuations in exchange rates are a major source of macro-economic uncertainty which affect the decisions of individual and institutional investors, returns, cash flows and values of firms. Géczy, Minton, and Schrand

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