

# The Effects of Financial Risk Management on Financial Performance of Money Exchange Dealers Case Study: Xchange Dealers of Kefayat Market in Balkh Province

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**Abstract:** *Financial and credit institutions, often known as non - bank financial institutions, are institutions that act as financial market intermediaries. In many ways, their services are comparable to those offered by banks. So, in Balkh province, research on the relationship between financial risks and the financial performance of these institutions and exchange dealers is particularly significant. In order to determine the consequences of these financial risks, they were separated into two groups and assessed using two hypotheses in this study. The impacts of each variable were estimated using a multivariate regression model. The independent variables in this model are systematic risk and credit risk, with the dependent variable of return on assets serving as a proxy for the financial institution's performance. The statistical population of this study includes exchange dealers and financial institutions in Mazar - e Sharif's Kefayat market, with 110 samples picked using a random sampling approach. The results demonstrate that all of the study variables that were tested at the 0.05 percent level of significance. The findings also shows that there is meaningful and significant relationship between foreign exchange risk, market risk, interest rate risk, and purchasing power risk on the MXDs' financial performance. For each indication of systematic risk variable, the beta coefficients are - 0.168, - 0.178, - 0.102, - 0.231, respectively. The components of the research's second hypothesis demonstrate a substantial association between credit risk and default risk trend on financial performance, as well as the power of correlation with ROA, which are - 0.068 and - 0.378, respectively*

**Keywords:** Money exchange dealers, financial risk management, financial performance, systematic risk, credit risk

**JEL Codes:** C1, G2, G47, P27

## 1. Introduction

Foreign exchange markets are often the most active and important asset markets in developing and transition economies, yet few research papers on the subject have systematically documented their structures or main characteristics (Canales-Krilienko, 2004). Money exchange dealers (MXDs) play a critical role in the economic development and business transaction facilitation of the businesses in Mazar e Sharif. Kefayat market is one of the important centers for the MXD in Mazar e Sharif, therefor we have decided to conduct our research study in this specific geographical location. As the MXDs play a vital role in the facilitation of business transactions, the associated risk of currency exchange should also be taken into consideration which is the subject matter of this study. The work exchange means trading of all kinds of money. As our target location is Balkh province which is located in border to Uzbekistan, and many of the goods are imported from this location and many of the remittances are done via hawala through money exchange providers and the local currency is converted to USD or other currencies. Therefor existence of money service providers/ money exchange dealers is a crucial factor to the flow of business. Even many major transactions inside Mazar e Sharif are done in foreign currency which makes the rule of

MXDs vital. "Risk is called the chance that an investment's actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment. Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment. A high standard deviation indicates a high degree of risk (Lyridis, 2015). The process of determining the likelihood that a specified negative event will occur. Investors and business managers use risk assessments to determine things like whether to undertake a particular venture, what rate of return they require to make a particular investment and how to mitigate an activity's potential losses" (Lyridis, 2015).

In an economically unstable country like Afghanistan in which the exchange rate is always floating it is extremely hard to mitigate the currency exchange risk, but by applying tools and techniques we can manage to reduce the risk to some extent or to mitigate some of the risks.

The main factors of money exchange risks are:

- Direct Foreign Investment (DFI)
- Monetary policy of the central bank
- Capital inflow and outflow
- Exchange Rate Stability
- Saving

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- Employment
- Trading Activities/ frequency of traders
- Political Situation
- Cash injection to the market (mainly USD)
- Trading Activities in the other currencies
- Political instabilities
- Inflation Rate (Horcher, 2005).

Money Exchange Dealers play a critical role in the flow of business and cash circulations, therefore it is always demanded to have a thorough analysis of the risk factors for the sector in order to propose practical and logical approaches to mitigate or at least reduce the risks, yet working in the monetary industry contains huge inherent risk which is hard to avoid, but by applying some rational practices; we can reduce or in some areas mitigate the risk.

## 2. Literature Review

According to Da Afghanistan Bank (DAB) law: Money Service Providers (MSP) means any service conducted in relation to money including safekeeping, money transmission (Remittance), check cashing, or currency exchange, and also Money Service provider means any individual or entity who is engaged into the business of providing money services. Meanwhile, MSPs are required to be licensed by DAB financial Supervision Department (Siddique, 2016, May 02). Beside Financial Institutions like banks, money exchange dealers play a critical role in the ease of transactions by exchanging the foreign currency into local currency and vice versa. The industry has been center of concentration to many researchers who have researched different angles of the industry. As Afghanistan relies more on imports specially through northern ports from Central Asia, Kefayat Market exchange dealers play a vital role in this regard. In this chapter we will review the previous literatures on exchange dealers, finance, and risk management. Money exchange dealers play a crucial role in the economic development of Afghanistan and ease of commerce either it is local business transactions or international business transactions. With the help of money exchange dealers, business remit their payments throughout the country and abroad, yet no certain research has been conducted on the financial risk management of the industry inside the country. In this research we will review the literature of the topics related to the subject matter. Some researchers like (Baig, 2020). have researched on the exchange dealers and money service providers and their impact on the business growth. On the research conducted by him, he has found that 80.3 per cent of the respondents are agree that MXD play a critical role on the business growth in Mazar e Sharif (Baig, 2020).

### Foreign Exchange Market is of two types retail and wholesale market:

- 1) *Retail Market*: The retail market is a secondary price maker. Here travelers, tourists and people who are in need of foreign exchange for permitted small transactions, exchange one currency for another.
- 2) *Wholesale Market*: The wholesale market is also called interbank market. The size of transactions in this market is very large. Dealers are highly professionals and are primary price makers. The main participants are Commercial banks, Business corporations and Central

banks. Multinational banks are mainly responsible for determining exchange rate.

### Other participants of the market are as follow:

- a) *Brokers*: Brokers have more information and better knowledge of market. They provide information to banks about the prices at which there are buyers and sellers of a pair of currencies. They act as middlemen between the price makers.
- b) *Price Takers*: Price takers are those who buy foreign exchange which they require and sell what they earn at the price determined by primary price makers (Daru, 2016, August 08).

There are approximately one thousand non - bank financial service providers offering money exchange services all around the UK which is four times more than the number of the same business registered in Spain, France, Netherlands, and Germany cumulatively. In UK money service providers are officially called Money Service Business (MSB). The reason that there is numerous amount of MSB in the UK is due to the existence of authorized payment institutions registered in the country who are allowed to operate at any geographic location inside the country and in the European Economic Area (EEA). There is financial crime risk associated with the sector because MSBs' access to banking services has been denied therefore the MSBs utilize alternative approaches which do not have sufficient anti money laundering supervision (Kraft, 2018). Taking the rapid economic growth of India into consideration, the foreign exchange market in the country is growing parallel to the economic growth and very rapid. According (Daru, 2016) the annual turnover of the industry is more than USD 400 bn. without the interbank transactions. This market is included of sellers, buyers, the market middlemen, and the Indian monetary authorities. The market is controlled by Indian monetary authority, regulated by The Foreign Exchange Management Act (FEMA 1999), and managed by the financial institutions active in the industry. Due to high demand for the market, it is running nonstop, all 365 days of the year and all over the country. The market serves to a range of different dealers from big investors who exchange millions of USD to local individuals who transact USD100. Exchange rate itself can impose risk to the economy as reflected in UNCTAD report "Despite the generally positive prospects, several challenges and risks face the world economy that may have implications for FDI flows in 2007 and 2008. Global current - account imbalances have grown dramatically in some developed countries. This could cause exchange - rate shifts, which may affect FDI negatively" (UNCTAD, 2007).

### Functions of foreign exchange market

Foreign exchange is also referred to as forex market. Participants are importers, exporters, tourists and investors, traders and speculators, commercial banks, brokers and central banks. Foreign bill of exchange, telegraphic transfer, bank draft, letter of credit etc. are the important foreign exchange instruments used in foreign exchange market to carry out its functions (Daru, 2016, August 08).

### The History of Foreign Exchange Market

The first time it was the ancient times that the demand raised for exchanging different currencies due to raise of multilateral

trades. Individuals who were helping others to exchange their money into different currencies (and charge their transaction charges/ fees) were mainly living in the holy land at the times of Talmudic writings (Thomas, 2011). During the 15th century, the Medici family were required to open banks at foreign locations in order to exchange currencies to act on behalf of textile merchants. To facilitate trade, the bank created the *nostro* (the Italian word for “ours”) account book which contained two columned entries showing amounts of foreign and local currencies; information pertaining to the keeping of an account with a foreign bank. During the 17th (or 18th) century, Amsterdam maintained an active Forex market. In 1704, foreign exchange took place between agents acting in the interests of the Kingdom of England and the Netherlands (Vasari, 2012).

### Money Transfer

The term of money exchange has different names in different countries for example, it is called hawala in Afghanistan, Hundi in India, Fei - Ch'ien in China, Padala in Philippines, Hui Kuan in Hong Kong, and Phei Kwan in Thailand (El-Qorchi, 2002).

### Risk and Financial Risk

First of all, it is import to know a little about the risk itself and then we have to dive into the literature of financial risk management and what have been done so far in this regard. Some authors like (Steiner, 2002). (Van, Donald, Imai, & Mesler, 2013). have researched in this regard.

“Although Foreign Exchange translation exposure affects the book value of a parent’s equity, Foreign Exchange translation exposure does not necessarily reflect Foreign Exchange business exposure. Often, there will be some overlap between Foreign Exchange translation exposure and Foreign Exchange business exposure, but sometimes a business can have Foreign Exchange translation exposure without having any Foreign Exchange business exposure, and vice versa. Academic advice on Foreign Exchange translation exposure is that companies should ignore it, because it is only about accounting book values and not real variables, like cash flow and business value. If a company uses financial instruments to hedge the Foreign Exchange translation exposure on its balance sheet that does not overlap with Foreign Exchange business exposure, a “real” Foreign Exchange exposure is created where one did not exist before” (O'Brien, 2014). Risk provides the basis for opportunity. The terms risk and exposure have subtle differences in their meaning. Risk refers to the probability of loss, while exposure is the possibility of loss, although they are often used interchangeably. Risk arises as a result of exposure” (Horcher, 2005). Financial risk arises due to tremendous factors such as sales, purchases, acquisition, new projects, etc. It can even raise as a result of natural transactions due to market uncertainty, competition, management decisions, government new regulations, international regulations, foreign country policies, or to some industries even the weather situation. The increase in risk exposure can cause sales and purchase price fluctuation which leads to reduction in the business/ company profitability.

“The risk that future FX rate uncertainty poses to a company is determined by both how volatile the FX rate is and the company’s FX exposure, which is the sensitivity of its

operating and financial results to the FX rate changes. In 2001, for example, the unexpected depreciation of the euro severely affected the revenues and earnings of a number of U. S. companies, including DuPont, Merck, Minnesota, Mining and Manufacturing (MMM), Johnson & Johnson, and Proctor & Gamble. In general, the FX exposure we will cover is more complex than the FX transaction exposure of single foreign currency revenue or disbursement, which is covered elsewhere” (O'Brien, 2014).

### Financial Risk Management

The field of risk management has undergone an enormous change in the past 40 years and the pace of change is accelerating, thanks in part to the lessons learned during the credit crisis that began in late 2006 (Van, Donald, Imai, & Mesler, 2013). Financial risk management is referred to as the practice of securing the economic value in a business through the utilization of tools to manage risk exposure to: credit risk, market risk, shape risk, volatility risk, liquidity risk, foreign exchange risk inflation risk, business risk, legal risk, reputational risk, sector risk, and so far. Same as general risk management, financial risk management also requires identifying the risk sources, measuring the risk, and plans to address it (Hull, 2012). Financial risk management can be qualitative and quantitative. As a specialization of risk management, financial risk management focuses on when and how to hedge using financial instruments to manage costly exposures to risk (Malz, 2011). In the banking sector worldwide, the Basel Accords are generally adopted by internationally active banks for tracking, reporting and exposing operational, credit and market risks (Van, Donald, Imai, & Mesler, 2013). While using financial risk management, it is recommended that the company managers must not hedge risks that the investors can hedge themselves at the same cost. When applied to financial risk management, this implies that firm managers should not hedge risks that investors can hedge for themselves at the same cost. This concept was captured by the so - called "hedging irrelevance proposition" (Crishnamurti, Krishnamurti, & Viswana, 2010). In a perfect market, the firm cannot create value by hedging a risk when the price of bearing that risk within the firm is the same as the price of bearing it outside of the business. In practice, financial markets are not likely to be perfect markets (Hampton, 1982). This suggests that firm managers likely have many opportunities to create value for shareholders using financial risk management, wherein they have to determine which risks are cheaper for the business to manage than the shareholders. Market risks that result in unique risks for the business are commonly the best candidates for financial risk management (Kasper, Meisner, & Nielsen, 2010).

### Foreign Exchange Risk

Foreign exchange risk refers to the fluctuations in a company's revenue and costs, as well as its overall cash flow, caused by unanticipated changes in exchange rates. In other words, it captures unanticipated changes in fiscal values (enterprise assets, resources, revenue, costs, cash flows, and future firm value) due to exchange rate fluctuations. Differences in the economic development of countries that use different currencies, the development level of financial markets, a country's political stability, the expectations of people who participate in financial markets, and accidental

factors are all factors that contribute to exchange rate risk (Habibnia, 2013). Transformational risk, transactional risk, and economic risk are the three categories of foreign exchange risk identified by Dufey and Srinivasulu (1983) for organizations operating on an international scale. The risk posed by the conversion of foreign currencies to each other is known as transformational risk or accounting risk. It was also highlighted as a potential accounting hazard. Economic risk is a measure of the impact of changes in foreign currency rates on the economic worth of a company (Dufey & Srinivasulu, 1983). The foreign exchange rate is an important macroeconomic component that is known to deviate from the predicted balance on a regular basis. It is impossible to predict the future level of currency rates since there are several elements in the market that impact exchange rates favorably or adversely. Still, there are certain ways for predicting future exchange rates, the most popular of which is relative purchasing power parity. The link between the relative inflation rates of two nations and the change in the exchange rate of their currencies is predicted by relative purchasing power parity (Rogoff, 1996). However, many empirical investigations suggest that markets with a time delay converge to the relative buying power equilibrium. Many academic research show that exchange rates vary significantly from the equilibrium in the short run. International capital flows in the form of portfolio investments have been viewed as the primary source of buying power differences in recent years. Fund providers participate in foreign capital market assets as portfolio investments, taking on all political and economic risk in order to earn high interest and dividend income (Aliber, 1976).

Most businesses in a worldwide economy are exposed to foreign currency. The uncertainty connected with changes in the value of foreign currencies is known as exchange rate risk. As a result, this sort of risk only affects the securities of companies that deal in foreign exchange or have foreign exchange exposures, such as exporters, multinational corporations, or companies that employ imported raw materials or products.

**Market Risk**

The herd mentality of investors, or their desire to follow the market's direction, is what causes market risk. As a result, market risk refers to the tendency for security prices to move in lockstep. Even the share prices of well - performing companies fall when the market is down. Almost two - thirds of total systematic risk is accounted for by market risk. As a result, systematic risk is also referred to as market risk. The most common source of risk in securities is market price fluctuations.

**Research Model**

Where:

- a) Financial management factors in MXDs
- b) Systematic Risk
- c) Credit Risk
- d) Foreign Exchange Risk
- e) Market Risk
- f) Interest Rates Risk
- g) Purchasing Power Risk
- h) Size of Credit
- i) Historical trend in default rate

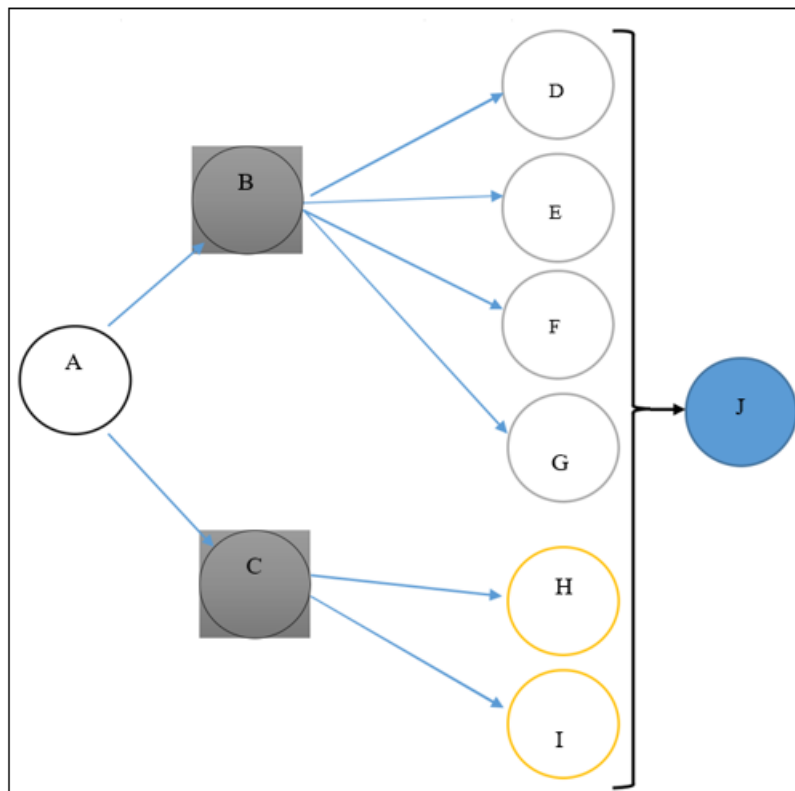


Figure 1: Research Model

**Validity and Reliability of the Questionnaire**

Validity and reliability of the questionnaire is one of the most important parts of information analysis that cannot be

acceptable without precisely determining the validity and reliability of the research. Therefore, the researcher first determined these two variables in below parts.

**Validity of the Questionnaire**

In fact, validity is applicability of the questionnaire under the same conditions in different regions and the same results will be obtained from different regions. One of the methods of validation of the research data collection tools is the use of experts and expertise in that fields. And in this research, the validity of the questionnaire already has been confirmed and approved by the supervisor.

**Reliability of the Questionnaire**

Reliability of the questionnaire test and examine by Cronbach Alpha which shows the entire correlation among the questions. The alpha value indicates the strength of the entire correlations of the questions. The amount of alpha is variable between zero and one. The amount alpha between zero and 0.5 is not reliable and the amount between 0.5 and 0.7 has a medium reliability but the alpha amount above 0.7 shows high reliability of the questionnaire. In this research and after analyzing the reliability test for the research questionnaire, the Cronbach's alpha is equal to 0.531 indicating the appropriate reliability of the research questionnaire.

**Table 1:** Reliability of the questionnaire  
Case Processing Summary

		N	%
Cases	Valid	110	100.0
	Excluded <sup>a</sup>	0	.0
	Total	110	100.0

Reliability Statistics

Cronbach's	
Alpha	N of Items
.731	10

a. Listwise deletion based on all variables in the procedure

**Computing Return on Asset of the MXDs**

As the dependent variable of the research is financial performance of the MXDs in Kefayat financial market of Balkh province, return on asset (ROA) determined as dependent variable of the research. based on data received through the questionnaires the ROA for each money exchange dealers calculated as the following table to use in the regression model equation.

**Table 2:** Descriptive analysis of calculating ROA for 110 company (research sample)

ROA	
No.	ROA= Net earnings after taxes (NEAT)/ Book Value of Assets (BVA)
1	0.15
2	0.04
3	0.04
4	0.12
5	0.18
6	0.18
7	0.05
8	0.16
9	0.20
10	0.32
11	0.23
12	0.17
13	0.44
14	0.24
15	0.16

16	0.16
17	0.29
18	0.15
19	0.10
20	0.26
21	0.18
22	0.12
23	0.26
24	0.26
25	0.37
26	0.18
27	0.1
28	0.33
29	0.09
30	0.22
31	0.17
32	0.10
33	0.10
34	0.21
35	0.19
36	0.23
37	0.25
38	0.18
39	0.18
40	0.05
41	0.16
42	0.20
43	0.30
44	0.28
45	0.15
46	0.52
47	0.30
48	0.28
49	0.15
50	0.68
51	0.27
52	0.18
53	0.16
54	0.28
55	0.08
56	0.14
57	0.20
58	0.15
59	0.10
60	0.24
61	0.39
62	0.17
63	0.10
64	0.30
65	0.28
66	0.15
67	0.61
68	0.30
69	0.28
70	0.15
71	0.34
72	0.16
73	0.33
74	0.27
75	0.15
76	0.14
77	0.24
78	0.12
79	0.18
80	0.28
81	0.15
82	0.26

83	0.20
84	0.32
85	0.28
86	0.25
87	0.61
88	0.17
89	0.28
90	0.36
91	0.18
92	0.28
93	0.14
94	0.10
95	0.15
96	0.13
97	0.21
98	0.29
99	0.17
100	0.10
101	0.28
102	0.36
103	0.09
104	0.12
105	0.34
106	0.19
107	0.17
108	0.10
109	0.24
110	0.18

**Regression Model Summary**

The correlation between the independent and dependent variables is defined in the second table of SPSS output analysis (ROA). In our case, the R value is 0.78, indicating a strong connection and demonstrating that our model accurately predicts ROA. In this study, R square equals 0.56, which is the square of R. It shows how much of the variation in ROA can be "explained" by the six predictors. Because regression optimizes R square for our sample, R square for the total population will be somewhat lower, a phenomenon known as shrinkage. The adjusted r - square calculates our model's population R square and so provides a more accurate indicator of its predictive potential.

**Table 3: Output 2 SPSS regression model**

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the estimate
1	.780 <sup>a</sup>	.562	.424	12.143

a. Predictors: (Constant), Foreign Exchange Risk, Market Risk, Interest Rate Risk, Purchasing Power Risk, Credit Risk, Trend of Default Risk

**ANOVA Test Analysis**

ANOVA is the name of the following table. This table demonstrates if the regression model can accurately (and significantly) predict changes in the dependent variable. And, as seen in the table's last column (sig), the column displays the statistical significance of the regression model, which must be less than 0.05 to be considered significant. In our study, the significance level is 0.031, which is less than 0.5, showing that the regression model is useful.

**Table 4: Output 3 SPSS regression mode**

ANOVA <sup>a</sup>					
Model	Sum of Square	df	Mean Square	F	Sig.
1	Regression	0.41			
	Residual	.537	26	0.21	
	Total	.579	29		

a. Dependent Variable: ROA= Net earnings after taxes (NEAT)/ Book Value of Assets (BVA)

b. Predictors: (Constant), Foreign Exchange Risk, Market Risk, Interest Rate Risk, Purchasing Power Risk, Credit Risk, Trend of Default Risk

**Coefficients Table of Regression Analysis**

The last table which indicates the coefficient of each independent variables on dependent variable is coefficients table which is shown in below. The b coefficients tell us how many units ROA increases for a single unit increase in each predictor. As a result, a one - point rise in foreign currency risk correlates to a - 0.16 - point increase in the money exchange dealer's financial performance (ROA). We can calculate ROA based on solely the scores on our predictors. We may compare the respective strengths of our predictors using beta coefficients. The p - values for our predictors are stored in the column "Sig. " We may state that a b coefficient is statistically significant if its p - value is less than 0.05 as long as the Sig value is less than 0.05.

**Table 5: Output 4 SPSS regression model**

Coefficients <sup>a</sup>						
Model		Unstandarized Coefficient		Standardized Coefficient	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.236	.040		5.944	.000
	Foreign Exchange Risk	-.041	.001	-.168	-1.690	.032
	Market Risk	-.071	0.18	-.178	-3.744	0.00
	Internet Rate Risk	-.049	.001	-.102	-1.457	.035
	Purchasing Power Risk	-.063	.021	-2.31	-2.354	.017
	Credit Risk	-.061	.001	-.068	-1.690	.022
	Trend of Default Risk	-.072	0.16	-3.78	-5.744	0.00

a. Dependent Variable: ROA= Net earnings after taxes (NEAT)/ Book Value of Assets (BVA)

$$ROA = 0.236 + (-168) * X_1 + (-0.178) * X_2 + (-102) * X_3 + (-0.231) * X_4 + (-0.068) * X_5 + (-0.378) * X_6$$

Where

Beta Constant: 0.236

X1= value of foreign exchange risk (EFI)

X2= value of market risk (MR)

X3= Interest rate risk (IPR)

X4= Purchasing power risk (PPR)

X5= Credit Risk (CR)

X6= Trend of default ratio (TDR)

### Final model of regression equation

The final model of the regression equation is formed as below through the SPSS data analysis output. In this model, the b coefficient is showing the power of correlating with each of the independent variables and the Xis shows the value of each independent variables. ROA is a proxy for showing the financial performance of the dependent variable.

### 3. Conclusion

In this section, the findings of the reported study are summarized. The research conclusion begins with descriptive data depicting gender, education level, and ROA calculation for each of the MXDs. The research hypotheses are validated using the regression model created for the study after defining the descriptive data. The overall coefficient of the adjusted regression model shows that 42% of the changes in the dependent variable are explained by the independent variables included in this model, and the analysis of the Sig of ANOVA test shows 0.031, which is less than 0.05, and explains that this model Regression is significant for this model. Both dependent and independent variables. The indicators of the first hypothesis of the research show a significant relationship between systematic risk and profitability, as well as the correlation of this variable with profitability, and all four indicators are less than 0.05, which indicates the significance of the test and the existence of a significant relationship between currency risk, market risk, risk Interest rate and purchasing power risk on financial performance of MXDs. For each sign of systematic risk variable, beta coefficients are - 0.168, - 0.178, - 0.102, - 0.231 respectively. The components of the second research hypothesis show a significant relationship between credit risk and the trend of default risk on financial performance, as well as the strength of correlation with ROA, which are - 0.068 and - 0.378, respectively.

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