CHAPTER 1

INTRODUCTION

1.1 Background

At the beginning of 2015, one year after the new president of Republic of Indonesia is elected, Indonesia Central Bureau of Statistics recorded a trade surplus of USD $709.4 million. While this is higher than expected and thus has a positive impact on Indonesia Trade and Account balances, the record also mentioned that the country's export shrank to USD $13.30 billion. The sharp fall of global oil price was one of the main causes the imports are declined. This phenomenon, coupled with the devaluation of Yuan, and other internal factors such as economy slow down has plummeted Rupiah to IDR 14.650 per US Dollar. This condition went on until the first quartal of 2016. At the beginning of second quartal of 2016, Rupiah made a considerable comeback and secured its position on IDR 14.400 per US Dollar. The exchange was stable until US Dollar strengthened in October 2018. According to the Bloomberg Dollar Index the rupiah had weakened 0.93 percent to IDR 15,048 per US dollar as of October 2, 2018. This number is the second largest after the devastating Asian Financial Crisis on late 1990s, in which 1 US Dollar equals IDR 16.650.

This volatile change in foreign exchange rate creates a high uncertainty for every business and corporates involved in global trade. The risk that arise from uncertainty regarding future exchange rate is called the Foreign Exchange Risk. While depreciation of IDR certainly benefits exporters from Indonesia, the same cannot be applied with the importers. On contrary, importers gain more profit during the apreciation. This volatility forces every business to hedge against unfavorable exchange rate movements.

Hedging is a risk management strategy to reduce the risk of uncertainty related to the adverse price fluctuation. There are two components to be considered in the hedging activity. First, hedging in short-run exposure and second, hedging in long-run exposure. Short-run exposure also called transaction exposure due to the fact that it is only short-term risk. Means that in the long run, the firm will still be fundamentally well. The long-run exposure also called economic exposure, because it is rooted in fundamental economic forces. Hence, they are more difficult and almost impossible to be hedged in permanent basis. (Ross, 2002)

There are a lot of hedging activities that can be done to protect the company against foreign exchange risk. The most common one is using financial derivatives. Derivative is a contract between two or more parties, which values is determined by the underlying financial asset that is agreed upon. The common underlying instruments include bonds, commodities, interest rates, stocks. There are five kinds of derivatives contracts that are commonly used, namely Future contracts, Forward Contracts, Options, Swaps, and Warrants. According to Governmental Accounting Standards Board, firms may find derivative transactions useful in a) Reducing risk exposure by converting floating rate debt obligation to a fixed rate b) Lowering borrowing cost through the use of interest rate swap, c) Managing cash flow (Jermann and Yue, 2018; Judge et al., 2018; Yu et al., 2004). Previous studies also have recorded that hedging can minimize the impact of foreign exchange rate fluctuations and reduce the probability of financial distress and even bankruptcy. (Aretz et al., 2007)

Considering the effect of hedging in protecting corporate business operations that has been explained above, corporate risk management has been rendered as an important corporate objective. Hence, more attention is put in the making of hedging policy, which falls in the responsibility of the CEOs. They are usually risk averse since they are invested both personally and monetarily in the firm they manage and so their policy decisions are normally conservative compared to a well-diversified shareholder. In other words, anything that affect the firm will directly affect their private wealth also. This has been the main cause of the risk-averseness in CEO. (Belgitar, 2015)

Adam (2012) stated that there are a lot of CEO biases that may affect the corporate policy making, including but not limited to risk aversion, mental accounting, and overconfidence. These biases may affect many decisions such as corporate investment policies, capital structure decisions, mergers and acquisitions, security offerings, investment bank relationships, and hedging. The behavior of risk-averse CEO becomes interesting and an on-going topic as their policy will determine whether to maximize firm value by accepting more risk (Rustambekov, 2011; Yun, 2013) or hedge more than the generally-accepted standard (Suen, 2018). There are still a lot of indicators showing the risk-averse tendency. Jing-Ming Kuoa (2017) mentioned that a high expense on CSR activity can be a good indication of risk-averse behavior. Because not only doing more CSR activity will put the company in less-riskier position, the CSR activity is also highly correlated with the CEO character.

Some previous researhes investigates the relationship between CEO characteristic and hedging decision. There are various variables that can be used as proxies for human characteristic. Doukas (2018), stated that using Risk Incentives in the form of Stock Option and Cash Compensation, CEO Firm Equity and Inside Debt as the Risk preference measure, there is no significant relationship between CEO characteristic and hedge decision. Croci et al. (2016), Hayes et al. (2010), Aretz et al. (2007) also reported no evidence for the claim that higher risk incentives for CEO can affect their hedge decision.

In contrast, evidence from Boubaker and Belkhir (2012) shows that risk incentives in the form of Stock Option have positive and significant affect with the hedge decision. They suggest that firms use equity-based compensation to incent risk averse managers to take more risky and profitable projects to benefit shareholders. Among other things, this would imply holding lower cash balances. Using the same proxies, research by Feng and Rao (2018), Liu and Mauer (2011) also reported the same result.

Based on the contradicting research evidences from previous studies as the starting point, this research aims to study the relationship between risk-averse behavior in CEO and the hedging decision, in manufacturing companies in Indonesia period 2013-2017, the period in which the second highest interest rate spike happened after the 1998 monetary crisis. Finance and Banking are also excluded, as their business model, risk exposures and hedging strategies are very different from industrial firms. Banks as financial intermediaries specialize in risk transformation and management and profit by taking on certain risks. They transform liquidity risk, interest rate risk, default risk, and foreign exchange risk and immunize, diversify or hedge the risks that they do not want or cannot hold given their limited equity

1.2 Research Problem Formulation

Based on the background explained above, the problem formulation would be “Does CEO characteristic affect the hedging decision?”

1.3 Research Objective

The goal of this research is to find whether characteristic of CEO affect the hedging decision.

1.4 Research Contribution

The following contributions are expected from this study:

1. Empirical Contribution

   The researcher hoped this study will help students expand their knowledge regarding the application of existing theory and shed a new view about the effect of CEO characteristic to the corporate hedging decision.

2. Practical Contribution

   a. For author, conducting this research is expected to help her broadening her knowledge and earning the accounting degree

   b. For corporate CEO, this study is expected to help better understanding the effect of their characteristic to corporate hedge policy

   c. For academics, this study is expected to help in any way as a source of reference and information to help future research in regard of CEO characteristic and hedge policy.

1.5 Research Systematic

CHAPTER 1 : INTRODUCTION

This chapter contains the background of corporate risk management, especially the hedging policy under the responsibility of CEO that have low risk characteristic compared to the other risk-neutral CEO. This chpater also contains the problem formulation, research objectives, research contributions, and the systematic of this study

CHAPTER 2 : LITERATURE REVIEW

This chapter presents the highlights of previous researches about the relationship of CEO characteristic and the corporate hedge policy, along with the theories related to this study, as well as the hypothesis development and the research framework.

CHAPTER 3 : RESEARCH METHODOLOGY

This chapter explains about the methodology used in this study, beginning with research approach, identification of variables, types and sources of data, population and sample, data collection methd, and data analysis method.

CHAPTER 4 : RESULTS AND DISCUSSION

This second to last chapter in this study presents the result from the processed data. Start with the general description of research subject and object that involves a brief explantion on how the research is conducted, the hypothesis testing, and lastly discussion about how the result of the research conducted lead to the hypothesis rejection or acceptance.

CHAPTER 5 : CONCLUSION AND SUGGESTION

The last chapter serves as conclusion of everything that has been done in this research along with recommendation that hopefully will be useful for the involved parties, including future research.