Currencies Direct

Financial Markets

Foreign exchange risk and the corporate treasurer: What makes a good hedge?

Managing risk

The first step in managing risk is to work out the specific risks you want to address. This is usually a three-step process:

1. DETERMINING what kinds of risk the organisation faces
2. QUANTIFYING the financial size of the risks and their potential impact
3. SELECTING which risks need to be mitigated, and whether full or partial mitigation is needed

Having completed this exercise, the treasurer must then select the appropriate instruments. In this paper, we'll use the example of foreign exchange risk to examine the entire risk lifecycle and the relevant choices and considerations.

Types of foreign exchange risk

There are two main sources of foreign exchange risk; transaction risk and translation risk. Each of these can be broken down into separate areas, and we will examine these in turn.

Transaction risk

Forecast

This is the risk arising from a business transaction which generates a foreign exchange flow (e.g. an income generated from exporting goods). If a company manufactures its products in the UK and sells them in Germany, it will price the sale in euros and so is exposed to changes in the euro-to-pound (EUR/GBP) exchange rate when it is forecasting its sales revenue. This risk is based on estimated cash flows.

Revaluation

Once a sale has been agreed, there is usually a period before the buyer has to settle the agreed sum. If we continue the example from the previous point, there is now a precise amount in euros which will be received on a future date, but the resulting sum in pounds Sterling is uncertain because the exchange rate may move.

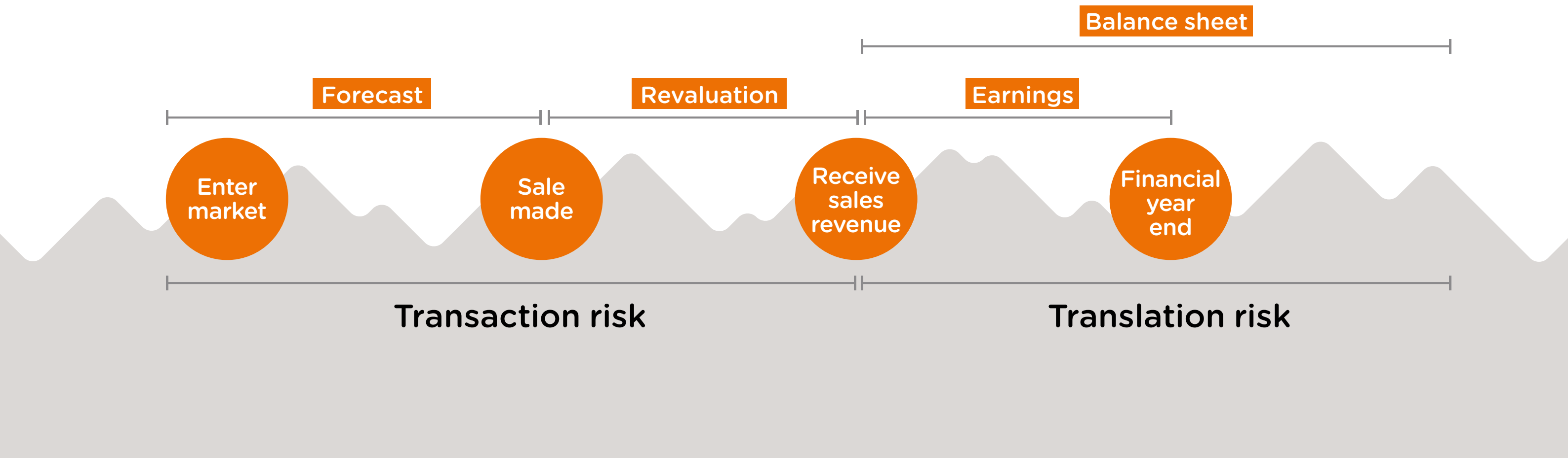
Translation risk

Balance sheet

One of the side effects of doing business abroad is that there are often cash and other balance sheet items accounted for in foreign currencies. These may be the result of completed sales, or could represent the operational cash balances of a foreign subsidiary or branch. Whatever the reason, these will be revalued on an ongoing basis and will have a changing impact on the company's equity value.

Earnings

The balance sheet revaluation problem is not restricted to cash balances. Profits earned in a foreign subsidiary or branch are usually accounted for in the operation's local currency. This means that, until they are converted to the company's base accounting currency, their value can continue to fluctuate.

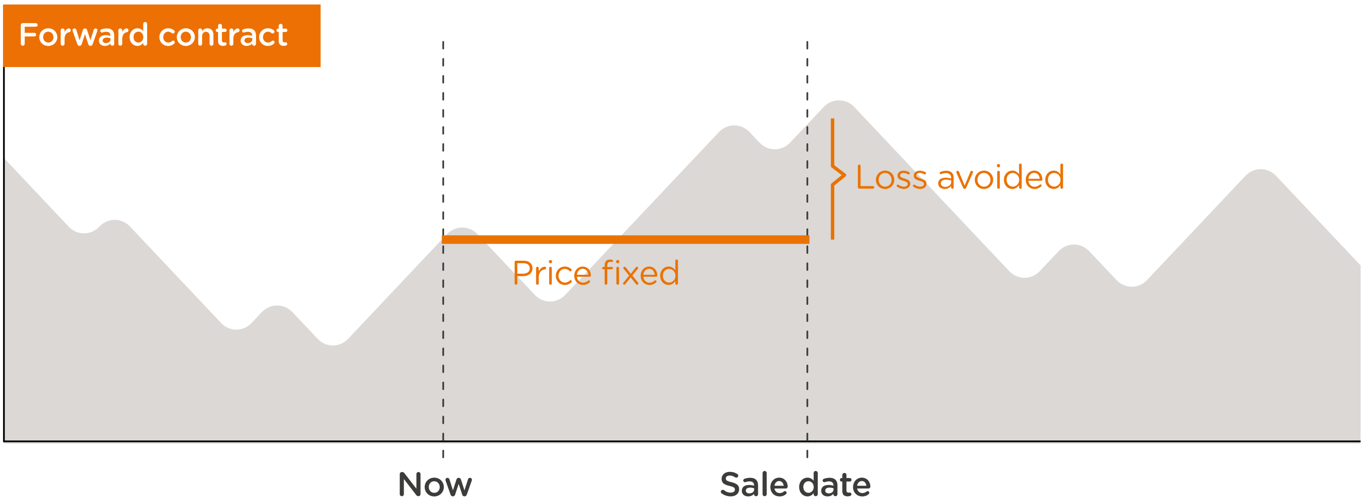


Foreign exchange hedging approaches

When a treasurer purchases financial instruments with the intention of reducing risk, this is called hedging. It is important to note that the purpose of a hedge is never to generate profits, but to reduce the possibility or (if loss cannot be avoided at all) the amount of a potential loss. There are three basic approaches, and the choice between them is partly driven by the degree of certainty surrounding the cash flow and partly by differing accounting standards.

Where cash flow is certain

When future cash flows are certain, it is possible to precisely hedge a risk. In foreign exchange terms, this would involve using a forward contract (fixed rate, for a fixed amount of foreign currency, on a fixed future date). This has the feature of being precise and certain, matching the certainty around the cash flow. It would be a good approach to use for revaluation risk.



Where cash flow is uncertain

There are occasions when the amount and date of future cash flows are uncertain. This is the case for forecast risk and often for balance sheet translation risk. In these cases, the treasurer knows that there will be exposure in the future, but has only a forecast based on plans or previous performance to base their actions on.

There are two ways of approaching this problem. The first is to look at the entire period in question, which is probably somewhere between three and 18 months (depending on the firm's underlying business cycle), take the budgeted exposure and to hedge a proportion of it.

If a firm expects to sell goods or services worth £1 million into Germany over the next 12 months, the treasurer might decide to hedge 80% of this, buying instruments to cover £800,000 of exposure. These instruments could be forward contracts, as with revaluation risk, but it may be worthwhile to consider using options.

With options*, a firm can enjoy the upside of currency movements when they move in the favour of the firm, but be protected against the downside when the market moves against it.

There are two problems with looking at the entire period in question. The first one is that the firm can be exposed to a very sudden exchange rate change when the end of each hedge period is reached.

The second is that not all cash flows have the same degree of uncertainty across a period; those which are closer to the current point in time can often be forecast with greater certainty. This approach treats them as being a homogenous set of forecasts.

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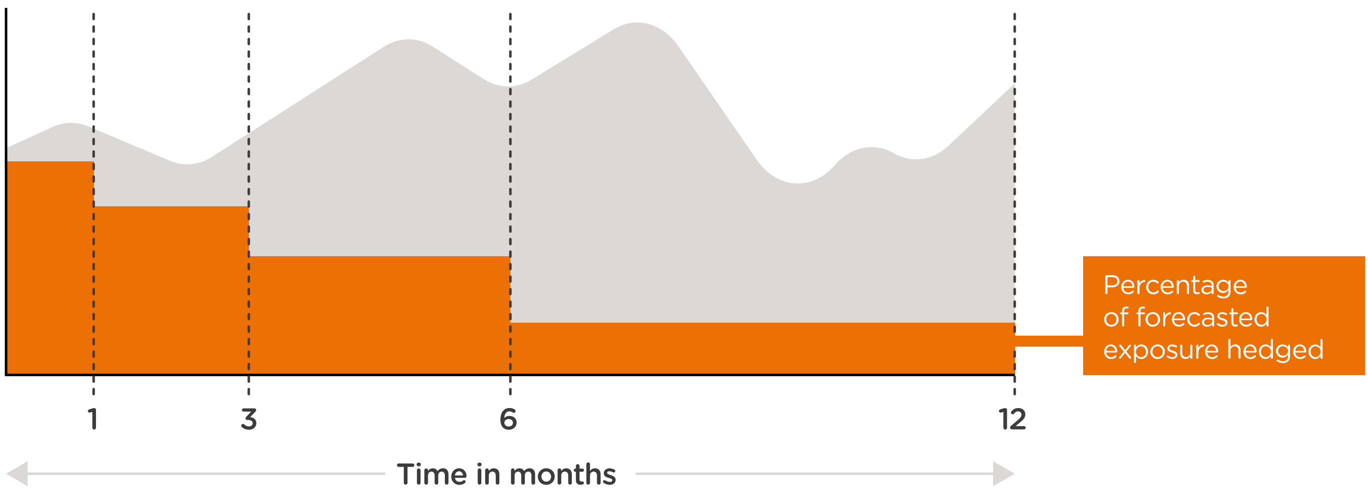
A slightly more sophisticated way is to layer the hedges over time. In this example, the treasurer may break the next 12 months into a series of "time buckets". For example, this might be 0–1 month, 2–3 months, 3–6 months and 6–12 months. The treasurer could then take a view on the accuracy of the forecasts and develop a strategy around this.

An example would be to hedge the first period at 80%, the second at 65% and the third at 50%. As time moves forward, so the near-term hedges would expire, and the treasurer could adjust the next period's hedges to the higher level as certainty increases. This means that the treasurer can adopt a rolling strategy based on forecast certainty. As with the first approach, the use of options could be considered for this kind of activity.

When either of these approaches is used for hedging balance sheet translation risk, it is referred to as net investment hedging. This is because the expected net balance sheet position is hedged, rather than the individual cash flows which build it.

The instruments and approaches are the same, but the treasurer needs to look instead at the lively cash and other asset and liability positions in foreign currencies over the coming periods.

Layered hedge with time buckets



Where hedge accounting isn't suitable

When selecting a hedge approach it is, of course, important to ensure that it covers the risks that it is designed to cover. It can, however, also be necessary to consider the accounting treatment of the hedge in the company's books. Hedge accounting treatment works to produce net P&L entries for the original risk and subsequent hedge transactions, but it can only be applied in situations permitted under the various accounting standards.

Although it is beyond the scope of this article to cover this in technical detail, in principle it is necessary to show how the hedge transaction is related to identifiable risks. This can sometimes be hard to do for some foreign exchange risks. Where this is the case, it is necessary to adopt a different approach.

Where there is a foreign subsidiary involved, one approach would be to regularly return earnings into the parent company's domestic currency, using either spot or forward transactions and so reducing the retained earnings exposure.

Whatever your exposures are, start by taking a global view of financial risk across the firm's operations. The risks then need to be analysed into type and probability, and appropriate hedging strategies designed and executed. Not all risks need to be hedged but, when they are, using the right combination of approaches and instruments can produce a result which is targeted and appropriate to the level of certainty which exists for your firm's business.

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