

MANAGING FX RISK

In our earlier piece we made a short introduction to FX risk and why this matters to corporates.

FX risk affects all companies and may impact the P&L, B. Sheet and Cash Flow. Currency volatility has been high recently and we believe it will continue due to trade patterns, crises and government policies.

In this paper we explore how companies can manage FX risk proactively and mitigate its impact.

Whilst this can appear complex and expensive there are possibilities for even the smallest companies.

GBP:USD

Wide Bollinger Bands on Brexit, indicating volatility



GBP:USD

Moving Average and spot price out of sync



TYPES OF FX RISK

Businesses are exposed to FX risk, even if they do not realise it.

Translation

Occurs when a subsidiary's financial statements are converted from its local operating currency to the parent's base reporting currency. May impact the P&L, B. Sheet and Cash Flow statements of the parent, in turn affecting covenants. Companies may not hedge this risk due to its long-term nature and because hedging may create reporting distortions which affect comparability.

Transaction

Occurs on conversion of one currency to another, such as for sales, purchases, funding or dividends. The exposure is subject to mark-to-market accounting with the resulting gain or loss reflected in the P&L.

Economic

When FX movements make a company uncompetitive versus an international competitor, even if it operates only in its domestic market. As an embedded business risk it is hard to hedge.

Future

An exposure which will arise in the future, either already contracted, planned or unexpected.

Operational

The risk of loss resulting from inadequate or failed internal processes, people or systems. In this context may include incorrect data, misreading markets or misunderstanding hedging products.

RESPONSES TO FX RISK

Businesses have various options in how to respond to FX risk.

Accept

Do nothing, thus leaving P&L and Cash Flow exposed to fluctuations which you cannot predict or control. You may do this if you think rates will average out over time (mean reversion) or believe the cost of hedging is too high. In many cases firms accept FX risk simply because they have no risk management in place.

Avoid

Desist from, or alter, the activity creating the risk. May be impractical from a commercial point of view. Companies should adapt their business model to reduce or avoid risk but this takes time.

Hedge

Reduce or remove the risk by using internal hedges or trading derivatives with an external counterparty.

Share

Share the risk (and reward) with commercial or financial partners.

Speculate

Risk carries opportunity as well as threat, albeit most companies prevent speculation through their treasury policies.

Must be aligned with to overall financial and corporate goals, not driven by the market.

Must be integrated with the underlying business e.g. cash flows, currencies and business cycles.

Must be proactive - markets, rates, customers and competitors change dynamically.

Is usually rule based

- *Hedge a minimum of AA% and a maximum of BB% of all identifiable transaction exposures. Only applies to currency pairs that have a quarterly exposure of at least £CC and an annual exposure of £DD*
- *Future cash flows must be VV% hedged over XX time period at an average rate of YY%. The targeted average hedging level is therefore ZZ%*

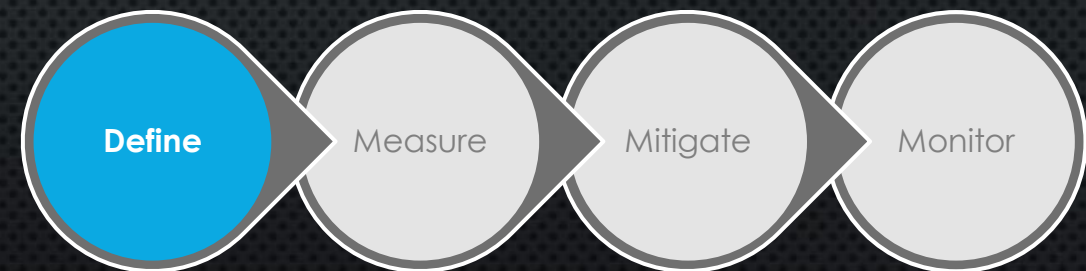
The purpose is to minimise risk and create predictable outcomes, not to swap one risk for another or generate trading gains.

Define risk appetite, ensuring it is appropriate for the financial and overall risk strategy.

Formulate a risk policy

- *Objectives (add value, eliminate risk, minimise cost, etc)*
- *Who has responsibility (subsidiaries or group treasury)*
- *Exposures to be hedged (transactional, translation, future, etc)*
- *Approved cover level/ratio*
- *Time horizon (normally done on a rolling basis)*
- *Permissible hedging instruments and counterparties*
- *View taking (passive, dynamic within a range, dynamic within a limit, etc)*
- *Define performance benchmarks*
- *Define risk budget*
- *Document processes and compliance*

Define budget rate.



Gather accurate and timely data from subsidiaries.

Validate the forecast and other data to eliminate errors.

Identify and understand exposures

- *Use a combination of measures such as VaR, CFaR, sensitivity analysis, stress testing*
- *Identify forecast gain or loss*

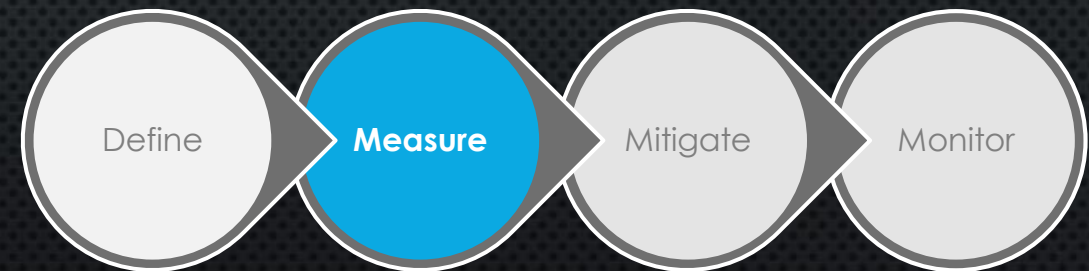
Evaluate the performance of previous hedging.

- *Mark-to-Market underlying exposures and hedges to measure effectiveness*
- *Is hedging cost affecting competitiveness (it may be cheaper to have a closely monitored open position)*

Monitor FX markets.

Hedge decision

- *Don't hedge, but continue to monitor?*
- *Hedge through internal methods?*
- *Hedge with a derivative?*
- *Timing of hedge to optimize value?*



Check counterparty limits and credit rating

- *Seek approval if outside risk policy*

Seek competitive price via phone, online platform or auction (for larger deals).

Validate price using a model or risk system.

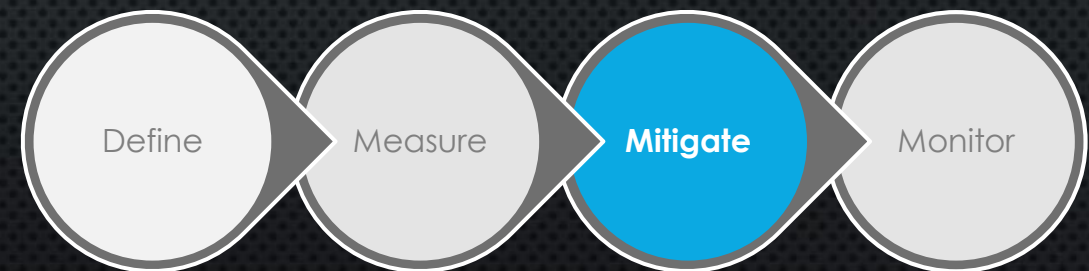
Execute trade.

Confirmation matching

- *Possibly a different person for segregation of duty*

Deal entry in Treasury, Risk or Enterprise system

- *Preferably a straight through process (STP)*



Risk

- *Value positions and monitor versus limits, coverage ratio, forecast, etc*
- *Analyse counterpart credit risk*
- *'What if' modelling and scenario testing*
- *Performance analysis of effectiveness*

Reporting

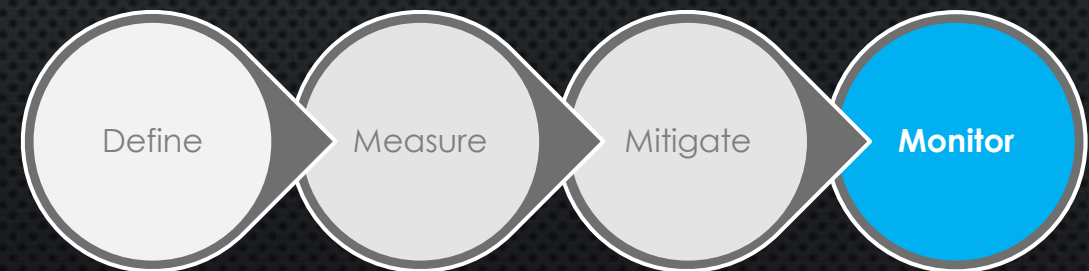
- *Management in line with agreed detail and frequency*
- *Statutory*
- *Regulatory, such as EMIR*

Maturity

- *Settlement*
- *Reconciliation*
- *Ledger entries*
- *Hedge accounting if appropriate*

Iteration

- *Is current risk management effective and adding value?*
- *Better co-ordination between treasury and business?*
- *Re-engineer business to reduce risk?*



FOCUS ON HEDGING

Optimising internal hedges reduces risk and the number of external hedges, in turn saving money. Examples can include intercompany netting, offsetting asset and liability positions and preventing/passing on risk to customers or suppliers through contractual or pricing mechanisms.



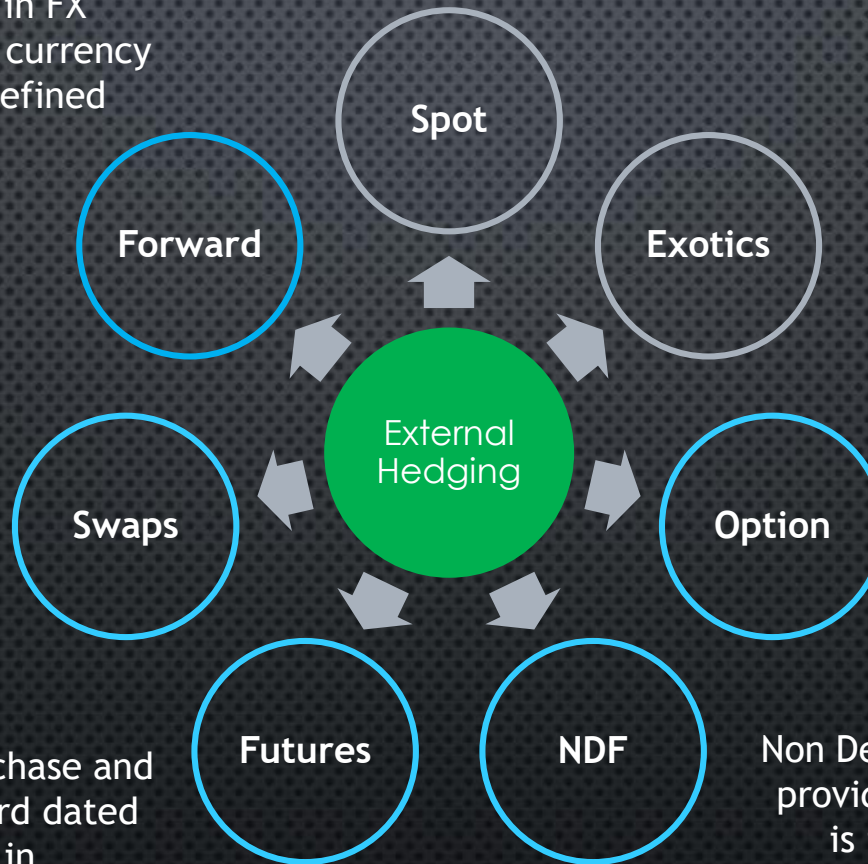
Trading derivatives with an external counterparty or peer. The range of hedging instruments is large, from simple through to highly structured solutions. The choice of instrument should be a combination of what is best suited to the desired outcome, risk policy and market conditions.

FOCUS ON HEDGING INSTRUMENTS

A Forward protects against a drop in FX rates by allowing you to buy/sell a currency at today's rate with delivery at a defined future date. Commonly used.

A Swap involves a spot buy/sell and simultaneous opposite transaction with the same counterpart, but for a different expiry date. As such it combines Spot and Forward trades. This allows delivery/payment to be made at a defined future date which meets the business need.

Futures allow for the simultaneous purchase and sale of opposing currencies, on a forward dated basis. Futures are traded on exchanges in standardised amounts and offset with other obligations (as opposed to OTC derivatives which are private, tailored and settled).



Options give the owner the right but not the obligation to enter into a deal. Call Options allow you to purchase a currency at a specified price and time in the future e.g. you want to benefit from a drop but hedge against a drop. Put Options allow you to sell a currency at a specified price and time in the future e.g. you benefit from a rise but hedge against a drop. The option is exercised if the spot price touches the strike price. Due to the flexibility this provides a premium typically applies.

Non Deliverable Forward's are a forward contract that provides a hedge but which cannot be delivered. This is typically due to currency controls which restrict exchange to local banks only. The NDF is closed/fixed on expiry, resulting in gain/loss which then offsets the paper gain/loss required to purchase the local currency from the local bank.

COMMON RISK MANAGEMENT MISTAKES

- ⚡ Inability to identify true exposure (lack of data, reporting in single currency, weak forecasting, etc)
- ⚡ Inability to get forecast on a consolidated basis
- ⚡ Failure to consider correlations between exposures (currency pairs and other asset classes)
- ⚡ Unclear risk management process
- ⚡ Lack of a structured hedging strategy
- ⚡ Failure to consider internal hedging opportunities
- ⚡ Allowing a market view to drive risk decisions
- ⚡ Ignoring cash flow implications (mismatch between exposure and hedge duration)
- ⚡ Use of complex derivatives which are inappropriate for the business need
- ⚡ Inefficient pricing of hedging instruments at trade
- ⚡ A belief that FX rate changes even out over time (mean reversion)
- ⚡ Lack of performance analysis (forecast cash flows, hedge assumptions, hedge effectiveness)

HOW WE HELP

Key Capital can help you address FX risk in many ways.

Financial Strategy



We can create a financial strategy which minimises the impact of FX on your business and supports corporate strategy. Solutions can include maximising natural hedges and de-risking commercial contracts.

Treasury Management



We can ensure your funding, hedging and cash flow management are optimised for cost, flexibility and financial risk.

Hedging



Feasibility studies, document preparation, partner search and pricing checks to support your hedging programs.

Solution Sourcing



Sourcing an IT solution to help you manage and report proactively. We can help you scope requirements, run a ROI analysis and manage the implementation project.

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