The Treasurer

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NAVIGATING FX RISK MANAGEMENT

Volatility in the FX markets is forcing organisations to review existing policies. **Lisa Dukes** and **Chris King** set out the risks and opportunities

RISK MANAGEMENT & STRATEGY

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Over the past few months, global financial markets have barely paused, and the FX market is no exception – initial USD strength coupled with a short sharp dose of GBP weakness has seen sterling move to record low levels and be more volatile than Bitcoin… well, almost!

With such extreme moves, companies with currency exposure, regardless of whether sterling weakness is structurally favourable or not, will have been considering how to manage the risks and opportunities arising from these exposures.

The current market dynamics have provided the impetus for many organisations to review existing treasury policies, and ensure they are fit for purpose – not just for the current environment, but also looking forwards.

POLICY DESIGN

A policy must be appropriate for the organisation and reflect:

- The risk appetite of the business;
- The degree of complexity (for example, proportion of cross-border business);
- The level of sophistication (for example, willingness to use structured products);
- That trading derivatives may not be the only answer; it can be coupled with intragroup netting and raising local debt to deliver the desired result for the organisation; and
- Planning for the future, supporting and enabling strategy or for contingent outcomes.

Any policy, particularly where managing risk, should be underpinned by a robust governance framework supported by qualified individuals. This will, of course, depend on the size and complexity of the business.

The FX Global Code of Conduct is an invaluable tool, which should act as a control framework to support the policy. It promotes best practice for all FX market participants in a way that is tailored and proportionate to the nature of their engagement and the size and complexity of their activities.

It's a great cross-reference check to ensure that the policy encompasses all key aspects and demonstrates commitment to the highest level of governance in all areas of environmental, social and governance across the treasury remit.

Reporting should seek to include all identified exposures, regardless of whether they are actively hedged or not, to ensure comprehensive risk management oversight.

A flexible policy is key to enable a rapid response in the event of significant market moves. For example, the ability to increase hedging (such as where super-profits would be protected) or change the approach (for example, to prevent locking in loss) without delay may be desirable. Having a broad range of products available enables the flexibility that may be needed at short notice during market turbulence.

Ensuring the necessary and appropriate delegated powers and permissions have been approved in advance is always worth the effort to have a complete toolkit when it matters.

COMPLEX CONSIDERATIONS

Protecting against increased costs or reduced revenues are usually the focus of a policy, but there are other considerations:

- Inherent within any currency hedging programme is exposure to spot and forward

WHAT RISKS ARE YOU MANAGING, AND WHAT RISKS SHOULD YOU BE MANAGING?

The primary rule of risk management is to identify all (yes, all) exposures and understand whether they are unacceptable or acceptable risks (i.e. whether the risk appetite of the organisation requires that an exposure is hedged in some way). Remember that 'a hedge' does not have to just lock in via a forward, as there are many situations (i.e. locking at market extremes) where this creates much greater risks.

This requires the treasury team to work closely with the business to help them understand where exposures might arise, and the importance of sharing such information with treasury.

Exposures can be categorised as follows:

Transactional: FX exposure on non-domestic transactions between being contracted and paid.

Pre-transactional: FX exposure between committing to a price on non-domestic transactions and being contracted.

Translation: FX impact on financial statements from the re-translation of non-domestic assets and liabilities or foreign subsidiaries accounts.

Contingent: FX exposure highly probable to occur on non-domestic transactions.

Economic: FX impact of longer-run strategic or competitive exposures or 'indirect', such as those buried within supplier contracts.

PROACTIVITY CAN BE CONDENSED INTO A FEW KEY AREAS:

- Strategic scanning of markets, mapping back to your own profit and loss;
- Considering sensitivities in the context of current ‘broken markets’, which likely means stressing more than previously thought;
- Innovation – try to think of risks in a holistic sense, rather than focusing on one aspect in isolation. Use advisers/banks to help consider optimal approaches;
- Communicate with stakeholders and outline planning for sensitivities. This usually means having a rolling strategy for the next quarter (or further out), which should give comfort internally;
- Prepare for strength – be proactive, and always seek to have an acceptable minimum level of hedging to cover the stress events; and
- Continuous loop – this is a daily grind, so enjoy it!

curves – even short-dated forward curves have seen significant volatility, with the extreme long-dated curve seeing longer-dated differentials swing more than 60 cents on GBP/USD (in addition to the c.25 cents move on spot) in less than five months. You can separately lock in the spot and forward components, providing additional flexibility to optimally manage the risk.

- Favourable moves, while structurally good, potentially generate issues around credit lines as the mark-to-market (MtM) moves against the business. Having a policy that proactively considers how to approach, secure and manage credit before it is an issue is good practice.
- Some products, including FX options, may seem complex or unwieldy, however, many already embed optionality without necessarily looking at the components within the structure, or the future sensitivities.
- Running relevant and up-to-date sensitivities should provide information to manage the exposures and portfolio dynamically – for example, whether the minimum hedge level is still sensible, given changes in supply costs or demand outlooks or impact on credit lines during market stress. While the costs of hedging of most G10 currencies don’t usually move significantly, for other currencies or in volatile or sanctioned markets this may not be the case. Be proactive and have processes in place to benchmark these costs and a plan in place to activate if they become punitive.
- This could include managing MtM exposures, assessing opportunities to increase hedging levels (tenor or ratios) or mitigating the imminent hedging requirements at unfavourable levels through product choice or policy reconsideration. The choice of product will be critical in managing the credit implications for each route.

PROACTIVE RISK PLANNING

Having a balanced overall position demonstrates to stakeholders thoughtfulness, strategic scanning and an ability to decisively act. This could include being prepared and insuring against potential moves, perhaps buying cheap protection for the future, as well as flexing the norm when the market is not accommodating.

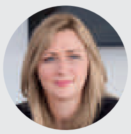
For example, businesses that suffer in the event of sterling weakness and that are fearful of a further sell-off could consider structures that reward for that sterling weakness while providing some certainty. While no structure will ever be a silver bullet, tailored risk management can help de-risk situations to give a position of strength in the event of adverse moves in currency.

Additionally, in periods of sterling weakness, there may be an opportunity to export your business given the GBP comparative advantage, and actually represents a good time for overseas acquisition, assuming it is funded with predominantly overseas debt.

MODERN-DAY MARKET DYNAMICS

There is a far higher level of hedge fund, or speculative participation in derivatives markets than historically. While this can provide additional liquidity, it typically exacerbates movements. Spikes could be wider than typically envisaged, even in major currency pairs.

Scenario planning is proven to be a key differentiator in a business’s ability to manage through stressed markets, particularly as boards and external stakeholders can get somewhat animated, creating additional pressure and scrutiny often at the least convenient times. Ensure you have the structure, processes and mental resilience to stick to your plans.

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