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WHAT IS THE RIGHT WAY TO HEDGE FX WHEN MANAGING CURRENCY RISK IN EMERGING MARKETS? ASK YURI POLYAKOV AND ASHLEY GARVIN

In recent years, many companies have invested in emerging markets in order to take advantage of higher economic growth rates in these countries. While the opportunities can be attractive, companies expanding into emerging markets also face a number of obstacles, including regulatory, tax and political considerations, as well as time-zone and cultural differences. Managing FX risk represents another key challenge.

Until last year, relatively low volatility in emerging market currencies meant that many companies did not hedge their exposures at all, or hedged only on a short-term basis. Since the second half of 2013, however, higher volatility in a number of currencies, including the Indian rupee (INR), Mexican peso and Brazilian real (BRL), has prompted more companies to focus on this topic.

Managing emerging market currency exposures does present a number of difficulties, and can be an expensive undertaking. In G10 currencies, risk management decisions are made in the context of lower hedging costs and deeper liquidity. In emerging markets, such decisions are less clear-cut due to significant hedging costs, which must be taken into account, and lower liquidity.

A systematic approach

In order to manage their emerging market currency exposures as effectively as possible, companies should consider the following points:

◆ **Differentiate between buyers' and sellers' exposures.** FX forward prices are determined by the market and predominantly reflect the difference in the interest rate environments of both currencies. The market typically implies that the value of the emerging market currency will be less in a year's time than it is today. Because of this, risk management should be approached differently, depending on whether the company is a net buyer or a net seller in a particular currency.

Buyers are looking to manage the risk associated with their costs. By hedging costs that are denominated in an emerging market currency, they can effectively lock in the implied future weakness of that currency – a weakness that may not actually materialise. In such cases, the company would be advised to hedge as much as possible in order to remove volatility from its costs and to create value by locking in the implied beneficial weakness.

For sellers, the picture is less straightforward because such companies are looking to manage the risk arising from their revenues and assets, rather than their costs. If a company does not hedge, it risks incurring losses as a result of volatility. If it does hedge, it locks in the implied future weakness of the currency – thereby eroding the value of the company's revenues or assets on the income statement or balance sheet.

Another consideration is that when hedging an asset, companies tend to experience a cumulative impact over time: the economic cost of hedging an asset over the course of 10-15 years could be as much as the total value of the asset itself (see The Economic Cost of Hedging chart, below).

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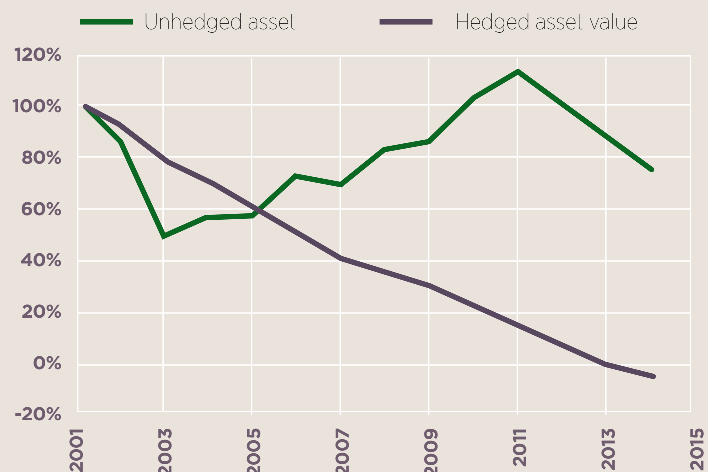
THE ECONOMIC COST OF HEDGING – US$/BRL ASSET HEDGING



When hedging a cash flow, companies tend to settle every year, so this compounding issue does not arise. Assets and revenues should therefore be approached differently when devising a risk management strategy.

◆ **Understand that not all emerging market currencies are alike.** It is common to speak about emerging market currencies collectively, but in fact, these currencies are not homogenous. Broadly speaking, emerging market currencies can be split into three groups:

- Pegged/managed currencies;
- High-yield differential currency pairs; and
- Low-yield differential currency pairs.

A number of currencies are pegged to the US dollar (US$), such as Emirati dirham, or to a basket of currencies, such as Chinese renminbi. Pegged currencies behave very differently from free-floating currencies: their value tends to move in a straight line and then jump, for example, when a revaluation occurs. For these types of exposure, a solid understanding of the country risks is required. In addition, a risk assessment should take place to understand the impact of the currency becoming unpegged.

The second group contains currency pairs that have high interest rate differentials, such as US$/Russian ruble, US$/BRL and US$/INR. For sellers of the currency, these are very expensive to hedge.

The third group consists of currency pairs that have low volatility and are not expensive to hedge, such as US$/Polish zloty (PLN) and US$/Thai baht.

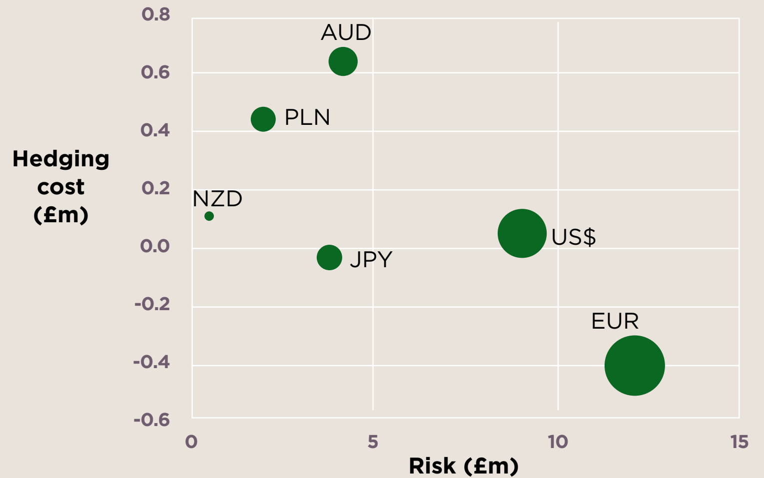
When dealing with these three groups of currencies, the risk management approach needs to reflect the differences between them. Where the expensive and volatile currencies are concerned, best practice is to exercise a systematic approach and distinguish between cost exposures and revenue/asset exposures, as outlined above.

◆ **Find the right trade-off between the performance of the hedge and the cost.** A company should understand what it will cost to hedge its exposures and how much risk it will be able to remove by managing them. The company can then make a decision about which currencies to hedge based on optimally reducing the risks for a given cost. This process is called 'currency prioritisation'.

◆ **Choose the right risk management strategy.** Before implementing a strategy, the company needs to consider the tenor and the nature of the chosen hedging. Hedging an exposure three months forward is fundamentally different from hedging an exposure out to one year. Longer-term instruments can reduce volatility more efficiently, but they do have some drawbacks: such instruments are more expensive and could also have a higher mark-to-market volatility, meaning that the impact on the profit and loss could be greater. On the other hand, shorter-term risk management strategies may also present some drawbacks. In highly illiquid currency pairs, the cost of executing 12 individual one-month hedges may be higher than putting in place a single 12-month hedge due to the execution charges for each transaction.

The hedging instruments available for managing

AN EXAMPLE OF CURRENCY PRIORITISATION – THE COST OF HEDGING VS THE RISK



emerging market currency risk include forward-based hedging, as well as option-based hedging (which can be used to achieve tail-risk protection). Other strategies include proxy, basket and natural hedging, but while these do have some benefits, they can be less favourable from an accounting point of view and do not provide a perfect hedge. Currency prioritisation, whereby risk management is undertaken selectively based on the company's key risk exposures and relative hedging costs, may be more effective.

> If companies remove the volatility of their assets, there is a risk that they may erode most or all of the economic value of those assets, which defeats the object of hedging in the first place

Conclusion

Recent volatility has prompted more companies to look at managing their emerging market currency exposures – but in doing so, they may incur significant costs. If companies remove the volatility of their assets, there is a risk that they may erode most or all of the economic value of those assets, which defeats the object of hedging in the first place. A systematic and informed approach is required to make sure that the benefits of a risk management programme outweigh the costs. ◆

Yuri Polyakov is head of financial risk advisory; and

Ashley Garvin is director of financial risk advisory at Lloyds Banking Group

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