Sheltering foreign investments

THE HEDGE OR NOT TO HEDGE QUESTION IS ONE THAT TREASURERS KEEP CONSIDERING. **JOAKIM LIDBARK** EXPLORES WHETHER THERE IS AN ANSWER TO THE QUESTION.

Executive summary

- Traditionally corporations have been fairly passive in their management of foreign capital exposures. If net investment hedging did take place it was often the result of necessity where the risk of significant losses on the capital account was imminent. The majority of treasury resources are geared towards traditional cashflow exposures. The Citi/ACT annual corporate foreign exchange risk management survey teases out the latest trends.

The optimal currency translation risk management policy can only be company specific, depending on the financial strength of the company, the structure of the net investment position, industry specific measures and the nature of the investment. The possible constraints include low/high yielding currencies; aggregation of exposures; and accounting considerations. A number of methodologies do exist which allow treasurers to quantify the risk associated with hedging net investment risk and therefore devise appropriate strategies.

WHY NOT TO HEDGE NET INVESTMENTS Some companies do not hedge net investments in foreign operations. There are three common arguments for not doing so:

The change in value of a foreign investment due to currency fluctuations does not impact earnings until it is divested. The change in value in a net investment from one period to the next is not a profit and loss item. Rather it is booked in the cumulative translations adjustment account (CTA) in equity. The value in CTA is recycled to earnings only when the company decides to divest the net investment.

In the long run foreign exchange (FX) movements are seen as a zero-sum game as corporations and investment portfolios may be assumed to have infinite life expectations, one could argue that hedging foreign currency risk is an unnecessary and expensive exercise to take.

The fluctuation in the value of a foreign net investment has no cashflow impact. As the instrument used to hedge the exposure does have negative cashflow implications (these could be positive or negative depending on hedging tool and market movement) this creates an unwanted mismatch. This is particularly important for companies with liquidity constraints.

WHEN TO HEDGE NET INVESTMENTS The need to hedge foreign capital will naturally vary from company to company with some companies' balance sheets highly exposed to fluctuations in the equity account. Reasons why corporates could decide to introduce capital hedging programmes include:

Fears over the loss of value in a net investment asset due to unfavourable movements in FX. This fear is heightened if the net investment is denominated in a currency that is unstable or prone to devaluations. With many corporates' balance sheets today carrying a greater risk of emerging market exposure, this is clearly a risk which is engaging more treasurers.

The company has a divestment programme scheduled for the next 1-2 years. In this case the treasurer may seek to manage the exit value of the divestment in order to ensure that the revenue expectations are met. Should the company benefit from hedge accounting treatment it may select to record all subsequent gains or losses in equity (CTA). This is later reclassified in earnings together with the cumulative translation adjustments associated with the value of the divested entity.

The composition of the company's net investment is largely made up of transferable assets, for example cash or securities. These assets are generally highly liquid and easily accessible compared to traditional forms of assets such as manufacturing plant and machinery that companies hold over the long term. Because of the liquid nature of these assets and because there is such a transparent market value it may be deemed that there is a more apparent need for hedging.

Concern of credit rating. A company with a BBB- rating may find it important to protect certain financial ratios where the equity value is in the denominator. A well structured net investment [hedging] programme can contribute to the maintenance of those ratios by stabilising the volatility of the CTA section of the equity accounts.

The corporate may want to reduce overall borrowing costs by hedging net investments in low yielding currencies to reduce its funding costs. (Any such hedge is commercially equivalent to borrowing in that low interest currency.) Not optimising the funding

cost destroys shareholder value. Some companies even use the spot method of effectiveness testing under IAS 39 *Financial Instruments: Recognition and Measurement* and FAS 133 *Accounting for Derivative Instruments and Hedging Activities* to ensure that the forward points run through earnings.

The company wants an economic hedge of a forecasted inter-company dividend. It should be noted that a hedge of a forecasted inter-company dividend is not a qualifying exposure for which a company can achieve hedge accounting under IAS 39 or FAS 133. Adding a net investment hedge can be seen as protecting the value of the dividend payment in domestic terms.

The company may want to ensure that it maintains a strong and stable balance sheet. This is most relevant in terms of mergers and acquisitions where companies would wish to maximise their financial strength if they were intending to make acquisitions or conversely to guard against hostile takeovers which could be triggered by a weak balance sheet.

While these arguments are linked with hedging capital, companies in need of funding have the opportunity of taking on local currency debt. The local currency liability provides an effective method of hedging a net investment as it creates a natural hedge. Under IAS 39/FAS 133 hedge accounting is allowed for debt. Issuing debt in the same currency as net investment leaves the company exposed to the coupon funding but this will normally be balanced out by the profits being earned abroad. Such a strategy does however have its difficulties in terms of liquidity and regulatory issues when dealing with emerging markets.

A MINORITY GAME Previous Citi surveys on corporate FX risk management have studied corporates based In North America, Europe and Asia Pacific. The 2006 results found that globally only 24% of the companies surveyed hedged net investment exposure. Half the sample hedge out to a maximum tenor 12 months while the rest of the sample hedge to greater than 12 months. As would be expected the use of foreign currency debt and cross currency swaps increases as the tenor increases. More European companies hedge net investment (37%) compared to North America (26%) and only 4% of Asia-Pacific companies. The 2006 survey found that European and North American hedging activity increased from 27% and 12% respectively compared to the previous year. Across the globe forwards continue to be the most prevalent hedging instrument used (78%), followed by currency debt (38%), cross currency swaps (31%) and options (28%), although there are regional differences – for instance, in Europe options are more common, being used by 43% of corporates.

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A copy of the survey was included in last month's issue of The Treasurer. Complete the hard copy or download or respond online at **www.treasurers.org/technical/fxsurvey.cfm**

Box 1: Net Investment Hedging

Many companies have investments in foreign operations. Such foreign operations may be subsidiaries, associates, joint ventures or branches. IAS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the financial statements of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange (FX) differences in equity until it disposes of the foreign operation.

In consolidated financial statements, an entity may apply IAS 39 hedge accounting to the foreign currency risk arising from its net investment in a foreign operation which means that any gains and losses on the hedge may be taken to equity until such time as the investment is disposed. The hedged item with respect to the FX risk may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.

TREASURY, RISK AND FINANCE PROFESSIONALS ACT

The ACT is delighted to be working with Citi on its annual Corporate FX Risk Management Survey for the first time. The survey has been running since 2005 and is a key benchmark for hedging activities for corporates around the world.

This year's survey focuses on what companies hedge and how they hedge it, including questions about strategies, hedging instruments, and hedge tenor. Respondents are also asked to define how their organisations handle trade execution and who has responsibility within the organisation for setting hedging policy.

We would appreciate it if you could take a few minutes to download or respond online at **www.treasurers.org/technical/fxsurvey.cfm.** Or return the hard copy which was included with last month's issue by fax to +44 (0)20 7374 8744 or by post to Holly Ashby, Association of Corporate Treasurers, 51 Moorgate, London EC2R 6BH.

Please keep in mind that the survey results of specific companies are kept confidential. Survey respondents will receive an analysis of risk management practices in their own industry – the wider audience will only see generic results.

Completed surveys should be returned by Thursday 31 January 2008.