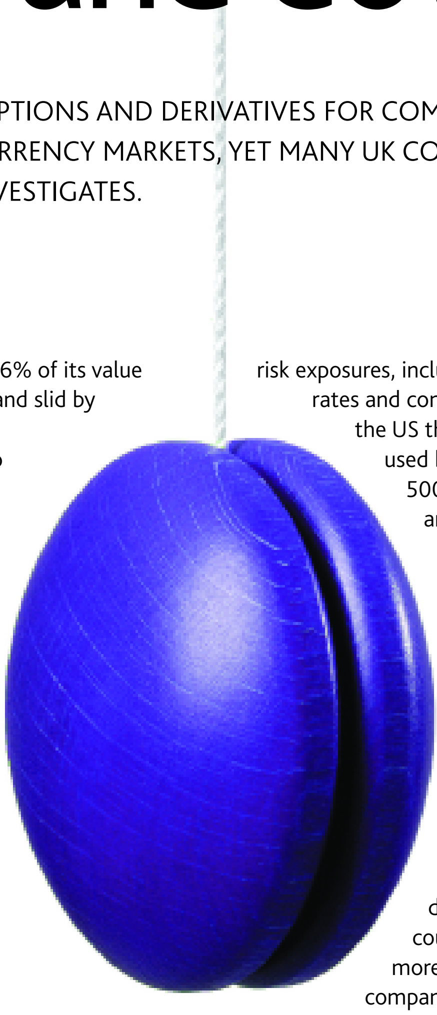
Ups and downs

THE VALUE OF FX OPTIONS AND DERIVATIVES FOR COMPANIES IS PERIODICALLY UNDERLINED BY VOLATILITY IN THE FOREIGN CURRENCY MARKETS, YET MANY UK COMPANIES ARE STILL RELUCTANT TO MAKE USE OF THEM. **GRAHAM BUCK** INVESTIGATES.



In 2008, sterling lost 26% of its value against the US dollar and slid by 23% against the euro. Although the past two years have seen a modest improvement in the fortunes of the British currency, there have been several periods of volatility in which a rally has been followed by a renewed sharp setback.

Such exchange rate volatility and other financial risk exposures can be guarded against through foreign exchange (FX) options and derivatives, which are routinely used by multinationals as risk management tools. According to the International Swaps and Derivatives Association (ISDA), 94% of the world's largest companies and 50% of medium-sized businesses use over-the-counter (OTC) derivatives to address a variety of financial risk exposures, including FX, interest rates and commodity price risks. In the US they are also routinely used by nearly all Fortune 500 companies and around half the country's mid-sized businesses.

LITTLE USE OF DERIVATIVES However, FX provider Moneycorp reports that research into a cross-section of UK companies shows the uptake of derivatives in this country to be much more sporadic. British companies also lag behind their peers in continental Europe in their understanding of options and derivatives. Alistair Hewit, Moneycorp's product development manager, believes this is partly because smaller companies are underserviced by their banks, which reserve these products for their major clients.

"Companies that were using options and derivatives ahead of sterling's slump in 2008 benefited enormously," says Hewit. "Those that missed out on hedging were often obliged to make real changes to their business, which frequently meant passing on costs to their clients.

"FX options aren't vital to every small business, and may not always be suitable. But if you're operating in a competitive market they at least merit consideration."

Volatility across a range of asset classes is likely to be a recurring theme over the coming years, he adds, as events in Asia increasingly influence those in the US, which in turn have an impact on Europe. "We're much more susceptible to global shocks, and growth over the next two decades will largely be driven by Asia and the other emerging markets."

BLASE ON FX RISK Although sterling's fortunes have improved modestly since 2008, Moneycorp's survey of UK finance directors last year found that many remain concerned by FX risks. Its research, conducted before the May 2010 election when uncertainty over the outcome saw the pound lose ground against the dollar and the euro, found that half of those polled did not expect any real recovery against the single currency during the rest of the year. A similar number believed that sterling would remain under pressure generally during 2010 while 41% said its current level would have a significant effect on their business over the next 12 months.

The survey also found that 87% of finance directors relied on banks to help them manage FX risks, while 47% admitted they had experienced a negative impact on currency trades due to a lack of understanding of FX risk. Nearly one in five (19%) revealed that they did not use structured products to manage FX risk, and 11% admitted that they didn't properly understand the FX products available. The lack of knowledge was most marked among those in smaller companies, 30% of which owned up to FX product ignorance.

The report suggests that banks' reluctance to offer these products to their smaller clients means the UK even lags several years behind the rest of Europe in its understanding and usage and even when banks do offer UK companies hedging products to protect against FX volatility, sensible advice and guidance may not be forthcoming.

THE DETERRENTS In an effort to persuade more SMEs to consider using options, derivatives and structured products, Moneycorp has addressed some of the perceptions that may act as a deterrent. One of these is that these products are considered to be speculative, capable of increasing risk rather than reducing it.

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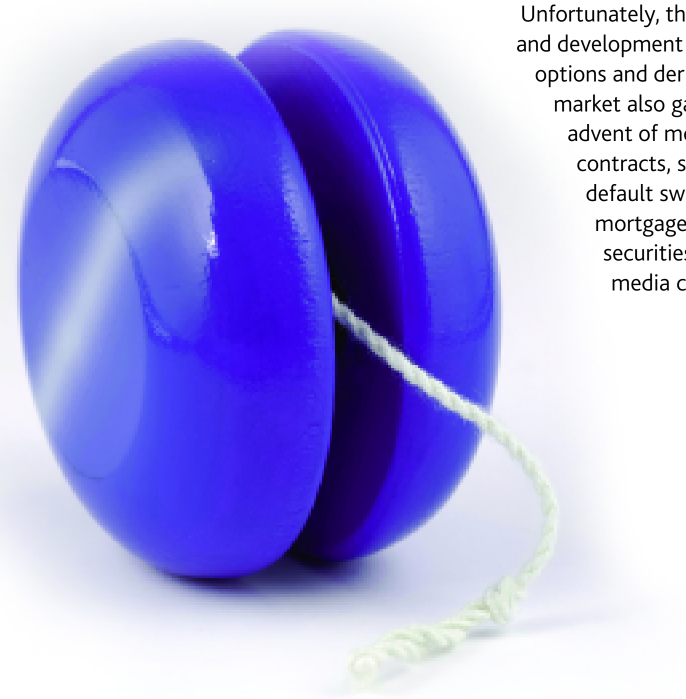
Options are legitimate hedging instruments used across various industry and asset classes. Used in conjunction with other hedging tools, they can provide valuable protection against negative market movements.

“FX options came to prominence in the 1970s, after the collapse of the Bretton Woods system caused serious problems for multinationals,” says Hewit. “They therefore have a valid place in the market as part of a prudent risk management strategy, and possess many similarities to an insurance policy.”

Unfortunately, the evolution and development of the options and derivatives market also gave rise to the advent of more complex contracts, such as credit default swaps and mortgage-backed securities. As a result, media coverage has often been negative, drawing an analogy with bets in a casino. The report accepts that there is the potential for abuse, but says treasurers should recognise that the basic strategy behind options and derivatives is sound and they should use this perception in determining whether options are suitable for their company.



The second deterrent is that smaller companies, perhaps buying a couple of hundred thousand euros per quarter, do not regard FX options as applicable to their business. However, in the modern world, exchange rate movements of up to 10% are no longer uncommon, and can occur over the course of a week rather than a quarter or longer. Companies can therefore end up paying significantly more than they need to.

PERILS OF JARGON A more substantive criticism is that potential users of options are put off by the jargon. While the basic concept is relatively simple, and similar to insurance, there is too much use of industry-specific terms.

“Those involved in derivatives and options are typically financial engineers, so while market participants understand the various terms, they are a mystery to newcomers,” Hewit adds. Further disincentives are the fees charged for FX option transactions and the belief of some treasurers that they would do better to rely on timing and buy at the top of the market.

Hewit says that the fee is a set figure, quantifiable at the outset, and should be weighed against the savings that an FX option offers against volatility. It takes only a modest movement in exchanges rates to reach a point where the cost of the premium is outweighed by a fall in the amount being converted, so the premium can quickly pay for itself.

As for timing, he points out that choosing the right moment is easier said than done, with even bank experts' predictions on the future direction of the main currencies varying significantly.

“Companies should attempt to be opportunistic if the market moves in their favour, but effective hedging cannot be based on guesswork or luck,” he adds. “Many companies buy only when sterling has reached a certain level, but waiting until this point is reached could prevent you from meeting orders in the meantime.”

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