operations and controls
HEDGING

Points on a spectrum

Executive summary

- Centralisation has been a major theme in the field of treasury and foreign exchange risk management over the past decade. The main structural impact on treasury organisations of this trend is clear: foreign exchange trading activity is transferred from individual business units to a group treasury organisation or regional treasury centre.

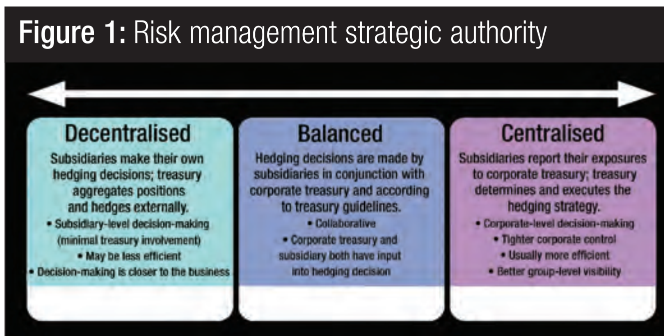
The impact of centralisation on strategic risk management decision-making (what to hedge, when to hedge, how to hedge) is not always clear. In a centralised treasury structure, who makes these hedging decisions? Are they the responsibility of individual subsidiaries or business units, which then use the corporate treasury as an in-house bank to execute the hedges? Or, are the authority and responsibility for hedging decisions transferred from the business unit to the corporate treasury itself?

DIFFERENT APPROACHES My experience has led me to view the relationship between corporate treasury and a subsidiary as a spectrum, in terms of strategic authority and decision-making ability.

At one end of the spectrum, the responsibility for determining risk management strategy remains with the individual subsidiary companies or business divisions despite the centralisation of the principal risk management functions, such as foreign exchange (FX) trading, back-office operations, internal netting, and so on. At the other end is the fully centralised operation, where all FX risk management activities, from operational to strategic, are consolidated within the corporate treasury function. In the middle, authority and responsibility for hedging decisions and strategy are split between the corporate treasury and the various subsidiaries, resulting in a more collaborative approach to risk management.

The decentralised model is characterised by an arms-length relationship between the subsidiary and corporate treasury. While all external trading activity is conducted exclusively through corporate treasury, the strategic hedging decisions themselves are taken by the individual subsidiaries, with limited input from corporate treasury in most cases. The subsidiary will decide what it wants to hedge, when it wants to hedge it and what instrument it wants to use. It will then execute this transaction with the corporate treasury, which can either hold the position or hedge it externally.

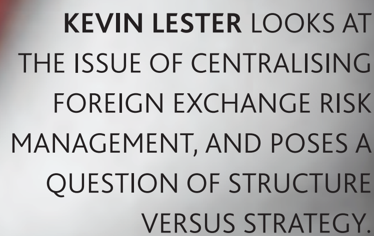
Figure 1: Risk management strategic authority



The main benefit of the decentralised approach is that the hedging decisions are made by those with the best knowledge of the actual exposures. The individual subsidiary will often have a better feel for issues such as how FX will affect the profit margins of the business, or how easy it will be for the effects of FX volatility to be passed on to the consumer or supplier. As such, it could be argued that, in these situations, the subsidiary is in a better position to make hedging decisions than the corporate treasury, especially when dealing with a corporation made up of diverse business units.

However, the danger of a decentralised hedging strategy is that the potential benefits of centralising in the first place may be lost. For example, I have seen situations where inter-company trade, which creates absolutely no foreign exchange exposure on a group level, has actually led to increased FX risk because one subsidiary hedged the exposure arising from the inter-company transactions, and the other did not (as they followed different individual hedging practices). As such, transactions which had no FX impact on the corporation as a whole were resulting in external hedging activity.

Take a situation where two euro-functional corporate subsidiaries



trade with each other in dollars. Clearly this situation does not create any FX risk for the group in and of itself, as these exposures will net upon consolidation. However, should the two subsidiaries elect to hedge this exposure in different ways (different hedge ratios, time horizons, and so on), then FX risk is actually created on a group level, assuming hedging is offset externally by corporate treasury.

While this may represent an extreme case, the same logic applies to any naturally offsetting exposures. Should different business units pursue different hedging strategies, potential netting opportunities could be lost, thereby decreasing the efficiency of the overall group-level hedging programme.

Another potential downside of the decentralised approach is that those with typically the most expertise in the area of foreign exchange hedging, corporate treasury staff themselves, are not involved in many key hedging decisions.

At the other end of the spectrum, a company may decide that all strategic hedging decisions should be the responsibility of corporate treasury, essentially removing the individual business unit from the process altogether. The only responsibility of the business unit will be to accurately report (and forecast) FX exposures to treasury. Decisions in terms of when, how and what to hedge are made by the corporate treasury.

This approach essentially aligns the structure of the organisation to the decision-making process. Its key advantages are that it maximises the potential efficiency improvements of a centralised treasury structure, aligns risk management strategy at the group level, and those making hedging decisions are generally specialists with a high degree of risk management expertise. However, a potential drawback is that strategic hedging decisions are moved further away from the overall strategic planning and decision-making of the individual business divisions.

SOMEWHERE IN THE MIDDLE Another alternative is the middle ground, involving both corporate treasury and the business units themselves in the strategic decision-making process. This collaborative approach can be quite successful, as it combines the risk management expertise provided by the treasury organisation with an in-depth understanding of how the risk affects the business.

It also ensures that treasury has a good understanding of the overall risks facing the company, both current and anticipated. In the highly centralised and highly decentralised approaches, this knowledge and understanding can be lost as the communication links between treasury and the business are limited to often standardised reporting and order-taking. For such a model to work effectively, excellent co-operation and communication between the business and treasury are essential and ultimate decision-making authority must be clearly defined.

There is no right degree of centralisation when it comes to determining an FX hedging strategy. Factors to be considered include:

- **Business unit diversity** A corporate group with very diverse subsidiaries (high-margin versus low-margin businesses, cyclical versus stable industries, and so on) will often benefit from a process where businesses have greater input into strategic hedging decisions. A company with a relatively homogeneous group of subsidiaries will be easier to operate in a highly centralised way.

- **Degree of centralisation** A corporation that is highly centralised anyway (in areas other than risk management/treasury) is often much more suited to a centrally managed risk management strategy. This is often related to corporate culture and how much power and control exist in the central functions versus the individual business groups. In my experience, a centralised approach to determining hedging strategy is generally found in highly centralised companies with a strong treasury function.

- **Alignment between responsibility and authority** It is very important to ensure that whoever makes the hedging decisions is also responsible for the results of those decisions. I have seen situations where business units have been hurt by deciding not to hedge (and the market moved against them), only for the group to remove the negative effects of this FX volatility through internal accounting adjustments. This can, over time, lead to the creation of a moral hazard, and discourage risk-averse hedging decisions.

WHOSE ROLE IS IT? While there is no single correct approach, the key is to make sure that the process of determining FX strategy is suitable to the structure and characteristics of the business itself.

A business already managed in a highly centralised way, where hedging goals and priorities are broadly similar between different business units, will often suit a highly centralised decision-making process that maximises the efficiency of the FX hedging programme.

However, where business units are more diverse, with different FX hedging objectives and constraints, it may be more appropriate to apply a decentralised process, thereby encouraging more input from the business and ideally ensuring that the FX hedging strategy and the overall business strategy are closely aligned. In these situations, it is critical for the corporate treasury to maintain a good understanding of the overall risk management strategy of the company, to ensure the hedging process is as efficient as possible and that the company achieves its overall risk management objectives.

Kevin Lester is Senior Consultant at HiFX Financial Services.
corporate@hifx.co.uk
www.hifx.co.uk