Feeling the FX strain

FOREIGN EXCHANGE IS BECOMING A BIGGER ISSUE AT TREASURY LEVEL AND ELSEWHERE, AS A RECENT ACT LONDON REGIONAL MEETING REVEALED. **PETER WILLIAMS** WAS THERE.

After years of relative stability, sterling has fallen remorselessly against the euro and its value remains at around £1=€1.10. Clearly, the drop has been no short-term blip. But how has the volatility of sterling and its weakness against the euro affected companies' hedging policies and their long-term strategic decisions about sourcing? A mini-survey discussed at an ACT London Regional meeting held at the end of January – which proved so popular that some treasurers could not get into the venue! – suggested that so far treasurers have not altered their foreign exchange (FX) behaviour (see Box 3). But what was equally clear from the meeting was that treasurers have plenty of concerns about FX in the current economic climate.

Figures published on the day of the meeting suggested that the UK economy had emerged from recession. But only just. Growth for the last quarter of 2009 was a weaker than expected 0.1% and sterling could be subject to further volatility in the months ahead. Our mini-survey suggested that there is no consensus in the treasurer community about what represents the "right" level for sterling against other currencies, notably the dollar and the euro.

So how are companies meant to react strategically to the volatility of sterling against the dollar and its decline against the euro? The consensus from the meeting was that, perhaps mistakenly, many businesses see FX as a treasury rather than a business issue. One of the problems for treasury departments, especially in large multinational companies that have operations all across the globe, is trying to ensure that all the various group businesses are more or less facing in the same direction in terms of the FX approach. As one contributor to the meeting noted: "Everybody doing something different is not an ideal scenario."

The key FX management decision that businesses have to take is how to manage their exposures. To answer that question, management needs to be aware of the extent of the company's exposure. It may be easy to pose the question, but finding the answer may be much harder in a business where lack of centralisation leads to a lack of information.

Whatever the approach of the business, treasurers have to decide what their role should be in FX management. FX management is an area where policies vary enormously between industries and there could be greater risk factors which overshadow FX. Treasurers invariably say they take a conservative approach, but what exactly does that mean? Do treasurers need to take a view on likely future exchange rates? How useful are forecasts of exchange rates?

Many companies would say that they have an FX policy in place but how do they measure the success or otherwise of that policy? For instance, travel companies have to fix the prices of holidays many months in advance, but they are more sensitive to the prices charged by their competitors and the cost of other commodities, notably fuel, than to FX rates.

Similarly, the meeting heard how importers of fine wine can take a relaxed view of currency rates as customers are relatively insensitive to price. Many

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companies say that one objective of FX management is to try to reduce volatility. But there is no standard way of measuring whether that is achieved. Should you measure currency fluctuations year on year, quarter on quarter or actual versus forecast?

Many corporates are still in a state of shock over the volatility in FX, particularly between the euro and sterling. When volatility is low there is little incentive to act. In favourable market conditions, treasurers found it relatively easy to lock in at budgeted rates and cost was not an issue. Those days have gone and look unlikely to return in the near future. In many instances companies have found that it is too expensive to put hedging policies in place. The lesson here is obvious: when you don't need to hedge, then that is the time to do it. During periods of panic and market disconnect, trying to put a hedging programme in place is significantly more difficult and commensurately more expensive.

In terms of the tools used, forward instruments are the most popular but options are also used.

THE COST OF VOLATILITY. Corporates have had to recalibrate their level of overseas exposure and cashflows. The devaluation has threatened some companies with potential breaches of covenant ratios, and banks have had to adjust the way that FX is measured to counter this, moving from a year-end rate to an average rate. The volatility has forced up the cost of hedging and, with banks' balance sheets under strain as a result of the credit crisis, any type of credit banks extend to companies, including FX exposure, is being re-examined and inevitably repriced higher.

Treasurers are unlikely to see FX management and hedging becoming easier in the short term. The anaemic UK recovery coupled with the end of quantitative easing is likely to put sterling under further pressure. Treasurers need to think about the range of possibilities. Sterling at parity with the euro? Or will debt problems in a number of euro zone governments see the euro under pressure?

In the past it could be argued that FX has been a fairly dull topic. But the movements on the markets have put paid to that view. Over the last two years, FX, along with so many other treasury-related topics, has been debated at board level. Now FDs, CEOs, shareholders and analysts all want to know about FX hedging. The treasurer had better have some answers.

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The Treasurer would be interested in speaking with treasurers about their FX approaches with a view to future articles on FX management. Please contact **pmatza@treasurers.org** *if you wish to contribute.*

Box 1: The hot FX topics

The discussion at the ACT's London Regional meeting touched on a host of FX issues and there were probably more questions than answers. Topic debated included trying to discern how investors view a company's hedging policy. Do investors expect companies to hedge translation risk and are they expecting more this year than in previous years? Do investors only notice FX issues when they start to impact on cashflows?

It was suggested that companies should think carefully about trying to hedge out FX risk as investors may want that risk in their portfolio. Rating agencies will also have a watching brief for FX especially if volatility causes companies to come close to breaching covenants.

The debate also returned to the dynamic between the business and corporate treasury. Some treasurers complain that there are actions they would like to take on FX but are prevented from doing so. In some cases there needs to be more of a partnership over FX issues.

Box 2: The panel

- David Wilson, London Regional group organiser
- Ian Stannard, FX strategist at BNP Paribas
- Gary Starling, manager at Accenture
- Daren Blaker, RBS Global and Banking Markets

Box 3: Survey results

Seventy treasurers in the London Regional group participated in our mini-survey, which asked the following questions:

1. Has the recent volatility of sterling against all currencies, and/or its weakness against the euro in particular caused your company to significantly change:

- **its foreign exchange hedging policy?**
  Yes = 22, No = 48
- **the way your company applies its existing hedging policy?**
  Yes = 28, No = 42
- **its attitude to the use of options? And will you use them:**
  Same = 51, More = 13, Less = 6
- **its suppliers, international marketing efforts or manufacturing locations?**
  Yes = 14, No = 56

2. What is the sustainable "normal" level for sterling:euro?