AN ALL-IMPORTANT RISK FACTOR

IN THE SECOND OF TWO ARTICLES, **DIDIER HIRIGOYEN** OF CITIGROUP PROBES INTO PRICING AND STRATEGIC RISKS. ONE THING CLEARLY COMES TO LIGHT – THE BUSINESS CENTRE HAS AN INCREASINGLY IMPORTANT ROLE IN HELPING TREASURERS MEET THEIR HEDGING OBJECTIVES.

In the last issue of *The Treasurer,* I looked at the everyday risks facing multinational corporations during their regular business and how currency risk is often underestimated. In this article, I will look at how to tackle pricing and strategic risks. This advice is inspired by some of the best practices observed across a wide spectrum of corporates and industries.

PRICING RISK

As we briefly described in the January/February issue, pricing risk arises when a company makes exchange rates assumptions in order to price its business in a foreign currency. The divergence between that implicit rate and the accounting rate at which the transaction will be booked when it occurs can alter substantially the transaction's profitability profile. This type of risk can actually be experienced in at least two areas of a company's business pricing activity.

- In the 'run-rate' business, especially when business units must embed exchange rate assumptions to price their product in a foreign currency. Such a procedure introduces an extra hurdle in the firm's hedging process, which, to be efficient, will rely on the business's ability to provide fairly accurate forecasts. In this case, a company should hedge the pricing rate versus the accounting rate of the period during which the transactions are expected to be booked. The notional amount to be hedged should reflect the forecasted exposure on the date the pricing rate is set.

- In the contractual business, the risk also affects the company at the time the operational unit makes foreign exchange (FX) assumptions for the purpose of pricing a business contract. This pricing risk differs somewhat from the run-rate business because of the hedging methodology. While the run-rate business can be hedged in bulk because of the pricing rate setting process, contracts may have individual reference rates that are difficult to consolidate for macro hedging purposes. They also often have different risk characteristics, such as:

  – **Contingent features in the case of tender situations (see p33 Jan/Feb issue).** Here, the business uses a specific exchange rate (or set thereof) to price a tender in the client's specified currency. The risk therein occurs at two different stages: first during the bidding period then between the tender award and the transaction booking date(s). The bidding period is the hardest one to hedge, because of the necessity to estimate the probability of winning the contract. Companies whose business is mostly conducted in that manner tend to look at their risk as a portfolio of tenders. In dealing with this kind of a risk, running an efficient operational and communication process between the treasury group and the business centres is crucial. Unfortunately, firms whose business only occasionally requires participating in bid-to-awards are generally ill-equipped to identify and mitigate that risk. Accounting regulation, especially US GAAP, also represents an impediment to efficiently hedging this type of exposure, as it cannot be designated as a hedged item in a hedge relationship. Therefore, any protection strategy must be marked-to-market through the income statement, which is an unsatisfactory solution for most companies.

  – **Long-term features.** As some contracts have a long life cycle, the risk can extend over multiple fiscal periods. In the absence of any pricing revision clause, hedging the FX portion of the contract's risk may be critical to preserve the long-term profit margin in the company's functional currency. It is key therefore to cautiously hedge the implicit pricing rate(s) from inception out to each expected interim completion date of the contract. One must, however, keep in mind the relationship that may exist between currencies and other components of the contract – commodities, for example. If any diversification is gained through exposure to various asset classes, then one must quantify to what degree in order not to upset the 'natural' equilibrium by hedging selectively one of them.

  – **Currency risk sharing features**. This is often an underestimated risk. Most companies that use these type of clauses believe they are beneficial because of the common, but sometimes mistaken, perception that risk is shared equally between the two parties to the contract. First of all, this is not always the case and operational units may give away free options to customers in order to 'sweeten the pie'. Secondly, most of the time, these clauses create a basis risk between the risk-sharing structure and the rate at which the transaction is booked, therefore introducing potential volatility in the firm's performance. Thirdly, these clauses are often complex with features such as averaging processes and knock-in or knock-out trigger levels. While most calculation formulas can be replicated using FX derivatives, some may require sophisticated instruments with limited market liquidity. Finally, businesses do not always feel compelled to communicate the existence of these clauses to the treasury group, as some believe they should retain the power to use the negotiation flexibility they offer if needed, or are simply unaware of the economic implications. For all these reasons, risk-sharing agreements must be diligently monitored and should be systematically relayed to the treasury department, preferably before they are implemented. Furthermore, they should be hedged on a case-by-case basis, respecting all embedded parameters.

STRATEGIC RISK

Under strategic risks we can record at least three areas:

- **The planning risk.** This refers to the FX assumptions a company makes when making long-term business decisions. To better understand whether this issue is critical for the firm, one must assess the company's true reliance on the internal plan. If the planning process plays a crucial role in senior management's ability to implement strategic decisions, then protecting the plan's underlying assumptions should be a priority at all levels of the business, including treasury. Therefore, plan rates (or budget rates) should be hedged to provide senior management with the visibility they need to achieve strategic targets. These goals may be expressed in terms of earnings or cashflow expectations, which is likely to determine how these rates should be set. But, in any case, they must have two key characteristics: be realistic and be hedgeable. Once they have been determined, it is the treasury's responsibility to secure a hedge rate and minimise any slippage. Therefore, the timing of the hedge, as well as the tool to be used, are critical to treasury achieving its objective. But, in the end, what we are really talking about here is the hedge of anticipated exposures. Therefore, timely and reliable forecasts of future business flows will need to be provided to the treasury department in order to design and implement the appropriate risk management programme. Although some companies may decide to handle the performance of the programme at the corporate level, it would make sense that the impact is mostly borne by the operational units. This would sensitise the business partner to the importance of the forecasting contribution to the overall risk mitigation effort.