Managing risk in the FX markets

CHRIS TOWNER EXPLAINS HOW CORPORATES WITH AN EXPOSURE TO MARKETS THAT ARE OFTEN VOLATILE CAN MANAGE THEIR RISK.

Executive summary

- Before reaching an actual trading decision, companies need to take into consideration their internal practices, including the identification of risk, hedging objectives and the development of policies, as well as external factors.

Most treasurers will have an exposure to the foreign exchange (FX) markets to a certain extent. For some, it will be purely on a tourist level, while at the other end of the scale some will be responsible for managing millions of pounds of FX risk for their company.

The FX market is by far the largest financial market by volume in the world, with an average daily turnover of $3.2 trillion. This article concentrates on how corporates with an exposure to this often volatile market can manage their risk and looks at internal practices such as risk identification, hedging objectives and the development of a risk management policy that all need to be taken into consideration when managing FX risk. It also discusses external factors that can influence the risk management process, including the instruments used to hedge risk, market volatility and market forecasts.

NO SIMPLE SOLUTION When a corporate has an FX exposure the solution is not as simple as just hedging the risk. In fact, the last decision that needs to be made is the actual trading decision. A corporate needs to define its hedging objectives and perform a thorough review and analysis of its actual FX exposures, in particular examining issues such as potential internal netting opportunities to ensure the accuracy of its position. No hedging strategy can hope to be effective if the exposures it has been designed to hedge are not properly measured and understood.

Finally, the parameters of the risk management policy, including hedging time horizons and hedge ratios, can be chosen. Once a policy is in place, it needs to be regularly reviewed to see whether its parameters continue to suit the risk management objectives.

The corporate needs to identify the risk by first defining the timelines related to both committed and forecasted exposures, and then assessing how certain these exposures are. One has to account for inaccurate sales forecasts and inefficient internal accounting systems, for example, to gauge confidence levels that the volume and the timeline of the exposure are correct.

WHEN A CORPORATE HAS AN FX EXPOSURE THE SOLUTION IS NOT AS SIMPLE AS JUST HEDGING THE RISK. IN FACT, THE LAST DECISION THAT NEEDS TO BE MADE IS THE ACTUAL TRADING DECISION.

Determining the hedging objective is also key as it sets the direction that a corporate wants to go in when managing its FX risk. This encompasses both what you are looking to hedge (earnings, balance sheet, and so on), and what drives your hedging decisions. For example, are you looking to postpone pricing impacts, or are you simply looking to hedge at the most favourable levels to gain a competitive advantage?

THE PAIN THRESHOLD With this objective in mind, the policy's timelines and hedging parameters can be set. A key consideration here is the pain threshold: how far does the foreign exchange rate need to move before tolerance levels become unbearable? The factors that affect this pain threshold can vary, and may involve margins, budget levels and competitive environment.

This internal decision-making process can be closely connected to market psychology and the fear/greed factor, which brings us to the external factors that influence the risk management process. The fear stems from the need for security to protect against an adverse move in the market. After all, the corporate is not in the business of speculating in the FX markets but in growing its own business.

So you could argue that an appropriate strategy would be to hedge 100% of the exposure. But then there is the greed factor. If we see a favourable move in the market, could we use this to improve our margins and therefore our bottom line? What about competitors? What approach do they take? You could argue that it makes more sense to hedge a lower percentage of your exposure, and take advantage of the favourable exchange rate. To illustrate this point, given the moves that we have seen in the pound/dollar exchange rate and the long-term weakening of the dollar, a company with a net requirement for dollars can get into just as serious a situation by hedging too much, as a company that receives dollars will by having little to no cover, depending on the characteristics of the industry.

WHAT-IF SCENARIO Once the internal issues have been resolved and an FX policy defining the hedging parameters decided, then the flexibility that the policy gives also needs to be managed. The flexibility element will ideally allow the corporate to be comfortable, with enough hedging in place to protect it from an adverse move in the market, while also giving it the opportunity to take advantage of favourable moves.

Determining an appropriate hedge ratio is more of an art than a science, and there are a number of ways to go about determining what level of hedging is appropriate. For example, one conversation I have with my clients before they go away on holiday is to run them through a couple of what-if scenarios. If £/$ is trading at 2.00 and the client is a dollar buyer, I ask how they would feel if they returned to £/$ trading at 1.90, compared to how would they feel if they returned to 2.10? It's a simple question, but one that can help a company identify if it is over- or under-hedged, and one that a company should ask itself proactively rather than reactively when the market reaches either scenario.

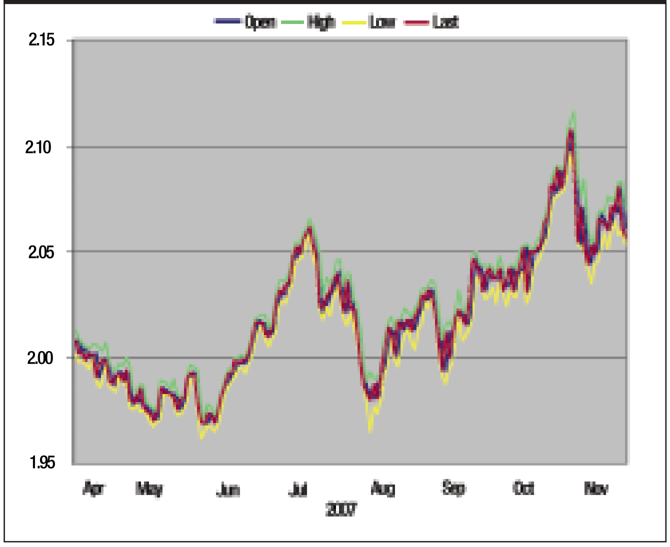
Take last August. It was peak holiday season and the credit crisis kicked off, resulting in severe market volatility. As can be seen from *Figure 1*, two key themes which can be identified. First, the credit crisis caused an oversold dollar to be aggressively bought back as investors reduced positions and piled into Treasury bonds, resulting in £/$ dropping by 10 cents from 2.06 to 1.96. Second, by November, £/$ was trading at 2.10 as rumours circulated that US investment banks in particular were sitting on huge losses. This volatility is what speculators love and corporates need to protect against, but the key message is that the corporate with sufficient hedging in place would have been in a position to ride out the volatility, while also having the flexibility to be adding to its cover during a rally towards 2.10.

Ideally, hedging should reduce the extremes of the fear/greed emotions, allowing a more level-headed approach to market timing decisions. Given the current volatility in the FX markets it is important to keep a close eye on both technical levels in the market as well as economic data releases. Themes such as US trade deficit, money supply and employment data come and go in the FX markets in terms of relevance. For 2008, the market looks certain to continue to suffer the hangover of the credit party of yesteryear, and housing market and consumer-related data will be watched closely.

Due to these extreme market conditions, the divergence in FX forecasts has been amplified. In terms of forecasting the £/$ exchange rate, one key question is whether this credit crunch that originated in the US is going to weigh more heavily on the dollar further into this year, or whether the repercussions will have a relatively more detrimental impact on the UK economy. FX forecasts are important when making hedging decisions, but it is important not to be too easily led by any one individual view. The priority should always be managing the risk and sticking to your objectives.

THE FINAL DECISION The last decision that needs to be made is what instrument should be used to do the hedging. Recent surveys that we have carried out show an increasing use of structured products among corporate clients, and these structured products can fit well within a company's hedging strategy. However, the more complicated they become the more we suggest that the corporate seeks independent advice to ensure they fully understand the potential risks involved. Having gone through the whole process of identifying the risk and determining a hedging strategy, a company could fall at the last hurdle by signing up to a structured product that is not suitable.

Figure 1: Pound/dollar exchange rate



THE KEY MESSAGE IS THAT THE CORPORATE WITH SUFFICIENT HEDGING IN PLACE WOULD HAVE BEEN IN A POSITION TO RIDE OUT THE VOLATILITY.

The risk management process can be a complicated one, and each individual step, from the identification of the risk, to the development of strategy and policy, to the final choice of instrument and timing, must be carefully considered. However, a successful application of this process can be invaluable in protecting a company's bottom line from the volatility of the foreign exchange markets.

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