Relaxed about risk?

Executive summary

■ Treasurers should make sure they are clear on the accounting risks as well as the actual economic risks that have arisen from the current market volatility. Any large gain or loss on the income statement that wasn't previously identified is likely to cause tension in the treasurer-CFO relationship.

For many practising treasurers, the current market volatility is a return to a more familiar situation of some years ago. In the period of steady non-inflationary growth across developed countries of recent years, the lower volatility seen in many markets was perhaps seen by some as here to stay.

Until 2007, interest rate markets had become much more benign, and one of the key foreign exchange crosses for UK companies, euro/sterling, had traded for some time within a relatively narrow range. In this world of low volatility, a number of companies became insensitive to the possibility of market movements catching them out. Some financial institutions ran higher interest rate risk, and some companies built into their plans the assumption that euro/sterling would trade within a range.

In Figure 1 the euro/sterling exchange rate history is illustrated. The currencies traded within a band up to August 2007; then sterling lost 16% of its value in the eight months to April 2008. The lesson for many is not to be caught in a comfortable assumption that the patterns of recent history will continue.

It is on this specific assumption that value at risk (VaR) is based. In the FSA discussion paper on liquidity risk, DP07/07, there is significant focus on stress-testing for a number of factors. The point is equally relevant for market risk factors such as foreign exchange rate risk or interest rate risk. VaR is a useful tool, but would not have predicted the step-change in euro/sterling (it is not supposed to), and any company placing reliance on it could have been caught out.

ARE COMMODITIES IN YOUR SCOPE? Recent years have seen a significant rise in commodity prices. For many, the cost of many commodities – for example, the cost of energy – had not been perceived to be risky to the business, and certainly not as material as it is now. Many businesses now have to include commodity risk management in their market risk management.

In some companies the purchasing department will be charged with negotiating energy and commodity contracts; this may also extend to hedging the cost. The risk management concepts are no different to financial market risks faced by the company. The distinction to be drawn is whether the company's core business is the commodity in question or whether the commodity is a non-core cost. If it is a non-core cost, it would make sense for the treasurer to co-ordinate with the purchasing department and ensure the risk management approach is consistent with the risk appetite of the company, as with other market risks.

POLICY FOR RISK In these times of high market volatility it is well worth reviewing your market risk management policies and asking yourself whether the scope of risks covered by them is still relevant, and whether the policies themselves contain presumptions about market movements.

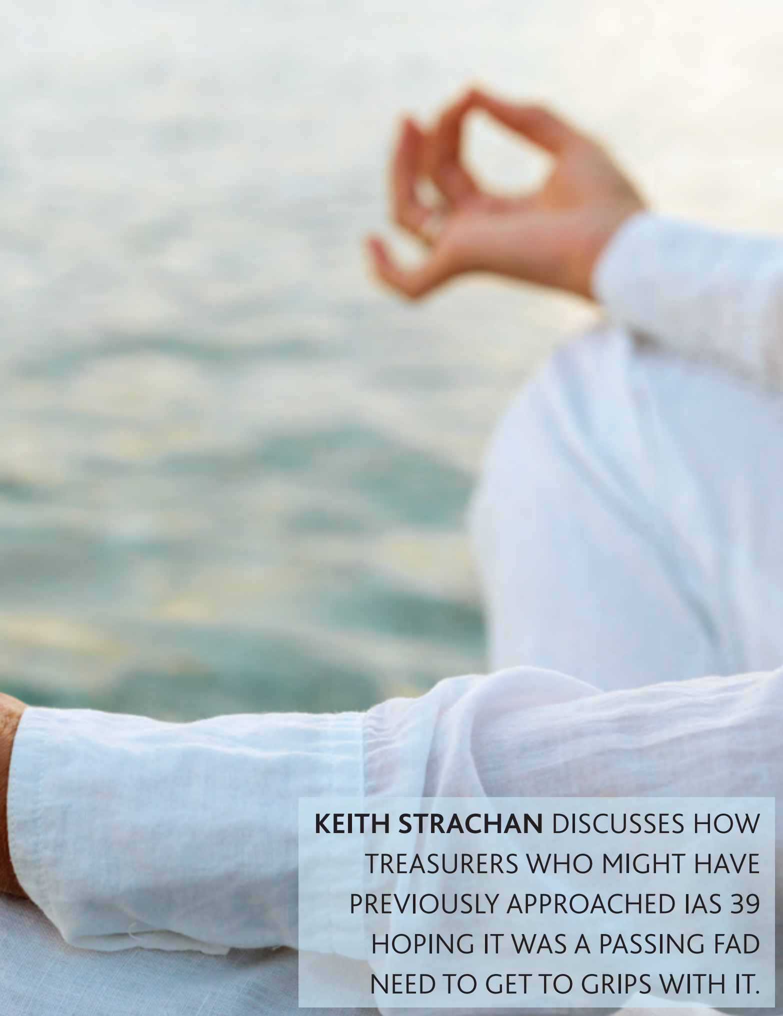
It makes sense to hedge only those risks likely to be material for the company; otherwise the costs associated with this risk management are likely to be value-destructive. Some simple questions need to be asked as a starting point, which should include:

- Is there a natural hedge in the business for this market risk?
- What is it that we are trying to achieve in hedging this risk?
- Is the risk big enough to be worth hedging?

To answer the third of these questions, treasurers should complete an exercise to quantify the risk, focusing on measures on which the business is judged, whether by equity analysts or debt analysts. Armed with the results, a judgement call then has to be made as to whether, and to what extent, the risk should be managed. This call can only be made by the board, based on their appetite for risk.

To quantify the risk, the range of market variables to test it has to be decided. The lesson for the euro/sterling exchange rate must surely be to test the risk using a shock approach, as the FSA has encouraged financial institutions to do.

This approach could also lend itself to considering an option hedging approach. It may be that taking a "normal" range of variables would not lead the company to decide to hedge. When considering a "shock" scenario, the size of the potential downside may tip the balance towards hedging. In this case, an insurance



approach may make sense, utilising out-of-the-money options, which limit the cost and allow upside benefit.

Hedging In January 2005 UK-listed companies (with December year-ends) adopted IFRS, which included two difficult new standards, IAS 39 and IAS 21. These standards have had radical effects on how companies manage risks. The prospect of the derivatives used being very much more visible on the balance sheet, and the question of how and when the gains or losses will be recognised in profit, have caused many companies to alter the financial products used to pass risks to the market. The "IFRS-friendly" term for hedging products is now highly relevant for conversations with banks!

In my line of work there is regularly cause to discuss IFRS implications from proposed hedging strategies. On occasion there may be a good economic hedge which is not IFRS-friendly; in other words, the accounting result does not follow the economic reality. This needs to be appreciated and stakeholders managed before the hedge is entered into. All too often hedge accounting is either difficult or compromised after the transaction is executed.

This article does not provide accounting guidance, other than to point out that any treasurer who approached IAS 39 with a view of trying to ignore it in the hope that it was a passing fad should now be under no illusions as to its importance.

The important implication is that the policy approach needs to include the accounting effects as a core consideration. It is perfectly valid to enter into hedges that are good economic hedges but which are not IFRS-friendly, such as the insurance approach I mention above of using out-of-the-money options. The resulting accounting implications need to be presented as part of the hedging approach and risk analysis. Option approaches are not so well suited to hedge accounting, given that the time value of the options will pass immediately through profit whether hedge accounting is adopted or not.

Intra-group loans The accounting for foreign exchange gains and losses is covered in the IAS 21 foreign exchange rates standard. The gains and losses on inter-company loans are covered in paragraphs 15, 32 and 33 of the standard. These paragraphs contain the rules for when gains and losses from intra-group loans should be posted to profit and when they should be posted to reserves as part of the company's net investment in a subsidiary (although derivatives used for net investment hedging are scoped out of IAS 21 and included in IAS 39!).

The same point made above about IAS 39 is equally relevant for IAS 21: the treasurer needs to be fully aware of how gains and losses on intra-group loans will affect the reported financials. This is especially so as the numbers can be very large.

A balance sheet hedging policy may have been agreed in principle, but it is the application which can be more challenging in making sure that first, the IAS 39 net investment hedges are appropriately documented, and second, that the resultant intra-group loans are also documented correctly if it is intended that they are to be treated as part of the net investment. Taking guidance from IAS 21, this means that settlement is neither planned nor likely to occur in the foreseeable future.

It is worth noting that the range trading of euro/sterling pre-dates the implementation of IFRS. There have been cases recently of companies being caught out by the loss in sterling's value, with "surprise" gains and losses on loan balances appearing in the income statement.

Should a treasurer be an accountant? For listed companies, the perception of risk management is very important. There are a number of companies that adopt risk management techniques in full knowledge that hedge accounting is not attainable. In these cases the communication to markets is all important, and there is good evidence that the equity investment community are prepared to consider this approach.

It is less acceptable to be surprised by the accounting outcome. A large gain or loss hitting the income statement, which has not been previously identified as being likely, will cause tension in the treasurer-CFO relationship. The treasurer must therefore be very clear on the accounting risk as well as the actual economic risk from the current heightened market volatility.

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Figure 1: Euro/sterling exchange rate history