RESHAPING YOUR FX HEDGES

ALTHOUGH AN FX OPTION OFFERS FLEXIBILITY AND PROTECTION, MANY TREASURERS FIND THE COST DIFFICULT TO JUSTIFY. JEREMY ADAM EXPLAINS THE RANGE OF BENEFITS THAT INTRODUCING OPTIONALITY CAN BRING

As the guardian of the company's cash, it is only right that the treasurer should be prudent with its money. The role of a treasurer, however, is not that simple. CFOs and FDs require the protection of earnings per share, balance sheet capital and financing headroom. At the same time they expect the business's economic and competitive positioning to be balanced with accounting requirements and the increasing impact of the regulatory landscape.

Efficient risk management execution should be delivered with minimal cost; cash flow must be managed optimally and hindsight will be an ever-present factor when assessing the policy's performance. Treasurers also know that forecasting FX rate movement is far from an exact science and this, in turn, makes the cost/benefit impact of FX on the business a difficult circle to square. But sometimes it is beneficial or necessary to incur a known cost in order to achieve maximum potential value for the business. Nowhere can this be more clearly demonstrated than in the world of FX hedging.

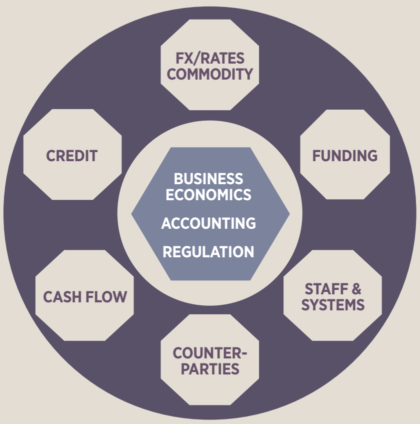
The majority of corporates hedge their currency risk using FX forwards. On the surface, it's easy to understand why. Vanilla forwards are simple instruments to use and accounting-friendly, they protect companies from adverse currency movements and have no upfront cost. Because of this, the purchase of an FX option, which incurs a premium, can be extremely difficult for treasurers to explain to senior management, particularly if the option is not exercised and essentially holds no 'value' at the end of its life. On review it can seem like expensive insurance.

Nevertheless, as we discussed in the April 2013 issue of *The Treasurer* (see pages 38-39), perceptions sometimes need to be challenged, as does the status quo. What is more, the post-crisis environment continues to see a re-evaluation of corporate risk management policies. And with market volatility still relatively high, corporates are striving to balance their funding and cash flow needs against counterparty risk and asset-class exposures.

Given this background, it can be easy for the treasurer to feel that they are being steered towards a certain course of action by the 'treasury wheel' (see below). At the same time, bank risk solutions services need to bear in mind the amount of time that a busy treasurer has to devote to their risk management activity. It's always worthwhile reassessing your current FX risk management strategy and if you are not totally happy with the way the company's FX risk is being managed today, or have previously found yourself in a tricky situation as a result of forward hedges, it is certainly worth asking your risk solution adviser to help review the process, compare peer group approaches and assess cost/benefit alternatives – including giving optionality another look.

MANAGING FX RISK

The different factors that corporates need to take into account when implementing a hedging strategy



Benefits of long optionality

Let's start with the FX forward – is it true to say that it presents no cost to the business? In respect of 'upfront cost' or 'direct cost' the answer may well be 'yes', at least in cash terms. But 'indirectly' and, more importantly, in times of increased uncertainty or crisis, then the answer needs to be more carefully considered since 'cost' and 'risk' are never mutually exclusive. Assessing these cost/benefit implications in combination with our checklist (see box FX: A treasurer's checklist, right) is a client service that we continue to see increasing demand for and is inextricably linked to counterparty risk, availability and/or cost of credit, regulatory capital requirements and business performance, with the obvious impact that a forward removes the opportunity to benefit from favourable movements in exchange rates.

By purchasing an FX option rather than an FX forward, a corporate has the obvious benefit of being able to choose whether or not to exercise it.

But more than that, by using an option, the company owns an asset, reducing its counterparty risk to the seller and offsetting the portfolio risk of existing FX forward hedges. And as options do not chew up credit limits, the company will protect its flexibility to be able to execute new hedges as and when it sees fit. This means that it can be nimble enough to take advantage of favourable rates if and when the opportunity arises. Moreover, these benefits come at a known maximum cost to the business – the price of the premium.

If the only consideration that is taken into account when assessing FX options is the cost of the premium, however, then the additional cost savings and benefits that a business can enjoy through owning options have certainly been overlooked.

Of course, replacing all of the company's FX forwards with FX options would be a radical move and potentially have a significant cash impact on the business, but a balance between the two can work very well. Take Company ABC, which has forecast an exposure of £100m and has executed a forward for the full 100% of the exposure. If the real exposure turns out to be £80m, the company has a risk on £20m that could be very significant from an over-hedged standpoint. But if the company has opted to use a forward to cover 80% of the exposure, and topped it up with an option for the remaining 20%, it has a reduced risk of being over-hedged, but has the option of the extra protection if it is required. These benefits start to make the cost of the option premium seem more worthwhile. And incidentally, the premium does not necessarily have to be paid two days after the trade.

Introducing long optionality can help to increase hedge-duration horizons

Your bank may be able to lend you the premium, all the way through to maturity of the option and net against any forward settlement.

Alternatively, Company ABC may wish to hedge using FX forwards for a duration that extends beyond its existing credit limit availability. Introducing long optionality can help to increase hedge-duration horizons and the participating forward – a hedge strategy where a forward and an option are combined and the option premium is paid by accepting a detrimental forward rate – is a good example of this strategy being used to optimise credit headroom by corporates today.

A helping hand

Unlike the above example, hedging cannot be done with the benefit of hindsight. This means that a corporate's hedging strategy needs to be carefully constructed and must take into account a broad range of possibilities and outcomes – the majority of which are very difficult to predict. Determining the right mix of hedging instruments and which durations to hedge the risk over can be challenging to do in-house, especially at a time when the treasurer's remit only continues to grow. Your relationship bank should be able to assist.

Food for thought

In summary, if you are unsure about your company's current forward-based approach to managing FX risk, worried about the impact of regulation and accounting changes, or even concerned that all your peers have more advanced hedging strategies in place, then perhaps it's time to take a step back and think about reshaping your hedges. Ultimately, opening your mind to the idea of using options in the hedging mix is about giving the company the best possible advantage in the current market, while securing as much protection as possible from unknown market conditions in the future.

FX: A TREASURER'S CHECKLIST

- **Does the prevailing FX rate result in a propensity or purchasing power parity advantage or disadvantage to your business?**
- If the FX rate is favourable, but you are not at a hedge point in your cycle/policy, can you pre-hedge in order to capture the present value?
- **If you were protected on 100% of your forecasted risk, but only committed to 75%, would your business benefit from 25% flexibility in the hedged notional?**
- Is the preservation of available credit limits a priority? In the event of a significant rate move and/or reduced market liquidity, will you be able to hedge the amount you want, when you want and with whom you want?
- **If your business faces a perfect storm (economic downturn, liquidity crisis, significant negative mark-to-market), would over-hedged FX be a significant issue?**
- Would a regulatory requirement to post margin or collateral be likely to restrict your use of mandated hedging products and/or dictate your hedging decision process?
- **Do bank counterparty risk and/or credit valuation adjustment (CVA) impact your FX hedge duration decisions? What are the risks associated with bank counterparts who do not charge CVA? Has your business considered bilateral credit support annexes?**
- If exchange rates move favourably during your hedging cycle, will the business be able to realise this opportunity? What is the internal decision-making process and how fast can a decision be executed? Would your existing FX risk management policy facilitate capturing such a potential opportunity?
- **What would the impact be on a multi-asset portfolio basis if you were to introduce long optionality into your business's FX hedging profile?**

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