A CLEARER FOCUS

THE IMPORTANCE OF AN EFFECTIVE FX RISK MANAGEMENT POLICY IN TODAY'S PARTICULARLY VOLATILE ECONOMIC LANDSCAPE REQUIRES A BROAD PERSPECTIVE AND CLOSE COMMUNICATION WITH THE BOARD. YURI POLYAKOV AND ASHLEY GARVIN EXPLAIN A REFOCUSED APPROACH TO HEDGING

SHUTTERSTOCK

Right now, many businesses are facing a new kind of financial risk. While currency volatility is an age-old concern for treasurers, unusually sharp fluctuations in the valuations of formerly dependable G10 currencies are proving challenging.

Driven largely by political events such as the EU referendum result in the UK and the election of Donald Trump in the US, such movements are interwoven with and influence other factors, such as commodity, inflation and credit risk. Indeed, these seismic geopolitical events make it increasingly important for treasurers to be able to assess the full scope of risk when managing FX or even seeking to optimise working capital.

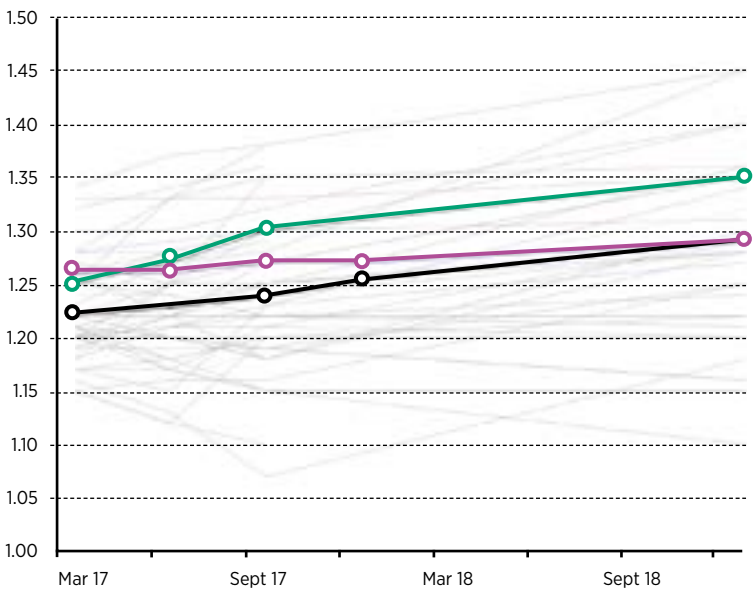
While UK net exporters may express a positive view of sterling's relative lack of strength, net importers are feeling the pressure. Many retailers, for example, are witnessing heavy margin compression under such conditions (amplified by increasing competition and changing consumer behaviour, for instance).

Moreover, calmer waters are not expected to return any time soon. With the triggering of Article 50, and the forthcoming election in Germany potentially throwing markets another curveball, the headlines throughout 2017, and beyond, will almost certainly be dominated by increasing market volatility. Managing risk caused by these 'known unknowns' is becoming more important than ever.

The changing risk landscape

Corporates are exposed to a range of different event risks that can impact performance, including strategic, compliance, operational, reputational and financial. The ability to respond to increased risks in these is typically slow and requires broader organisational changes. Nonetheless, not all is lost as financial risks stand out as a class of risk that can be managed with more speed and less organisational friction than the other. As a result, corporates may wish to review and apply a new risk-tolerance threshold against the way that they currently manage a broader set of financial risks, such as FX, interest rates and credit.

FIGURE 1: PROJECTED GBP/USD



Please note: for illustration purposes only. Forecasts may not be achieved
Source: Bloomberg data as of 1 March 2017

Existing hedging book, new challenges

They may also wish to revisit their current hedging practices, even if they have been successful in mitigating downsides throughout previous bouts of volatility.

For example, given the economic responses to recent variables, such as geopolitical, regulatory, macroeconomic and market competition risks, there has been a move away from stable hedging rates for GBP/USD of the past few years to new levels.

Corporates that had been using longer-term hedging strategies (so those adopting a rolling layered approach that saw them hedge incrementally lower percentages over consecutive quarters) were able to achieve stable levels over 2014/2015*.

*SOURCE: LLOYDS BANK ANALYTICS AS OF FEBRUARY 2017

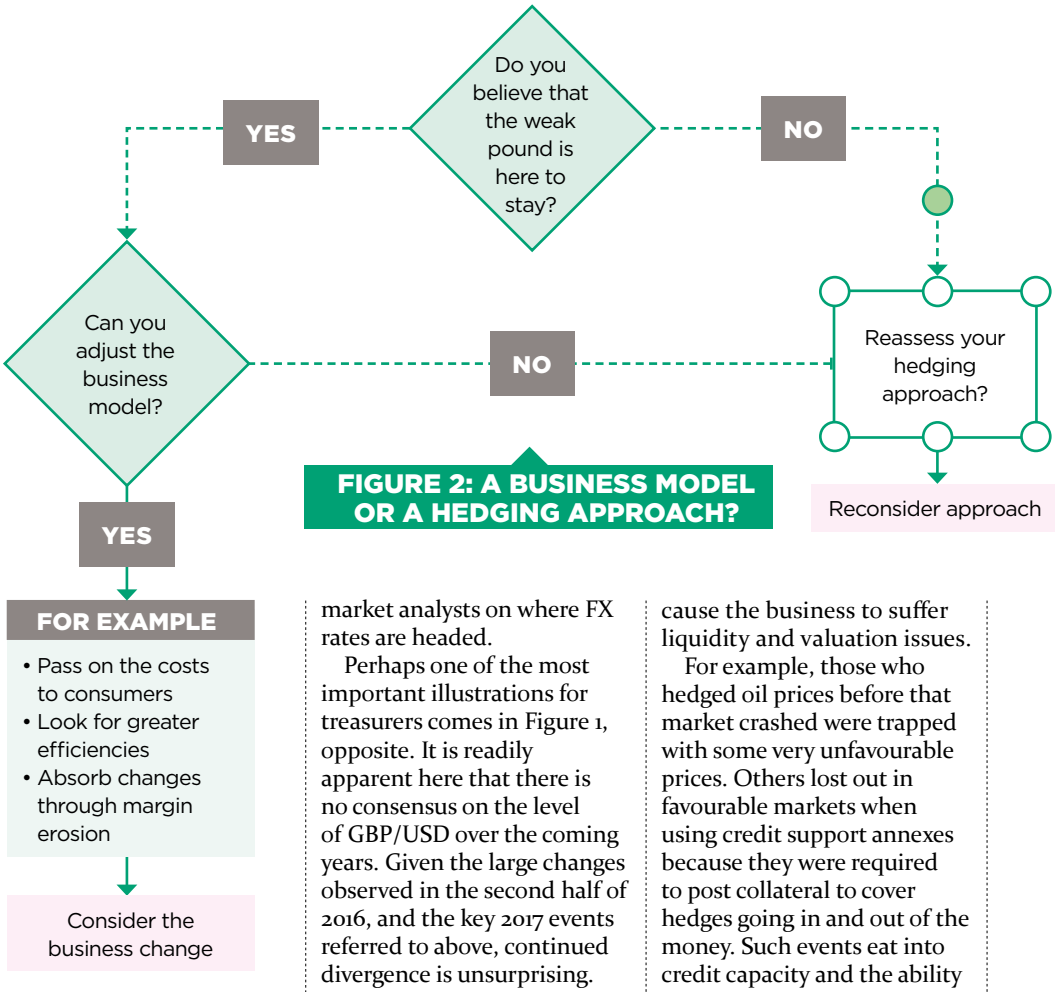


FIGURE 2: A BUSINESS MODEL OR A HEDGING APPROACH?

However, since the UK referendum result, unidirectional volatility has been progressively pulling hedges lower. So, while that layered strategy may have slowed the impact of falling rates on these businesses, hedging levels are now starting to affect them. In addition to this, the nature of this type of strategy would lock the company into adverse rates if sterling were to recover substantially.

No agreement

Yet building out that new strategy comes with certain challenges. For those who are not immersed in the research, there may not be full appreciation of the degree of disagreement among market analysts on where FX rates are headed.

Perhaps one of the most important illustrations for treasurers comes in Figure 1, opposite. It is readily apparent here that there is no consensus on the level of GBP/USD over the coming years. Given the large changes observed in the second half of 2016, and the key 2017 events referred to above, continued divergence is unsurprising. Although the forecasts show an expectation of general recovery in GBP/USD, there continues to be a sizable range of outcomes from the 53-strong bank panel (1.45-1.10) up to 2019.

It is difficult to avoid taking a view of where markets may head, but whatever their strategy, treasurers need to be clear about the impact of their chosen path, especially if it ends up veering off course.

In other words, the chosen strategy may be very effective in protecting the business if the market behaves as expected. If it takes an unexpected turn in the direction of something the company did not initially need to be protected against, however, a rigid strategy could cause the business to suffer liquidity and valuation issues.

For example, those who hedged oil prices before that market crashed were trapped with some very unfavourable prices. Others lost out in favourable markets when using credit support annexes because they were required to post collateral to cover hedges going in and out of the money. Such events eat into credit capacity and the ability to re-hedge.

The next step

The question of how to respond, with sterling at historical lows, could find an answer in the flow chart of Figure 2, above, where planning for either business model or hedging approach adjustments could suggest a course of action.

An action plan

Above all, corporates need to take a flexible approach to risk strategy so that when the market reality changes, strategy keeps pace. Treasurers must therefore step up the level of communication so that C-suite and board-level stakeholders are fully cognisant, not only of a broad sweep of specific risks faced by the business, but also of the strategy applied to help mitigate such risks.

But it also means treasurers should seek the approval of senior executives when confirming new strategies, or reaffirming existing ones, in the light of expected continued turbulence. Furthermore, it is essential to communicate the approved risk strategy and its expected outcomes to investors and other stakeholders. Informing and educating in this way helps to manage their expectations. It does this by demonstrating that there will likely be controlled impact rather than complete mitigation of any risk, should the market behave in a certain way.

In the current volatile economic and geopolitical environment, it is apparent that in order to manage against a weak pound, corporates may need to re-evaluate and at times change their approach to managing FX and other financial risks. The measures taken may be achieved either within policy or by gaining a temporary policy exception, granted under extraordinary circumstances.

Treasurers now have a duty to bring their knowledge and expertise to bear on a wide range of issues and know that their role now includes communicating these issues to senior executives and the board to gain the highest level of approval; a case of when there's trouble on the bridge, be sure to call the captain.

Treasurers should seek the approval of senior executives when confirming new strategies

Yuri Polyakov is head of financial risk advisory and **Ashley Garvin** is director, financial risk advisory, Lloyds Bank

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