4.5.2 Foreign Exchange Risk in Trading and Policy Exercise

Study Unit: Unit 1 – Treasury Strategy

Module: Module 4 – Financial risk

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Summary: An exercise examining hedging policy and associated issues of strategy, authority, control and effectiveness in the context of a company supplying an automotive manufacturer.

Keywords: foreign exchange, hedging, policy, controls, governance, strategy, risk, benchmarking, performance

CLAYMORE LTD

Claymore Ltd, a medium-sized manufacturing business supplying components to a Japanese automobile manufacturer, Ranger Corp. Ranger is Claymore's biggest customer. Claymore's Board has delegated responsibility for treasury matters to a Treasury Committee consisting of the CEO, the Treasurer and the Managing Director. Claymore's treasury department consists of the treasurer and an assistant. Besides financial risk management and funding activities, they are responsible for Claymore's working capital management, including levels of stock, receivables and payables. Treasury manages all payment instructions and customer receipts (although the receivables and payables ledgers are maintained by dedicated departments). Claymore is funded by a bilateral committed revolving bank facility from Noddy Bank. Noddy Bank provides Claymore with facilities for trade finance, foreign exchange and interest rate hedging, and handles all Claymore's transactional banking activity. CCY is Claymore's base currency.

Claymore makes all its sales locally in CCY, but buys significant amounts of raw material and components from abroad. Claymore's immediate business volumes are dependent on Ranger's production schedules. Although activity can be (and is) budgeted for the year, actual activity can only be confirmed once Ranger's forthcoming production schedules are received. These set out the number and type of components that Ranger will buy in the next month, together with an indication of the next two months' requirements. The latter can and will change without notice, depending on customer orders for Ranger vehicles.

Below, in Background information - Part 1, is a copy of Claymore's foreign exchange hedging policy; Background information - Part 2 provides some background material presented when Claymore's Board approved the policy.

Question 1
Do you think the policy is consistent with the stated strategy?

Question 2
Do you think the policy parameters contained in Part 2 the “Foreign Exchange Hedging Policy Background” are sensible?

Question 3
What is your opinion of the “primary measures of success” outlined in the Authority granted by Board Resolution (Board Reporting section of Policy Statement on page 5) and what is your assessment of the practical implications of this Authority?

Question 4
What does the policy tell you about Claymore’s attitude to risk?

Question 5
What improvements would you suggest to the policy and to the parameters contained in the “Foreign Exchange Hedging Policy Background”?

BACKGROUND INFORMATION – PART 1

Claymore Ltd - FX Hedging Policy Statement

Strategy

To adopt a hedging policy, which specifically prohibits speculation, and which minimises uncertainty by taking action to protect the business from exchange rate fluctuations which could lead to a performance that is adverse to the expected outcome included in approved projects, budgets, plans and forecasts.

Policy

This will be achieved through the adoption of the following FX Hedging Policy:

1. **Recurring revenue purchases**

a. On a rolling basis, currency exposure arising from all significant recurring revenue purchases, such as raw materials and components, should be reviewed and hedged where appropriate.

b. Deals may be made with a maturity date of up to six months to a maximum value of the underlying transactions confirmed by customer schedules and commitments placed on overseas suppliers to cover customer schedules. *(Note, that while Ranger issues schedules with one month firm and two month forecast commitments, for sourcing from overseas suppliers, for example from Japan, an order commitment of between four and six months is required to be given by Claymore to the supplier)*.

2. **Non-recurring revenue purchases and capital purchases**

a. All foreign currency based expenditure within budgets, and detailed capital or revenue projects must be clearly identified with value, timing, and assumed rates; and the board, or board committee requested to specifically ratify the intention to take hedging action.

b. On a case-by-case basis, currency exposure arising from non-recurring revenue purchases and capital purchases should be hedged when the board specifically approves the transaction, or if later, when a firm order is placed.

c. Deals may be made with a maturity date of up to 18 months if supported by stage payments agreed with a supplier in purchase order documentation, and up to the maximum value of that order, subject to an overall value limit of CCY 10,000,000.

d. (Note, initial experience of large items of capital expenditure, for example presses supplied from Japan, is that there is a minimum lead-time of 12 months from placing an order to the final payment being made. To allow contingency for unforeseen circumstances, operationally orders and deposits will be placed up to 18 months before final payment. It is at this point that hedging action should be considered).

3. **Payment instructions made in foreign currency**

a. The Company may enter into outright spot or forward foreign exchange transactions in order to fix the exchange rate applying to payment instructions issued to the Company's Bank from time to time, where the payment currency is not the same as the currency in which the relevant bank account is denominated.

b. Such a transaction may only be entered into in order to hedge one or more previously approved payments. Specifically, approval must have been given to make the payments before entering into the Foreign Exchange transaction.

c. The Company is specifically forbidden to enter into a transaction that involves "third party settlement" (i.e. where the currency purchased is paid by the Bank directly to a third party rather than to the Company). Funds relating to all foreign exchange transactions must be settled to and from the Company's bank accounts, and payments made to third parties must be made from those accounts in accordance with the relevant mandate in force from time to time.

Restatement of Specific Authority of the Treasury Committee in relation to Foreign Exchange (Board Resolution of the Company dated XXXX refers)

All foreign exchange dealings must be within the FX Hedging Policy. The FX Hedging Policy must be approved by the Board.

All foreign exchange dealings must be approved by the Treasury Committee.

The Committee is only allowed to approve and / or authorise the instruments listed below in implementing the FX Hedging Policy. For the avoidance of doubt all FX trades must relate to underlying business cash flows.

<u>List of instruments and limits:</u>

i) The outright purchase or sale of currency for value spot or at a forward date.

ii) The simultaneous purchase (or sale) of currency at one date with a sale (or purchase) of the same amount of currency at a future date, i.e. a currency swap. *Note: The purchase of currency options is not permitted without express Board approval.*

Individual deals where the net effect is to buy or sell currency in excess of CCY5,000,000 must be authorised by the Board i.e. outright foreign exchange or option transactions or mismatched swaps. This limit shall not apply to matched currency swaps (defined above).

The Board must approve individual deals with a maturity in excess of 6 months for recurring revenue transactions, and 18 months for non-recurring revenue and capital transactions.

Board Reporting

Board reports will contain a summary of currency hedging transactions, with values and rates compared to budgeted values and rates, or approved project values and rates. ***This will be the primary measure of success for hedging action.*** *As a memo note only, the reports should record the impact of actual rates that existed in the market at the date of the transactions.*

BACKGROUND INFORMATION – PART 2

Claymore Ltd - Foreign Exchange Hedging Policy Background

1. Introduction

This paper has been prepared to provide the background to the adoption of a *foreign exchange rate hedging policy*.

2. An explanation of Currency Hedging

Where transactions involve payment in foreign currency, the Company must assume an exchange rate for the purposes of getting Board approvals. Approvals may take place over an extended time scale, for example there will be a time lapse between outline approval for a plan or budget, to the approval of a specific investment project. However, from the point at which a decision is made to proceed with an investment project at an assumed exchange rate, or for example the purchase of components from an overseas supplier contained in a budget, the anticipated sterling cash flows of the business may be put at risk by fluctuations in the currency markets. *Hedging policy seeks to reduce the risk to the projected financial outcome arising from a currency transaction by taking positive action* (rather than taking no action). This will be either to protect the rate used in the budget for the purchase of components, or to protect the rate used for investments when specific Board approval was obtained for the project.

The success of hedging should be measured by comparing the certain forward rate achieved through hedging to the rate assumed in the project or budget, and not by looking back after the transaction in order to compare the hedged rate to the actual rates that existed in the market at the time of the transactions.

3. An explanation of the alternative "No Hedge" Policy

Of course, it is recognised that whilst taking out a hedge protects a specific planned and approved financial outcome by removing the risk of a loss or shortfall, this also removes the opportunity of an unplanned windfall gain. Some large, multinational companies may take the view on large capital transactions, that since they are continually making investments, whether they take positive hedging action or no action, the effect of exchange rates on investment cash flows will average out, with lower than projected costs in some years, offset by higher costs in other years. (It is understood that this is the Ranger approach). Although hedging would ensure that the rate assumed in each project would be protected, when taking the long term view, hedged rates themselves would reflect the cyclical peaks and troughs of the market and on continuous investment would also average out. It is this viewpoint which can lead to a reticence to adopting a positive hedging policy, but this decision must be taken in the context of the frequency, scale and relative importance of the transaction to the financial circumstances of the business.

4. The Case for Adopting a Currency Hedging Policy

It is recommended to adopt a currency hedging policy in order to set out the agreed parameters within which the Company should enter into foreign exchange (“FX”) transactions. The Board will recall that the Company is funded from a combination of share capital and bank loans, and there are financial limits set by the Bank to which the Company must adhere. Furthermore, the Company's performance against these limits is measured on

a quarterly basis every year. The business was provided with the necessary funding on the basis of sterling financial projections accepted by the shareholders and banks, and the business must perform within these projections as a minimum if it is to continue to enjoy the confidence and support of its investors. If the Company fails to protect its cash flows from the volatility of the currency markets by adopting a no hedge policy and seeking to obtain a windfall unplanned currency gain, it will also expose itself to the possibility of an unplanned currency loss. The Company's stakeholders would not expect either outcome and, if a substantial currency loss was incurred, resulting in significantly higher costs than plan, this could put the Company in breach of banking covenants or prevent the timely payment of funds to stakeholders.

In addition to the strategic points outlined above, in its operations the Company requires the flexibility to pay currency, typically to suppliers, but without the overhead of maintaining, controlling and accounting for an appropriate currency-denominated bank account. By entering into an FX transaction, it is possible for the Company to fix a rate with the paying bank (currently Noddy Bank Plc) so that the cost of the currency payment amount that will be charged to the Company's bank account (in CCY, say) is fixed at a relatively preferential rate. In this case, the currency payment amount(s) must match the amount of currency purchased; if there is a mismatch the Bank will apply the mismatch amount to the Company's CCY account converted at a less commercial rate.

5. An explanation of Speculation

This can be defined as contracting for the purchase of a certain amount of foreign currency at a pre-agreed exchange rate, without there being a confirmed or anticipated underlying business requirement for the currency. The speculator anticipates that the currency can be converted back into sterling at a more favourable exchange rate at a future date, generating a windfall cash gain. Speculation is specifically prohibited by the hedging policy.

6. Setting an Exchange Rate for Investment Projects, Budgets, Plans and Forecasts

When setting the exchange rate to be used in an investment project, budget, plan or forecast to be presented to the Board for approval, there are a number of possible approaches each of which have advantages and disadvantages, as summarised below:-

a) Pessimistic rate

Assume an exchange rate that is lower than (adverse to) the spot and forward rates available in the market when a project or budget is being prepared.

Advantages:
i) It is possible that the actual exchange rate at the time of the transaction will be more favourable, resulting in lower costs and a more favourable outcome than was planned
ii) This might be seen to eliminate the need to take out a currency hedge.

Disadvantages:
i) This unrealistic rate could lead to uncompetitive prices having to be quoted to customers in order to satisfy shareholder return requirements, but resulting in the failure to win the business, or get the budget approved.
ii) Failure to hedge still leaves the eventual outcome open to uncertainty, whether favourable or adverse.

b) Optimistic rate

Assume an exchange rate that is higher than (favourable to) the spot and forward rates available in the market when a project or budget is being prepared.

Advantages: i) May show good returns for the project, very competitive customer pricing and a strong budget.

Disadvantages: i) This may be an unrealistic rate which results in the eventual outcome being adverse to the approved project or budget.

ii) It is unlikely that this exchange rate could be protected through hedging action.

c) Prudent realistic rate

Assume a prudent exchange rate that is based on the spot and forward rates available in the market when a project or budget is being prepared.

Advantages: i) Returns for the project are presented on a realistic estimate today of the outcome that is achievable with a reasonable degree of certainty.

ii) The outcome can be substantially protected through hedging.

Disadvantages: i) It is recognised that exchange rates may be at a cyclical high or low, when a project or budget is prepared. Since the hedging action may not take place until sometime later, when the transaction is confirmed e.g. through the placing of an order and the payment of a deposit, there is the possibility that rates available for hedging may be materially different than those assumed in the project. In these circumstances, the appropriate action would be to rework the project at the latest available exchange rates and if the outcome is materially different, to seek Board approval for the new project. Once approved, hedging action would be taken to protect the exchange rates assumed in the project.

The Board has approved the prudent realistic approach to budget and project rate setting linked to the adoption of a currency hedging policy.

7. Board Approved Policy:

The board has approved the adoption of a hedging policy, which specifically prohibits speculation, and removes the uncertainty of not hedging by taking action to protect the business from exchange rate fluctuations which could lead to a performance that is adverse to the expected sterling outcome included in approved projects, budgets, plans and forecasts. This policy is attached.