4.4.2 Risk Responses Exercise[1]

Unit: Unit 1 – Treasury Strategy

Module: Module 4 – Financial risk

Date: 1 September 2014

Summary: An exercise on constructing a response to a particular risk.

Keywords: risk avoidance, risk retention, risk increase, risk reduction, risk transfer, hedging, insurance, derivatives, asset beta, rewarded risk, unrewarded risk, risk appetite, risk budgeting, risk response, key performance indicator, opportunity cost, speculation, basis risk, counterparty risk, operational risk

Recall the exercise in risk identification and assessment in Exercise 4.2.2, which concerned the fuel price risk in the airline operations of Leisure Tours. The dimensions of policy identified in the model answer (admittedly accepting the shortcomings of exam conditions), included:

- timeframe
- instruments, e.g. collar options
- competitor behaviour
- collateral call management
- own fleet, third party carriers
- hedge accounting

Required:
You are the group treasurer of Leisure Tours and the CFO has asked you to put together bullet notes on the costs and benefits of hedging fuel prices – no more than 700 words – to brief the Board on the strategic alternatives.

Bear in mind some of the following factors affecting fuel price risk:

- ability to pass on prices
- timescale to change prices
- issuance of price lists
- competitor behaviour
- change in demand from differing fuel price levels
- timescale to change business models
- investor expectations
- other risk factors in business model (ERM approach)
- financial risk in business
- fuel price volatility

[1] Included in this exercise is an activity requiring you to post in the online forum. This activity is indicated by the icon. You are expected to post forum exercises to the appropriate forum within the two-week timeframe of the module. Please see the study timetable for reference.

- practicalities of hedging, such as facilities required, risk and liquidity, margins etc.
- ability to spot market trends, highs and lows
- the risk framework
- risk appetite

Conclude your paper with a brief recommendation as to a possible approach to fuel price risk.

Post your notes to the module forum: create a new post in the *Forum exercise from 4.4.2 Risk responses* category with the title, U1/M4/4.4.2/Risk responses/[Your name].

Student notes:
There is no right answer to this question, the exercise is really intended to make you think about all the issues so that when you meet this (or a similar) problem in real life you are well prepared to meet the company culture and any ingrained management opinions and approach the problem in a disciplined way, while being prepared to listen to other arguments and approaches.

Do not consider what other firms have done, as there is no research time allocated to this exercise, but do consider how behaviour of competitors that differs from your own may influence outcomes.

© Association of Corporate Treasurers