4.5.3 Foreign Exchange Risk in Trading and Policy Exercise Answer

Study Unit: Unit 1 – Treasury Strategy

Module: Module 4 – Financial risk

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

Answer 1

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

The policy is consistent with the strategy, however, the treasury team's implementation of the policy cannot on its own ensure that the strategy is achieved. This is because in order to deliver on the strategy it is necessary to manage the crucial aspect of the time taken between determination of the rate for use in a project appraisal, budget or forecast (and how this is determined) and the rate achieved on the hedge (which might be set some time later). Coordination with operating functions will be crucial, however the lines of responsibility must be clear, as must be the manner in which treasury's performance will be assessed.

Answer 2

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

- The paragraph "An Explanation of Currency Hedging" concludes with the following statement:

  '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.'

  The second part of this is undoubtedly true – there is no merit in applying hindsight and concluding that the company would have been better off had it not hedged. However, there is an argument to be made that the first part of the statement may be inappropriate. The preceding paragraph to the quotation above acknowledges that approvals may take place over an extended time scale and any delays in entering into the hedge will increase the likelihood of a difference between the actual and budgeted/forecast cashflows. When this is the case, is this a failure of the hedging policy (the implementation of which is the responsibility of the Treasury team), or of the internal project approval process (over which Treasury has no control)?

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- Paragraph 4 discusses the impact of currency fluctuations on reported results and the ability to service both debt and equity investors. It is therefore to be expected that the impact of currency fluctuations are likely to have a material impact on results and cash flows. This observation is of interest with respect to analysis elsewhere and it is also noticeable that there is no mention of materiality or of tolerances.

- Paragraph 4 also discusses the use of a local currency account to settle FX payments and states that currency amounts will be charged at a "relatively preferential rate". This is careless wording for such a document; "booking a rate" for a payment in currency is usually to be preferred over simply issuing a payment instruction in a different currency from the paying bank account – the latter approach can be extremely expensive. However it is unlikely to be a better rate than would be obtained from Noddy Bank's corporate dealing desk. It should also be noted that by making foreign currency payments in this way, the company is exposed to poor rates from its bank, and may be better served by operating a competitive quote system for larger amounts (once again, thresholds would be necessary, above which the policy would require competitive quotes). Has Claymore the volume to make it worth involving a second bank, and if it did, what would be the effect on the Noddy Bank relationship? However competitiveness is even more relevant in view of the comments earlier in paragraph 4 in which it is implied that FX volatility may be material to the company's results.

- Paragraph 5, which explains speculation, states that this occurs in the absence of a confirmed or anticipated underlying business requirement for the currency. This is correct to a point, however strictly speaking it would be necessary to define what it meant by "anticipated" – what degree of probability would need to be achieved for an event to be "anticipated" instead of "possible", the latter perhaps qualifying as speculation if the possibility was only, say, 5%.

- Paragraph 5 makes clear that speculation is prohibited, which makes it all the more important to ensure that it is clear precisely what is meant by the term. This can be achieved by making clear what is permitted (i.e. what exposures should be hedged) on the basis that any other action is considered to be speculation.

- Paragraph 6 discusses the three approaches to setting the rate for investment projects, budgets, plans and forecast and, quite reasonably, concludes that use of a prudent realistic rate is appropriate. However, there is no specific quantitative information on what this means in practice, and how such a rate should be calculated. The Treasury Committee should establish a precise methodology, which may differ depending on the use to which it will be applied (non-recurring items versus budgeted data for example) and arrange for it to be approved at a senior level. If left to an individual's judgement there would be a range of rates which could be used and leaves the process open to management bias. The prudent approach states that "the outcome can be substantially protected through hedging" and this raises the same point as earlier – the extent to which this is the case will depend on the length of time between setting the rate and hedging the transaction.

Answer 3

What is your opinion of the "primary measures of success" outlined in the Authority granted by Board Resolution and what is your assessment of the practical implications of this Authority?

- The primary measure of success will be in the form of a report containing "*a summary of current hedging transactions, with values and rates compared to budget values and rates, or approved project values and rates".* This is discussed in the first part of the answer to question 1 above and is arguably inappropriate since it measures the success of the policy with reference to an activity outside of the control of the treasury department. Furthermore, as noted above, it is necessary to be specific with respect to the manner in which the budget/forecast rates are determined. Some sort of coordinated approach is recommended here, otherwise, operating units will use inappropriate rates in their planning. If treasury is involved in setting these rates, then there is a case for treasury being measured against achieving them.

  Certainly, the treasury department should be given a clear policy stating which transactions should be hedged, and when, how, and with whom the hedge should be entered into. Clearly it is important for the treasury team to work closely with commercial colleagues in order to ensure that exposures are identified, understood and monitored however the project approval process is unlikely to be treasury's responsibility. In Claymore's case with such a small team and with the Treasurer being part of the small Board Committee delegated with execution of the policy, hedging practice should remain reasonably controlled. However in the absence of a formal policy in this area, there remains the risk of misunderstanding or misinterpretation of verbal agreements.

  An alternative means of assessing performance might be to split the activity in two, with valuations attributed to the movement between the rate set at the commencement of the budget/project approval process, the rate achievable when the hedging policy dictates that the transaction be hedged, and the actual rate achieved. Treasury's main responsibility should be in ensuring that hedges are entered into when required by policy, that these arrangements are monitored to ensure open positions do not arise, and to report on the mark to market value of current hedges.

  <u>Practical implications of the policy</u>

  The authority relates to foreign exchange, and therefore is not limited to hedging transactions, although these are covered by the authority:

  - *"All foreign exchange dealings must be within the FX Hedging Policy":* This seems the wrong way around – FX transactions entered into in accordance with the FX Hedging Policy should comply with any FX policy, specifically the board authority (FX spot deals may not be hedging transactions so why should they conform to the hedging policy?)

  - *"All foreign exchange dealings must be approved by the Treasury Committee"* how often does the committee meet – this must be practicable, and there should be a materiality limit.

- Permitted instruments should be specified in the hedging policy and should conform to this authority.

- Why state that the purchase of currency options is not permitted, except by board approval? – By stating those transactions that are approved (spot, forward and swap deals) anything else is prohibited, although the Board could approve them. Claymore's Board seems to be keeping the Treasury Committee on quite a tight leash here; perhaps because the cost of an option strategy could have a material effect on margins. But the need for further approval certainly restricts Claymore's ability to take advantage of transient opportunities in the market.

- Board approval must be sought for deals exceeding 6 months for revenue, and 18 months for non-recurring transactions. This may be unworkable if exposures need to be covered prior to the next board meeting (as is likely) and so a better solution would be to provide for policy exceptions (for example, via the authority of two committee members, to be ratified by the full committee later). Such an exception procedure should be included in the FX hedging policy. Indeed, it is better for all relevant information to be included in the FX hedging policy and so it should include the permitted instruments and exception procedure drawn from the board authority.

- The summary at the end states that the impact of actual rates that existed in the market on the date of transactions should be recorded. This serves no purpose since hindsight is irrelevant to hedging. A more appropriate item for inclusion would be regular reporting of marked to market valuations on hedging instruments (only forwards here).

Answer 4

What does the policy tell you about Claymore's attitude to risk?

It is unclear whether Claymore's FX hedging policy is as it is because FX risk is material to its results and cashflows, or if its approach is to remove all such risks as far as possible. The latter may be a reaction to a high level of business risk due to the inherent uncertainties of its largest customer not committing to orders beyond one month, in which case an attempt is made to remove all risks as far as is possible.

The policy is risk averse, with a continual emphasis on the fact that speculation is not permitted (although this is common). It also indicates a mistrust of any but the simplest hedging instruments, which rather limits the treasurer's ability to add value.

Answer 5

What improvements would you suggest to the policy and to the parameters contained in the "Foreign Exchange Hedging Policy Background"?

For comments on the parameters contained in the "Foreign Exchange Hedging Policy Background", see the answer to Question one above.

The policy is not explicitly linked to a risk management framework, and appears somewhat in silos. In a company of Claymore's size this may not be a huge disadvantage, however the whole policy could probably be tightened up and more explicitly linked to the business

strategy if it were integrated with a risk management framework. Crucially, there seem to be no mechanisms to check the success or to facilitate continuous improvement of the policy.

It is not clear from the explanations how Claymore might be able to change its pricing to react to its own underlying costs. Has Claymore agreed fixed pricing with Ranger and if so, over what period? If Claymore can flex its price according to its own costs, then the risk response (and hence the hedging problem) is completely different to the situation where prices may be fixed. If prices are fixed then Claymore should consider much longer term hedges as a response to the risk.

If prices can be moved according to costs, then only very short term hedging is required to deal with the issue of mismatched timings on orders between customer and supplier. Indeed a better risk response might be to pressure the supplier into accepting a lower notice period for orders.

There is no mention of the competitive situation at all in the policy or in the background statement. The trading situation of Claymore is quite complex in that seems to sell in its local currency (mentioned as sterling in the background information), even to the Japanese major customer, although this is not clear, and buys raw material in other currencies. There is much scope for Claymore to become uncompetitive and consideration should be given to the situation of those firms to whom Ranger might go for supplies instead of Claymore. It might be that Ranger uses more than one supplier for the parts that Claymore supplies so that it can easily switch between suppliers as the price changes. Where there is greater competition, there is an argument for a longer hedging period, to protect the business model from these pressures and allow Claymore time to react.

These issues emphasise the need for the treasurer to be in constant contact with his commercial colleagues.

With respect to the hedging policy, the following points are relevant and have as a common feature the need for total clarity and lack of ambiguity. The treasury team should be in no doubt whatsoever of what actions need to be taken, by whom and when:

- <u>Recurring revenue purchases:</u>
  - *1a: "on a rolling basis*": needs to be defined – it is unclear over what time period the hedges are to be applied. Given the business of the company, and the fact that its main customer is Ranger, it will plan on servicing this customer for the foreseeable future and so will need to source the raw materials. Although Ranger will only commit to one month at a time, it may be appropriate for Claymore to hedge up to 12 months out, on a reducing scale to allow for reductions in orders from Ranger – a policy of hedging 100% of next month's certain requirement, and reducing amounts thereafter, perhaps ending with 50% of the forecast requirement in 12 months time might be more appropriate. This would need to be updated monthly, and would tie in with the requirement from some suppliers for orders up to 6 months in advance. The most appropriate balance and hedging profile would depend on the likely materiality of the FX exposures (perhaps value at risk could be applied here) and the likelihood of Ranger cutting back significantly on their requirements, which would leave Claymore with open FX positions and raw material orders that aren't required – it's a

risky business to be in! However, 12 months has no magic in it. It is quite possible that competitive advantage might dictate a longer lock in period, perhaps fixing low costs, for example. This is also influenced by pricing power, as explained above, and how far into the future prices are agreed.

- *1a: "Currency exposure"*: how is "exposure" defined? Does it mean "certain", in the sense that the underlying agreement is irrevocable, or does it mean likely, in which case what level of probability corresponds to this, and who determines it. As discussed above, it may be appropriate for FX related to raw material purchases to be hedged based on a 12 month rolling forecast, with a reducing percentage each month. Also, it would be normal to assign a level of materiality below which hedging should not be undertaken, even if the exposure is certain. This would clearly need to be carefully considered but would ensure that administrative time and dealing costs do not arise by application of the policy in inappropriate circumstances.
- *1a: "should be reviewed and hedged where appropriate"*: what is appropriate? The policy needs to specify when to hedge.

- <u>Non-recurring revenue purchases:</u>
  - *2a: "Assumed rates"* requires defining – presumably this means the rates as determined according to the prudent approach as specified background material.
  - *2b:* is clearer here than for recurring purchases re when to hedge – hedge if the board approves the expenditure, or later if when an order is raised (presumably if board approval is not required).
  - *2c:* The upper limit of CCY 10,000,000 is slightly unclear. Whilst a lower limit, below which hedging should not take place is understandable, an upper limit makes no sense (so is presumably not what is intended). One would expect to see a higher authorisation level for significant hedging transactions, but not a prohibition.
  - *2d:* In certain circumstances, hedging for up to 18 months should be considered: considered by whom? The policy must be clear and so exercise of discretion should be avoided. The policy should provide the mechanism by which this could occur – perhaps by separate approval from two members of the Treasury Committee, to be ratified by the following meeting of the committee?

- <u>Payment instructions made in foreign currency</u>
  - a and b cover payment processes and are arguably not relevant to hedging, instead sitting more comfortably within foreign currency payment authorisations and processes within a more general Treasury Policies document. The hedging policy should be focussed on what exposures should be hedged and how this is actioned, not of the mechanics of settlement. However, note that in businesses with limited resources (including many operating units in larger Groups), payment instructions may well be combined with explicit or implicit foreign exchange transactions and hedging and settlement policies need to cater for this.
  - c is standard, however as for a and b, should not be within a hedging policy.