*Larry Kirschner*

# Lost in Translation

## Why your hedging program is not working

Hedging currency risk should be a relatively simple concept—and exposure is identified and offset or neutralized with an instrument that behaves in an opposing manner. If the underlying exposure is negatively impacted by higher prices, then enter into a hedge that will gain in value when prices increase to offset or negate this risk. If prices rise, one side of a transaction will perform well and the other side will perform poorly. Conversely, when prices fall, one side should lose and the other side should perform well. It may be useful to think of a hedge as functioning like a see-saw, with the fulcrum representing no net gain or loss on currency movements. In both cases, risks are offset and the middle remains stable.

There are a lot of talented people trying to achieve goals around minimizing risk. Finance professionals are very good at designing tools that provide solutions to complex problems. Companies are very good at understanding and employing these tools. If it is so simple, then why are so many hedging programs not working? Why do your gains and losses not net to zero each month when both sides are remeasured?

If a subsidiary is not letting a parent company know in a timely manner when their exposures are changing, a hedge has little or no chance of working properly.

## Secret ingredient

Here is the secret ingredient: Hedging only works properly when the underlying exposures are correctly identified and monitored. At the beginning of the month, a company may look at the projected activities of their subsidiaries around the world. They may then methodically net these exposures (i.e., create internal entries to offset like exposures) internally. Then a company can enter into hedges in the market that offset or neutralize the remaining risks. On paper, this should work just fine. As the values of the exposures vacillate in the currency markets, the values of the hedges should oscillate and perform inversely. This can be a well conceived and perfectly executed plan, until something at the subsidiary or underlying risk level changes and those changes are not reported back to the hedging "quarterback" until a later date.

For example, assume that the euro functional French subsidiary of a U.S. company is holding a material amount of British pounds in its bank account. It may have a very good reason to do so. Perhaps it has a payable that is denominated in pounds. Or, perhaps the subsidiary plans to create one in the near future. In most companies, the U.S. parent would be keenly aware that unwanted gains and losses will be realized when the British pound balance is remeasured into euros by its French subsidiary. To eliminate these gains or losses, the U.S. parent can hedge the pound balances on behalf of the French subsidiary. This is a textbook and perfectly strategized transaction until the French subsidiary uses the pounds without notifying the parent.

Once the pounds are removed from the French company's bank account, the parent is left with a financial hedge and no underlying or offsetting exposure. When the financial hedge is remeasured at month's end, the offsetting gain or loss on the French subsidiary's British pound balance no longer is there to offset the movement on hedge. Had the French subsidiary let the parent know that it used the parent's pounds, the parent could have unwound the related portion of the hedge at that instant. This action would have eliminated any stray month-end hedging gains or losses. In other words, it's all about communication. If the parent does not know that the subsidiary is changing the underlying exposure, it cannot do anything about it. If the parent is kept in the loop, it can react and make the appropriate adjustments in the hedging program.

The same result may occur if a French subsidiary has made a euro-denominated sale to Britain. In this example, nothing needs to be hedged since the French company is receiving euros. However, the risk profiles changes if, midway through the month, the British customer asks to have its invoice redenominated from euros into pounds. Before the request to change the terms of the invoice, the French company had no exposure associated with the sale, assuming the British customer paid euros as invoiced. But once the invoice was redenominated into pounds, there was currency risk associated with the transaction.

## Internal communication is key

Many hedging problems occur because an underlying risk was changed without changing the associated hedge. In other words, these hedges perform poorly because of a lack of internal communication rather than from faulty design. If a subsidiary is not letting a parent company know in a timely manner when their exposures are changing, a hedge has little or no chance of working properly. Finance-minded people throughout the company should be enlisted as ambassadors for the hedging program. Ambassadors should be the eyes and ears of a company who are on the lookout for actions that could cause a hedge to go awry. Alternatively, they should be attuned to actions that create a need to hedge.

There are certainly benefits and efficiencies in centralization. Most programs are best executed and administered within an integrated structure. However, if all of the strategic information is too closely held and the strings are pulled by a select few in corporate treasury, a global hedging program may be filled with derailing opportunities.

On the other hand, if there are lots of eyes and ears watching for potential obstacles, a program has a greater chance of success. Although it may be easier said that done, making subsidiaries a part of the hedging process will pay off if you take the time and energy to engage and educate them before hedging activity occurs. If all key stakeholders have a good understanding of how they fit into a larger hedging program, team members will be more apt to communicate changes in a timely manner. This communication is especially important when underlying changes impact the overall hedging results of the company. While it may not be quite as carefree as riding up and down on a see-saw, a well-functioning hedging program should be equally as well functioning.

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