The Power of a Dollar

In late 2008, global financial markets were blown apart by a sharp and sudden spike in volatility. For many years leading up to this big bang, more than a few companies had become complacent with their foreign exchange risk management practices. Some companies even felt that they truly understood how to consistently beat the markets. Others adopted a *laissez-faire* attitude; they believed that random, unhedged foreign exchange gains and losses offset each other over time and chose not to address foreign currency exposures at all. Although there may have been some big currency-related wins using these strategies in the past, the 2008 reality check is causing many companies to revisit or establish new foreign exchange risk parameters. Fortunately, these policy renovations do not have to be painful. Regardless of whether a company is writing a new policy or tweaking an outdated document, a few simple steps in the short-run can help minimize unanticipated foreign exchange shocks.

To illustrate how foreign exchange risk has changed, consider the relationship between the U.S. dollar and the Canadian dollar. At the beginning of the third quarter of 2008, the market was assessing the short-term volatility of the U.S. dollar vs. the Canadian dollar to be around 9%. In other words, the market felt that over a 30-day horizon, a company with an unhedged $10 million exposure between the U.S. dollar and the Canadian dollar could reasonably expect the maximum movement between this currency pair to be around $900,000. Since the market prices volatility both up and down, the market movement would result in a favorable outcome half the time and in a negative outcome the other half. What this means is that the market was assessing a maximum risk to an unhedged position with this profile to be around $450,000. By November 1, however, the volatility associated with 30-day U.S. dollar vs. Canadian dollar risk had shot up to over 26%. The

by Larry Kirschner

market felt that the same unhedged $10 million exposure could now yield a gain or loss of $1.3 million—or more than double the volatility from just 60 days earlier.

The volatility scenario was even worse for emerging markets. As the third quarter began, for instance, the market felt that the Brazilian real vs. the U.S. dollar was another relativity stable currency pair. With volatility at just over 9%, the risk profile of the U.S. dollar vs. the Brazil real was very similar to the U.S. dollar vs. the Canadian dollar. But by November 1, 2008, that volatility eclipsed 38%.

If a company generates a $1.9 million revenue windfall from an unhedged Brazilian real position, this may be cause for celebration. In reality, however, the corporate executive might be wise to keep the champagne corked. Even in the best-case scenario, such a windfall would likely lead stakeholders to demand an even higher repeat performance in the future, spurring unachievable expectations. Conversely, an unanticipated $1.9 million currency-related loss would obviously not be well-received. So rather than ignoring this type of risk, the market has developed several tools to measure and offset foreign exchange-related exposure in the marketplace.

Hope is not a solid hedging plan. Every company could benefit from currency stability, but ignoring volatility is beyond treacherous—it is a quick way to lose your job. As shown with the Canadian dollar and the Brazilian real examples, all foreign exchange risks are not the same. A solid risk management approach recognizes that each currency pair has a unique relationship and should be assessed accordingly. No one knows with certainty where the currency markets are going to trade tomorrow, much less longer term. It is not uncommon for the projections of top-tier foreign exchange firms to vary by 20% or 30% when they project a currency's value 12 months into the future. Not only can projections be off by a considerable amount, they may not even uniformly predict that a currency will move in the same direction. In spite of such widely divergent views in the marketplace, forecasting and hedging are not futile efforts.

Given the uncertainty and volatility in the foreign exchange markets, the attention a company devotes to writing a solid risk management plan can become very important. Managing foreign exchange risk begins with an internal understanding, assessment and prioritization of exposures. Companies should not strive for short-cuts or a one-size-fits-all solution. At a basic level, the propensity to accept risk differs greatly among companies.

A good risk management philosophy is well aligned with a company's overall corporate culture and objectives. Some companies are willing to accept large, short-term accounting-related profit or loss swings in order to achieve a long-term economic outcome. Other companies are more interested in managing currency-related risks so that short-term gains and losses are minimized with respect to profit and loss reporting.

At a minimum, most companies want their foreign exchange risk management plans to address booked or known cash flows. These types of transactional exposures can include items such as payables, receivables and dividends. Beyond this concept,

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Icelandic Crisis to Spur Euro Spread?

After Iceland's economy collapsed due to the massive foreign debts it had incurred during a time of rapid expansion, trade in the country's currency effectively ceased in October. Soon after the economic failure, Iceland's government called it quits with the resignation of its entire ruling commission.

Now, with new leaders in place and a desperate need for financial stability, the country's new commerce minister has said the adoption of the euro as Iceland's currency would be a proper step toward much-needed economic strength. It is hoped that such a move would improve consumer confidence, which is at a record low. Iceland's new Prime Minister, Johanna Sigurdardottir, has supported joining the European Union and adopting the euro.

Iceland may not be the only country eyeing the euro. With the recent fall of Latvia's coalition government, the country would undoubtedly benefit from such a relatively stable currency and the domino effect it would have throughout its economy. Though the tiny Baltic country had plans to adopt the euro in 2012, the country may attempt to expedite the admission process as hope for the country's economic future hardly exists at present. The next step for Iceland and Latvia: meet the euro requirements—something that may be increasingly difficult with the rest of Eastern Europe reeling and many predicting a period of infighting among the major EU powers.

–Emily Holbrook

companies are concerned with protecting the annual budget rate. They want to hedge forecasted foreign cash flows to insure that there are no foreign exchange fluctuations from their budgeted U.S.-equivalent objectives. Others are also interested in protecting items that are more translational, such as their earnings from foreign subsidiaries and net investment in a foreign subsidiary. A philosophy could address hedging to protect, or even expand on, a company's global competitive position. In some instances, market share may take precedence over predictable revenue or cash flows.

Once a company has identified and prioritized international exposures, it can begin assessing which risks should be hedged. A basic step in this assessment is to internally "net" offsetting exposures. Companies both receiving and paying British pounds, for example, may be naturally offsetting their currency risk to some degree. Rather than depositing receivables into a pound-denominated account until the payable is due, the market has developed financing tools to help companies more efficiently manage these types of mismatches.

Companies who conduct international business between multiple foreign subsidiaries may be able to expand on the concept of netting by setting common exchange rates and value dates to settle all of these internal transactions. Commonly, companies will centralize this function in order to more efficiently capture these exposures. In most companies, internal netting can only be used for a portion of overall foreign exchange-related exposures. As companies look to the market to offset risks that cannot be netted, it becomes clear that hedging is more of an art form than an exact science.

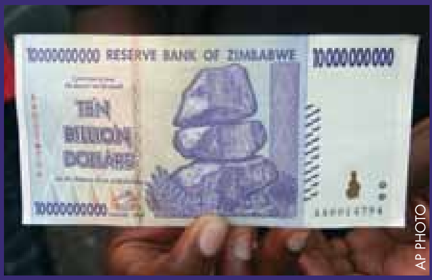
The market can help navigate and interpret the complex and shifting risk management canvas. An early step in the risk management process is to assess which exposures should be hedged. Rather than hedging all foreign exchange exposure greater than $1 million, a company may want to look at the risk profile associated with an individual exposure. In other words, $1 million exposure for 30 days between the U.S. dollar and the Hong Kong dollar has a materially different risk profile than $1 million exposure for 30 days between the U.S. dollar and the Brazilian real. If a company's intention is to limit unanticipated foreign exchange gains or losses to $100,000 or 10% (as an internal risk assessment) of the $1 million threshold, it may want to restate its policy to explicitly address the concern for risk that exceeds $100,000.

Using the market's assessment of volatility and a $100,000 risk tolerance, a company would not need to hedge its U.S. dollar vs. Hong Kong dollar 30-day exposure until it reached $400 million (0.5% volatility adjusted for negative outcomes) while their U.S. dollar vs. Brazil real 30-day exposure would need to be addressed at just over $800,000 (24% volatility adjusted for negative outcomes).

There may be many unique ways to look at these types of risk. Rather than building an internal volatility model, companies can turn to their

Hyperinflation Destroys the Zimbabwean Economy

On top of crippling political instability, increasing exodus of the population and a tragic cholera outbreak, hyperinflation of Zimbabwe's national currency has further eroded the quality of life in the country over the past 12 months. It is said to be the worst inflationary crisis since post-war Hungary experienced similar turmoil in 1946. For months, the value of the Zimbabwean dollar was falling by half every day, a mathematical devaluation that led some economists to estimate national inflation in February at 10 sextillion percent—otherwise known as 10 to the 21st power.



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The country had been devastated by three- to five-figure inflation rates for a number of years, but this final downward spiral resulted from a national monetary policy based upon printing more and more money. This move has proven to be the most disastrous in a series of fiscal mismanagements by long-time autocratic leader Robert Mugabe, whose refusal to accept electoral defeat and leave office in March 2008 ushered in the worst of the nation's economic catastrophe—along with a new era of internal violence, human rights abuses and health care crises.

Although a power-sharing agreement among Mugabe and political opponent Morgan Richard Tsvangirai in September of last year eased some of the most egregious political violence in Zimbabwe, the country's economic crisis has not been averted. The central bank's only response has been to print greater and greater currency denominations. At one point a Z$100 billion note that had been introduced just days earlier only had the purchasing power of three eggs. Not long after, a Z$100 trillion note entered circulation. Finally in February, after the national stock exchange had been shuttered for two full months, the central bank licensed the stock market to trade in foreign currency and allowed both companies and individuals to use foreign currencies, including both the U.S. dollar and the British pound.

–Jared Wade

financial partners for help in understanding what risk factors they may want to use in their internal analyses. While no model is infallible, most financial institutions can provide a solid methodology for assessing foreign exchange risk.

Once these structural steps are thought through, a good plan needs to address action items. For instance, which instruments will be used in the hedging program? Some exposures may be best offset with the absolute certainty and efficiency that a forward contract offers while other risks may be better offset with an instrument that offers more flexibility or even some optionality.

Along with permissable instruments, a good policy identifies who is authorized to enter into hedges, when the hedges should be initiated and with whom the trades can be done. Some policies allow for a predetermined degree of flexibility when deciding what and when to hedge. For example, a policy may require that 75% to 85% of an exposure be hedged no later than 48 hours after identifying the exposure. Alternatively, a policy may dictate that hedges are placed weekly, preferably on Monday morning. The policy should outline what degree of judgment is allowed by the person who will be placing the trades.

Companies should not neglect other internal controls such as who will authorize or approve trades and the frequency of reporting and monitoring of positions. At regular intervals, a policy should be reviewed and tweaked or updated. A company would be wise to outline a process for evaluation and modification of its plan.

The goals of a solid foreign exchange management strategy should be twofold: enable a more predictable and stable financial performance, and ensure no foreign exchange-related surprises will arise that would require unpleasant explanations. Aside from helping expose and address potential vulnerabilities, the exercise discussed here will establish a framework for the future. ■

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