

IN THE FACE OF DOUBLE-DIGIT CURRENCY MOVES, TREASURERS NEED TO UNDERSTAND WHICH RISK EXPOSURES MATTER MOST AND HOW TO EXECUTE A PLAN OF ACTION.

FX Risk Revisited

T&R: What has happened to currency markets in the wake of the financial crisis? **Kirschner:** With the rapid global meltdown of unprecedented proportion in late 2008, decades of relative stability in foreign exchange (FX) markets came to an abrupt end. In just two days in October, currencies like the Mexican peso and the Icelandic krona lost more than 20% of their value against the U.S. dollar. The krona snapped back more than 28% percent over the next two days before sliding into a 30-day decline that ended in its losing half its value in 2008. Over a 30-day period, the Canadian dollar lost 25% against the U.S. dollar before staging a 12% comeback



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one week later. In this new era, movements of 10%, 20% or 30% are no longer viewed as outliers. This type of volatility over short periods of time has become the norm.

T&R: So, then, why hedge?

Kirschner: Unexpected currency moves in the double digits can cause material profit and loss. Yet, how best to value risk going forward is a far greater challenge for treasury departments. Ignoring risk because it is simply too much trouble to understand may actually work at first.

Chances are 50-50 that a lack of strategy may actually pay off due to a favorable currency move. The trouble is that once this type of pay-off occurs, stakeholders are likely to budget for the windfall to be repeated, possibly even increased. Such expectations will ultimately create a very difficult and impractical situation. Conversely, a negative outcome (i.e., a FX-related loss) due to ignoring risk is more likely

to raise even broader concerns.

Measuring all FX risks with the same yardstick can be equally dangerous. An exposure of \$1 million U.S. dollars to the Canadian dollar with a 30-day payment horizon has a much different risk profile than an exposure of \$1 million U.S. dollars to the Mexican peso or the Argentine peso with a multi-year payment horizon. All currency-related risks are not interchangeable.

T&R: How to frame these risks?

Kirschner: No one actually knows where the currency markets are going to trade tomorrow, much less longer term. Often, top-tier firms' projections of a currency's value in 12 months will vary from 10% to 30% and these projections may not even uniformly predict movement in the same direction. A 30% variance between several trusted and able advisers can make budgeting difficult and frustrating.

T&R: How should multinationals cope with currency volatility?

Kirschner: Managing FX risk begins with an understanding of which risk exposures matter most. This can be clarified by applying the business strategy as well as company policies and philosophies.

Some place their primary focus on protecting the value of booked or known cash flows. For others, the primary focus may be on protecting a budgeted FX rate against currency fluctuations or how FX volatility impacts earnings from foreign subsidiaries. Some even have policies to protect net investment values in foreign subsidiaries. In some instances, market share may take precedence over predictable revenue or cash flows.

T&R: After understanding priorities, what's the next step?

Kirschner: Identify and understand the types of exposures and how changes in FX rates can alter booked or known cash flow exposures. For example, cross-border payables, receiv-

ables and dividends may all be exposed to volatility in the FX marketplace. The value of international investments or income can also be affected by changes in FX rates.

Any unbooked or unanticipated exposures should also be identified and ways to internally net offsetting positions should be identified. For example, a U.S. company is receiving a British pound payment stream over the next three months and has a like amount of British pound payables in six months may have an internal netting opportunity if it can place the British pound receipts in a pound-denominated account until its British pound payable is due. Without netting, the company would have sold pounds into the market upon receipt, and later purchased pounds from the market when its payable came due.

The currency market has developed a number of instruments to replicate this solution with off-balance-sheet derivative transactions. Often, internal netting can only be used for a portion of overall FX-related exposures. As companies look to the market to offset risks that cannot be netted hedging may become more of an art form than an exact science.

T&R: How should a company decide what to hedge?

Kirschner: A risk tolerance should be assessed that suits a company's culture. One company might require hedging all currency-related risk of more than \$1 million, while another, more than \$100,000 in risk. With no perfect predictor of future

exchange rates, companies must rely on historical data processed by sophisticated models to predict future scenarios, which help traders establish a market for volatility.

For instance, measuring the Canadian dollar's volatility against the U.S. dollar over a historical perspective may indicate that 95% of the time the Canadian dollar did not move more than 7% versus the U.S. dollar over a 90-day period. This would imply that \$1 million U.S. exposure to the Canadian dollar for the next 90 days should not result in a FX gain or loss of more than 7%, or \$70,000. If a company has established an internal risk tolerance of \$100,000, this exposure would not be hedged. The company would accept a 5% chance of an FX gain or loss of more than \$70,000.

However, the same type of analysis may also show that the Australian dollar's volatility against the U.S. dollar over the same period has been under 13%. This would imply that the

same \$1 million exposure to the Australian dollar over the next 90 days could result in a FX-related gain/loss of \$130,000. Unlike the Canadian dollar exposure, assuming a \$100,000 hedging policy, this risk would be hedged.

This gets more complicated with emerging markets currencies. The 90-day risk between the Brazil real and the U.S. dollar may approach 30%. Thus, a \$1 million exposure in Brazil would result in a \$350,000 FX risk. The tenor of the exposure is critical. Assuming the benchmark \$1 million exposure in Canada, but extending the tenor to one year, the risk increases from 7% (\$70,000) to 16% (or \$160,000). While a \$100,000-risk-policy would not require a company to hedge the \$1 million exposure to Canada with a 90-day horizon, the same exposure with a one-year horizon would be hedged. Both the currency pair and the tenor must be considered when determining risk.

Asking these additional questions can help create an action plan for hedging:

- **Who will execute the hedges?**
- **When will the hedges be initiated?**
- **What instruments should be used?**
- **What counterparty risk is acceptable?**
- **What is the internal management approval and oversight process?**
- **How frequently should these positions and exposures be monitored?**
- **How should internal controls be organized?**
- **Is the FX budget rate achievable?**