# A melting pot

WITH WILD VOLATILITY IN THE FOREIGN EXCHANGE (FX) MARKETS, TREASURERS AND CORPORATES NEED TO ADDRESS CURRENCY RISK.


## Executive summary

- This year has proved to be challenging for UK corporate treasurers with foreign exchange exposure a key and unexpected emerging risk. With currency movements likely to materially impact cashflow, passively relying on the notion that currency fluctuations will even themselves out in the long run could be dangerous. What is the cause of this volatility, can we expect more and what should corporates do?


**Adam Cole, head of global FX strategy, RBC Capital Markets**

I would cite two factors in particular as driving the spike in FX volatility toward the end of this year. Firstly, volatility is "migrating" to FX from other financial markets, in particular equities. Foreign exchange has always been a melting pot of influences from other asset markets and it was inevitable that the rise in asset market volatility associated with the financial crisis and its economic impact would ultimately flow to FX markets. Note that the volatility implied by currency options (typically around 20-30% in the majors currently), although historically high, remains well below that implied by equity options (currently astonishingly high at around 60%).

Secondly, this migration of volatility has recently been compounded by a drying up of liquidity in markets, whereby normally innocuous flows are having a disproportionate price impact. This reflects a general lack of tolerance for risk – be it market risk or counterparty risk – on the part of banks and other "liquidity providers" such as hedge funds.

There are some moderately encouraging signs that the worst of the spike in volatility may be behind us. However, it is likely to take months, if not years, for financial market volatility, including FX, to return to anything like "normal" levels. A return to the liquidity-fuelled stability in markets that prevailed through 2006 and the early part of 2007 is unlikely.

On the positive side, the extraordinary measures taken by governments and central banks in recent months, including unprecedented injections of short-term liquidity and the wholesale nationalisation of parts of the banking industry, are beginning to pay dividends in the form of falling risk spreads elsewhere. The spread of Libor (interbank) rates over central bank policy rates, for example, has been grinding lower since early October.

We can also take some encouragement from the fact that most currencies are close to "fairly valued" at current levels. Sharp movements in currencies in recent months have, by and large, been movements towards rather than away from long-term equilibrium levels, as measured by, for example, purchasing power parity. With little evidence at present of severe currency misalignment, the need for sharp movements in exchange rates going forward is diminished.

Any decline in FX volatility going forward looks set to be a very gradual process and markets are likely to continue to be characterised by sudden spikes in volatility reflecting periodic liquidity droughts.

We would always advocate a policy whereby corporates with significant exposure to currency movements actively budget for currency risk management. It should go without saying that in an environment of heightened volatility, risk budgets need to be increased.

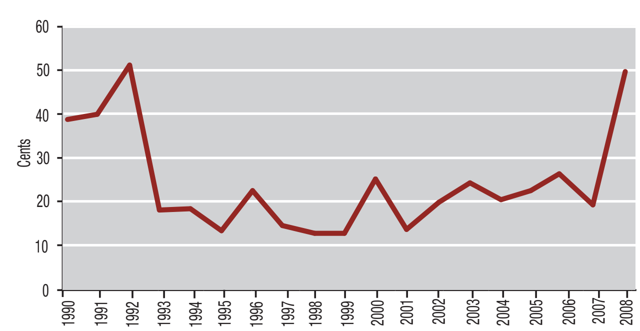
With currency movements likely to materially impact cashflow passively relying on the notion that currency movements will be "neutral in the long run" is an increasingly inappropriate policy. Active management of currency risk – be it through outright forward hedging or through options – is likely to be an increasingly important part of the corporate treasurer's role.

**Bob Munro, senior consultant, HiFX Financial Services**

For many UK corporate treasurers with foreign exchange exposure to the US dollar, this year has probably been the most challenging of their business careers. From a high of 2.04 in March, sterling has fallen a massive 25% against the greenback to 1.53, with one week in October seeing a 22 cent fall, equivalent to the average range for an entire year. This 51 cent roller-coaster ride, the largest since the 1992 ERM exit, represents a step change increase in the risk to companies' margins and bottom lines and no doubt has prompted more than one or two sleepless nights. And it's not just the importers who suffer. Exporters can find their over-zealous attempts to capture better rates on the way down can quickly leave them at a disadvantage if their competitors choose or fail to take forward cover.

For the record, and contrary to the doom-mongering UK press, it hasn't all been about sterling weakness, and as if we didn't need any more contradictions, the dollar strength has not been an unequivocal vote of confidence in either the dollar or the US economy. The phenomena we have witnessed as the sub-prime lending crisis has morphed into a credit-crunch, financial market melt-down and a stock market rout, is largely the result of panic selling of assets by investment funds, particularly the highly leveraged hedge funds. It's estimated that up to 75% of these funds are dollar based, if we include all the funds from Gulf oil states and the Far East, where the currencies are linked to the dollar. The stampede by these funds to liquidate assets, in response to a rush for the exit by their investors and the withdrawal of leverage by the battered banking sector, has led to a huge increase in the demand for dollars, swamping the normal ebbs

**Figure 1: GBP/USD annual range**



and flows. The increased volatility has, ironically, tempered the enthusiasm for speculating in the dollar, resulting in a markedly less liquid inter-bank market and exacerbating the instability.

The impact for an "importing" economy such as the UK is higher inflationary pressures. The soaring cost of goods priced in dollars will inevitably have to be passed on through the system and absorbed by either companies or the consumer. The good news for the consumer, and perhaps the Bank of England, is that the major high street retailers exert enormous pricing power over the "invisible hand" community of importing companies who supply the goods. The bad news for these importing companies is that they are caught between the rock of the big boys demanding lower prices to prop up their ailing sales, and the hard place of their supplies costing up to 25% more since the start of the year. In the light of the rapid economic slowdown, the bully boy tactics of the usual suspects is worthy of further examination but for now we will concentrate on what can be done to alleviate the importer's currency problem.

For any of these companies bearing the brunt of the foreign exchange risk, the key to lessening the impact is having a hedging strategy that is based on sound risk management principles and leans heavily on planning, structure and discipline. The key criteria are that the strategy should suit a company's underlying business model, taking into account sales lead times, budget rates, payment terms, pricing power and the competition. Only once all these factors have been taken into account can the company's hedging policy be formulated and action taken.

The cardinal sin is to do nothing, leaving profits completely exposed to the exchange rate risk. However, locking in what looked like favourable rates for an extended period, past your confirmed/anticipated order book and past your competitor's ability to re-price, is equally speculative and can be just as damaging to your underlying business. This is where the structure, amounts and periods, are crucial and where maintaining discipline in the face of fluctuating markets becomes more important.

Allowing for some flexibility, to take advantage of the constantly oscillating market rates, it is important to try to take the emotional element out of dealing in the markets by eliminating, as far as possible, the "fear and greed" mentality. Maintaining an agreed minimum level of cover at all times, sometimes despite the poor current rate, and taking advantage of improved rates, even when the Sunday papers are telling you it's going further, will stand you in good stead in the long term and take some of the stress out of managing foreign exchange risk. Corporate treasurers are often fairly isolated from their treasury peers outside the company, within their industry and even within their own company, and find dispassionate independent advice can help them identify and act at key moments when the foreign exchange markets are at their most bewildering.

Finally, while currency forecasting track records will vary between institutions, using the better ones may help in the long run to optimise a company's timing when it comes to initiating hedging deals. However, one guarantee is that all forecasters are certain to be wrong at some stage, and that slavish reliance upon any one forecast will end in tears. Using a balanced hedging strategy, that combines a prudent level of risk management, with flexibility to act, if the rates move favourably or sharply against the underlying trend, should help lessen the impact on the bottom line. Foreign exchange risk will never go away or be solved, but it can be managed.

**Piers Cracknell, commercial director for Moneycorp**

Management of currency risk is a very individual matter. There is no "one-size fits all" approach as no two companies are alike, each has its own exposures, attitude to risk and policies.

Active management of currency risk addresses significant needs: protection of the company against financial shocks, clearer sight of future cashflows, as well as confidence gained by the company's bank(s), shareholders, customers and employees.

The most common area addressed by companies is transactional exposure and much has been written about this subject. Consequently the growth of instruments available to manage this type of risk, the increasing use of multi-bank platforms at corporate level driving greater price transparency as well as the use of structured products has led to significant progress being made in addressing this issue.

However the more pressing issue for companies today is the declining value of sterling and the wider ramifications it brings. The rapid devaluation of sterling in recent weeks has focused company attention to assessing different types of financial risk they face, those risks being more systemic in nature such as overall company risk, industry risk and economic risk. The pound's 25% decline against the dollar in three months and all time low against the euro does not just impact on profitability, it can affect whole industries and wipe out entire companies. Companies who have hedged at higher levels will take little comfort from the fact that their booked rates may be better than present levels, effectively all they have bought is time. Such a significant shift cannot be ignored.

Risk identification is the essential first step to managing currency risk, before quantifying the risk, assessing the range of products available to use prior to hedge placement and finally monitoring of the hedge. For too many companies exchange rate risk management ends there and in today's environment it's simply not enough. Real stress testing is a necessity and the following questions should be considered:

What provisions do companies have in place for risk of ruin? What is the contingency for such an adverse shift in exchange rates? How can the company operate with a 30% positive or negative movement in the exchange rate?

The last point may seem a little extreme but volatility in FX has picked up significantly. Daily turnover is now at $3.2 trillion and growing. Once caused by a unique event, a 2 or 3 cent shift in a day is now much more common. Variance of forecasts has widened significantly, for instance, at the beginning of 2008 who would have forecasted a $1.50 – $2 cent range on GBP/USD? If they had, which view would the company have gone with? The average? The point is that now, more than ever, companies really need to run their business model using both extremes, to stress test the business, its systems and profitability by assessing how the business would look at both ends of the forecasted ranges.

The type of hedge product to use is also a point in question. The use of currency options and structured products at corporate level is likely to be under the spotlight. Option premium costs have picked up by virtue of the underlying volatility, but crucially the sheer range on GBP/USD in the last three months has meant that significance of "there's no such thing as a free lunch" will have come back to haunt many a company, particularly those products with a sting in the tail known as a "reverse knock in" or, worse still, a "knock out". Can an option structure with a "knock out" really be classed as a hedge, particularly if the rates move the wrong way and the company is left with no cover? That's the question that many company boards will be asking right now. There will be a shift back to basics, a move to more traditional forward hedging and vanilla premium payable options.

Managing currency risk should be part of daily commercial life for any sized company affected by exchange rate movement, whether directly or indirectly. In the current environment where companies' exchange rate policies are being stress tested, it's crucial to remain disciplined and stick to your objectives.