Kerius finance

Hedging currency risks can be simple and cheap !

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Managing currency risks does not mean that you should try to predict future exchange rates; it is precisely the opposite. A formalized risk management strategy is even more necessary since we do not know how currencies will fluctuate, or by how much !

Why some companies do not hedge their risks when they should

The volatility of exchange rates impacts negatively international business because it generates instability and lack of predictability of revenues, costs and therefore profit margins. Despite that, a lot of companies do not or only partially hedge their currency risks.

There are several reasons: some companies think that foreign exchange risk management would be too complex, expensive or require too much time. Others don't know enough about the instruments and hedging techniques, that gains and losses eventually offset each other over time making hedging useless, or even that hedging is a speculative action !

It is incorrect to say that hedging is expensive or complex: hedging can be simple if a customized policy is established beforehand, using simple products. Moreover, it is not necessary to know the exact payment amounts or collection dates in advance since appropriate management can easily solve this. Finally, foreign currency fluctuations may (but not necessarily) compensate each other over time, but the company's financial structure may not be able to accommodate a very strong, sudden adverse change?

The different types of currency risks you need to be aware of when setting up a risk management policy

- Operational risk related to current or future transactions, whose commercial terms can be multiple: tenders, framework contracts or firm orders, price indexations, payment methods and delays, etc.
- Financial risk, for instance linked to dividends and intercompany loans;
- Translation risk related to the conversion of statutory P&L and balance sheets into consolidated financial statements;
- Economic risk relating to the elasticity of sales to foreign currency fluctuations.

In addition, one must consider the **specificities of the countries and currencies involved, for example**: more or less volatile, transferable or convertible currencies, high or low interest rates impacting the forward rates, hedging instruments proposed by the banks.

It is possible to mitigate currency risks, applying appropriate hedging methods to :

- Minimize the effects of exchange rates fluctuations on earnings;
- Increase predictability of future cash flows;
- Facilitate the pricing of export and import;
- Temporarily protect competitiveness in a difficult environment and give time for managers to set up new solutions (price increase, reorganization or relocation of production or supplies, for example).

The inception of a formal currency risk management strategy is essential to achieve this success. Several steps are generally recommended.

First step: identify and quantify the currency risks to determine their impact and stake.

Second step: formalize a policy, i.e. define the hedging objectives, the practical modalities and the reporting needs (performance monitoring, regulatory or IFRS). These arrangements should consider the following :

- When the company should start hedging its risks and on which maturity: an important question since risk occurs before invoices are issued or received ! It is therefore important to accurately monitor the emergence of risks.
- Tools and instruments that may be used and under what circumstances;
- Responsibilities: decision, implementation, controls;
- How will the results of hedging transactions be measured ?

The third step consists of implementing cover according to the predefined policy at optimized market conditions so that the direct or indirect costs do not jeopardize the effectiveness of hedging.

The fourth step requires producing precise controlling reports to evaluate the effectiveness of this policy in offsetting risks on cash and on P&L.

On this basis, with simple principles and common sense, most companies could improve their currency risk management practices.

KERIUS Finance (Geneva - Paris) is an **independent advisory company** specializing in **treasury management and hedging of currency, interest rate and commodity** risks. www.kerius-finance.com – s.rouzaire@kerius-finance.com

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