TREASURY TRENDS

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Are exchange rates keeping you awake at night?

In any given year, on average, the NZD/USD will trade within a 20% range. The average annual range is similar for the AUD/USD. During the financial crisis in 2008, the annual ranges were closer to 40%. What this demonstrates, and what we all know, is that currencies move around. Sometimes a lot.

If your business has material exposures to the unpredictable fluctuations of exchange rates ("FX"), it pays to make sure that an appropriate risk management framework is in place to limit this variability or protect against adverse market moves. How would your business be impacted if, within the space of a year, input costs or overseas revenues changed by 40%?

Key points

- Material currency exposures should be managed to protect against volatility and adverse market moves.
- A robust FX policy will ensure Board expectations and management strategies are aligned.
- Keep It Simple Stupid.
- Accurate forecasting of exposures is essential for any risk management strategy.
- Regularly review your hedging strategy, including product mix.

The right risk management framework

An effective risk management approach starts with a robust FX hedging policy, formalising the broad parameters, controls and delegations within which FX exposures are to be managed. The policy ensures that expectations at the Board level are aligned to management's ongoing strategy approach. A policy should be fit for purpose, easy to read and understand, recognise the actual exposures the business faces, and be flexible enough to provide comfort throughout the business cycle. It's no use having a policy that was filed away 15 years ago by someone who has since left the company. Nor is it any use having a policy that is never referred to, or is impractical to implement or measure against. Further still, it's no use pursuing a hedging strategy with no policy limitations. The policy and the strategy should work in harmony; one sets out the framework; the other is the execution within that framework.

An FX hedging policy can be a standalone document or sit within the wider treasury policy. It should set out the hedging objectives, clearly identify the business' FX exposures and the hedging parameters. It should also confirm who is responsible for what, which hedging products can be used, what management reports should be produced and how historical performance can be benchmarked.

Why hedge?

What are the objectives, and risk appetite, of the organisation? These should be the first questions asked when the policy is being developed. In most instances it is impractical to completely eliminate all exposures to FX movements, but conversely, most organisations will want some level of protection where a material FX exposure exists. A healthy dose of art and science will often be used when deciding hedging policy parameters, with industry norms, repricing ability, forecasting accuracy, company culture and the nature of the underlying FX exposures, all playing a part.

Take, for instance, these two scenarios: The first is an agricultural export company that has a policy which allows some flexibility, with between 75% and 100% of the expected seasonal sales hedged at any point in time. This allows management some discretion in hedging strategy, depending on the level of the currency, the outlook, and how the season is looking. This company is constantly active in the market but it can tailor the amount and type of hedging product as part of its strategy. The second company leases airplanes and has a much longer term hedging profile to match known payment commitments stretching over a number of years. These hedges are entered into at the point that the payment obligations are contracted and are unlikely to be changed for a number of years.

In both cases, the policies were written with the specific business model and exposure profile in mind. A common approach is to split the hedging horizon (say, next 12 months), into time buckets, with required hedging levels increasing for nearer time buckets, i.e., the 0-3 months bucket must have hedging between 70% and 100% whereas the last bucket might have 0% to 50% allowed. Again, having a range allows some flexibility

(Continued on page 2)

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in strategy and recognises that exposure forecasts will likely change in time.

Know your exposures

Accurate forecasting of exposures is essential for any risk management strategy. This is easier said than done. However, any hedging based on future expected exposures could leave the business dangerously over/under hedged if forecasts are not accurate. Where possible, natural hedges can be utilised as a way of reducing exposures and the need to hedge, whilst also reducing the cost of hedging.

Regular monitoring is key if a strategy is going to be successful but conversely, the need for constant tinkering should also be avoided. Spending a bit of time on a monthly basis should be sufficient to confirm exposure levels and set an appropriate hedging strategy for the month.

It also pays to set out a benchmark against which performance will be measured. This could simply be the mid-point of the hedging policy parameters. Monthly reporting of exposures and benchmarks is also a good way of maintaining transparency. It will also provide a basis for regular reviews of performance, strategy, and forecasts, which could be updated, or amended, if these are proving inconsistent.

The hedging toolkit: What instruments to use

When choosing a risk management product, stick to the basics. Forward exchange contracts are by far the most prevalent hedging product in this part of the world. Generally, forward exchange contracts, vanilla options and collars, will do the job well. The key is risk mitigation, and making sure that there is protection, regardless of market outcome. Too often, we have seen people sold into the idea of exotic products (knock-ins, knock-outs, double-no-touch, barrier options, dynamic ratio forward extra options), which have the habit of disappearing when you need them most, or, providing a hedging outcome unknown until maturity. In simple terms — if you can't explain it to your board, don't use it.

As market conditions change, so can the hedging strategy. NZD/USD and AUD/USD 12 month forward points have turned positive recently, which reverses the last few decades of pain for importers. Conversely, exporters now have to contend with locking in forward rates above the current spot rate. Volatility is also historically low at the moment, which can make vanilla option strategies a relatively compelling proposition.

Keeping an eye on market movements and levels can also pay dividends. FX markets are open 24 hours and are often more volatile during offshore trading sessions. Placing orders can be a good way of taking advantage of overnight volatility. Knowing where support/resistance levels are, helps in knowing where to place orders, with markets often retesting familiar levels. It is fine having a view (everyone has one) but also have a 'plan B' for when that view proves wrong.

Be forward looking

Good FX management will be forward looking and will provide time for favourable market moves to be targeted, rather than being caught short and forced to transact at unpalatable levels.

Making sure your bank or deal provider is not pulling the wool over your eyes is also a key risk management requirement. Bank spreads can slip, so it pays to deal with two providers to maintain some competitive tension, or to get an independent quote on larger transactions. Operational procedures should also be documented, and well understood, to ensure that any transaction errors are identified and rectified in a timely manner.

FX hedging is all about reducing uncertainty and starts with a good FX hedging policy. Accurate forecasting, the hedging product mix, regular monitoring (and a good advisor!) are all elements that will help you navigate the turbulent FX markets and make a hedging strategy successful.

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