Treasury Trends

ISSUE 435 — JULY 2021

www.bancorp.co.nz www.barringtontreasury.com

Successfully managing foreign exchange risk

Events of the last 18 months have reinforced the benefits of a consistently applied, tailored Foreign Exchange ("FX") risk management policy which focuses on the 'medium-term' (6-24 months forward) outlook. This article takes a fresh look at the steps involved to successfully manage FX risks.

Key Points

- Having an FX risk management policy provides some rules and disciplines around how FX risks are managed and by whom
- The policy has to be aligned to a business' own objectives and nature of the risks they face
- Stress testing adds value for some
- The policy has to be a living document
- Have a plan and consistently and regularly apply it

Why have an FX risk management policy?

First and foremost, the purpose of an FX risk management policy is to assist in **managing areas outside of a business' control so it can focus on areas within its core control.** In doing so, the goals and objectives of an FX risk management policy should include reducing the volatility of financial performance (from month to month and year to year) due to movements in FX rates, hence deriving greater certainty of financial results. Improved profitability on average should be a desired and achievable outcome from proactive and thoughtful FX risk management. Having an FX risk management policy provides some rules and disciplines around how FX risks are managed and by whom.

How do we determine an FX risk management policy?

An FX risk management policy is specific to each business and should not be a simple 'copy & paste' of another organisation's policy. The policy is determined by the business' own objectives, level of risk tolerance, the specific FX exposures being managed and the sensitivity of business performance to those risks.

When designing an FX risk management policy there are at least four key criteria commonly referenced to help determine this:

- Whether there are any reliable, **naturally occurring risk offsets** (such as offsetting movements in commodity selling prices) which can mitigate the impact from adverse movements in foreign exchange rates. However, any apparent relationship between a stronger currency value and higher commodity selling prices is unlikely to reliably hold all of the time.
- Whether the organisation has **product pricing power,** and if so, what is the time lag around being able to implement price increases. A business with an ability to pass on the impact of adverse FX rate movements to customers through higher prices indicates an ability to potentially be less hedged and/or for a shorter time period. A business that needs more time to adjust costs and/or selling prices requires a more stringent hedging policy to allow for such risks to be protected for longer.
- **Customer payment terms of trade** including the length of time between when sales are invoiced and funds received; a business may typically desire close to 100% certainty around confirmed amounts over the immediate months ahead. However, note that the FX risk typically starts well before product is invoiced.
- Knowledge of competitors' **FX hedging policies** and whether the business chooses to be closely aligned with these or makes a conscious decision to be different.

How do we test whether the proposed FX risk management policy is actually suitable?

Once the business and economic rationale have been determined for the preferred FX risk management policy this will typically be

(Continued on page 2)

stress tested using financial simulation models to confirm the likelihood of the policy achieving expected goals and objectives.

- The recommended policy may be tested against a range of other candidate FX risk management policies, including competitors, if these can be estimated. In total there can be a comparison of approximately 6-8 different hedging policies.
- Financial stress testing is typically conducted with financial modelling over a back test period where performance of the recommended policy is compared to other policy variants across actual history.
- While the back test provides useful information to relative policy performance should history repeat, it also needs to be ensured that the recommended FX policy caters well in all weathers of future potential FX rate movements and scenarios. Accordingly, a number of **hypothetical forward looking scenarios** will also typically be selected to assess policy performance across different foreign exchange rate environments.
- The objective is to confirm an FX policy that minimises volatility of performance and for an exporter provides a lower FX rate achieved on average. For an importer the objective is to deliver a higher FX rate achieved on average. The combination described will contribute to financial stability (greater certainty and reduced volatility of profits) and support overall financial performance (greater profitability on average).

How is an FX risk management policy used?

Once an appropriate FX risk management policy has been approved by the organisation's Board of Directors, factors assisting ongoing successful implementation include the following:-

- Management of FX risks should be implemented by frequent and regular 'small decisions' around entering hedging, rather than infrequent large decisions. Over reliance on the latter often leads to desired hedging amounts not being put in place as FX markets move away from the rates being targeted.
- The approved FX risk management policy will typically allow a level of management discretion between minimum and maximum hedging percentages over different time periods.
- A market 'view' of future FX rate movements and outcomes can be accommodated within the FX hedging strategy, but the strategy itself is not solely reliant on the outcomes of future FX rate movements.
- Some choice across simple hedging instruments provides ability to incorporate an FX market outlook into the strategy while ensuring effective management of the risk at all times.

The overall emphasis of FX risk management is being forward looking and proactive and mitigating the potential to be forced to make sub-optimal decisions in the future, and/or 'quickly'. Regularly reviewing information on FX exposure forecasts (with other parts of the business) is a critical and key practical input to effectively manage FX risks.

What does success from a good FX risk management policy look like?

Ultimately, success is measured by the FX risks being efficiently and effectively managed in a way that does not adversely impinge on other parts of the business. Criteria that can be specifically measured around the performance of the FX policy include:

- Export receipts being supported, procurement costs controlled and profitability protected and supported.
- Variability of profits from one period to the next being reduced, assisting certainty of business financial performance and generating additional shareholder wealth.

In short, having a considered, developed plan and implementing it consistently.

Is it time to benchmark your FX risk management policy and performance?

This document has been prepared by Bancorp Treasury Services Limited ("BTSL") and Barrington Treasury Services Pty Limited ("Barrington"). Whilst all reasonable care has been taken to ensure the facts stated are accurate and the opinions given are fair and reasonable, neither BTSL, Barrington, nor any of their directors, officers or employees shall in any way be responsible for the contents. No liability is assumed by BTSL or Barrington, their directors, officers or employees for action taken or not taken on the basis of this document. ACN 46 050 931 541 Operating under AFSL Licence No. 244594.

WHERE WE AND OUR PARTNERS OPERATE

BANCORP TREASURY & BARRINGTON TREASURY NZ
Phone +64 9 912 7600
AUCKLAND
WELLINGTON
CHRISTCHURCH

BARRINGTON TREASURY
Phone 1800 425 079
SYDNEY
MELBOURNE
BRISBANE
SUNSHINE COAST
PERTH
ADELAIDE

BARRINGTON ASSET CONSULTING
Phone 1800 425 079
SYDNEY

PMC TREASURY
Phone +64 9 912 7600
LONDON
NEW YORK
SINGAPORE

BANCORP
BANCORP TREASURY SERVICES LIMITED

Barrington
TREASURY SERVICES

Barrington
ASSET CONSULTING

BANCORP
BANCORP CORPORATE FINANCE LIMITED