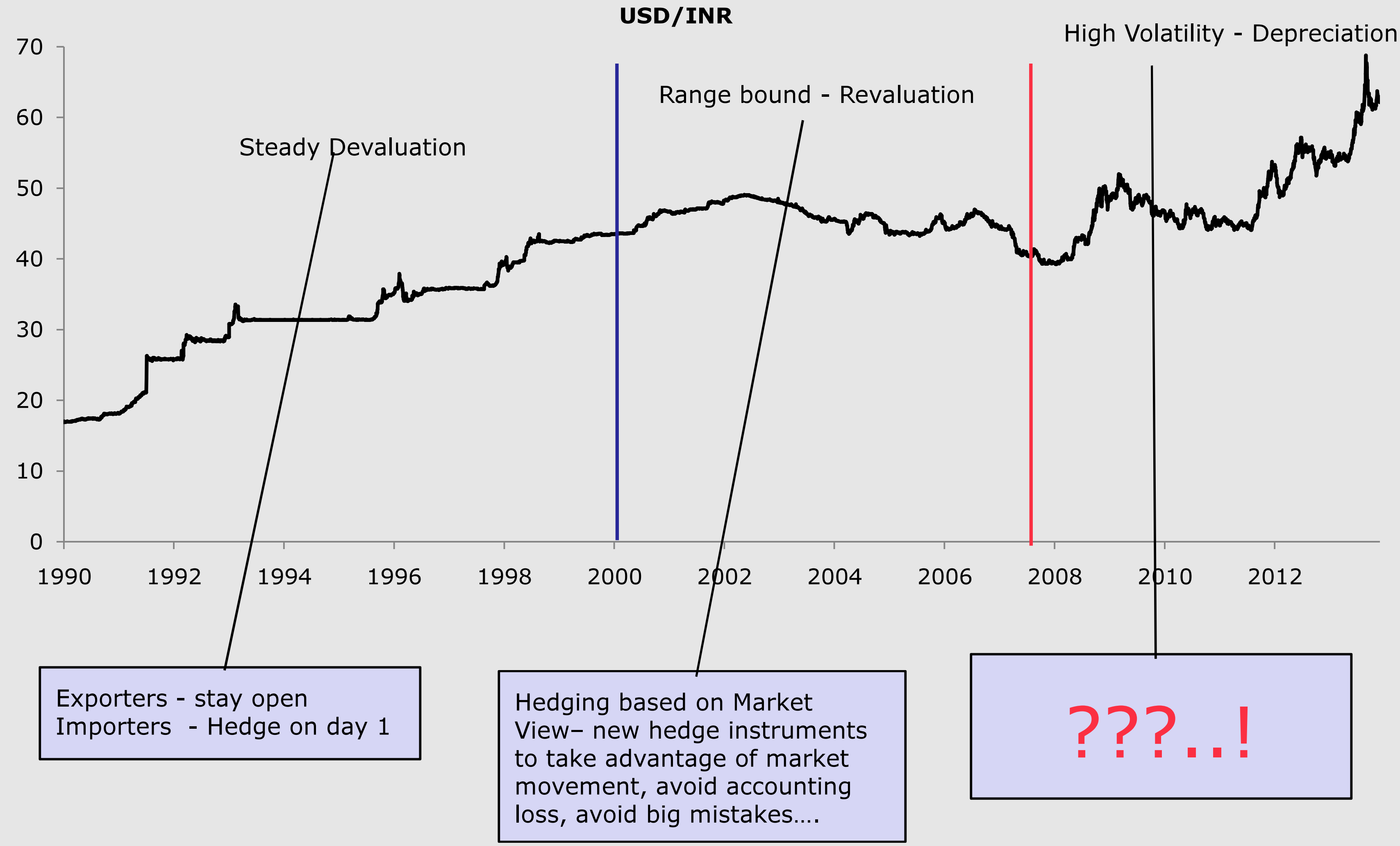
# FX Risk Management- a guide to Financial Management

**December 2013**

# Agenda

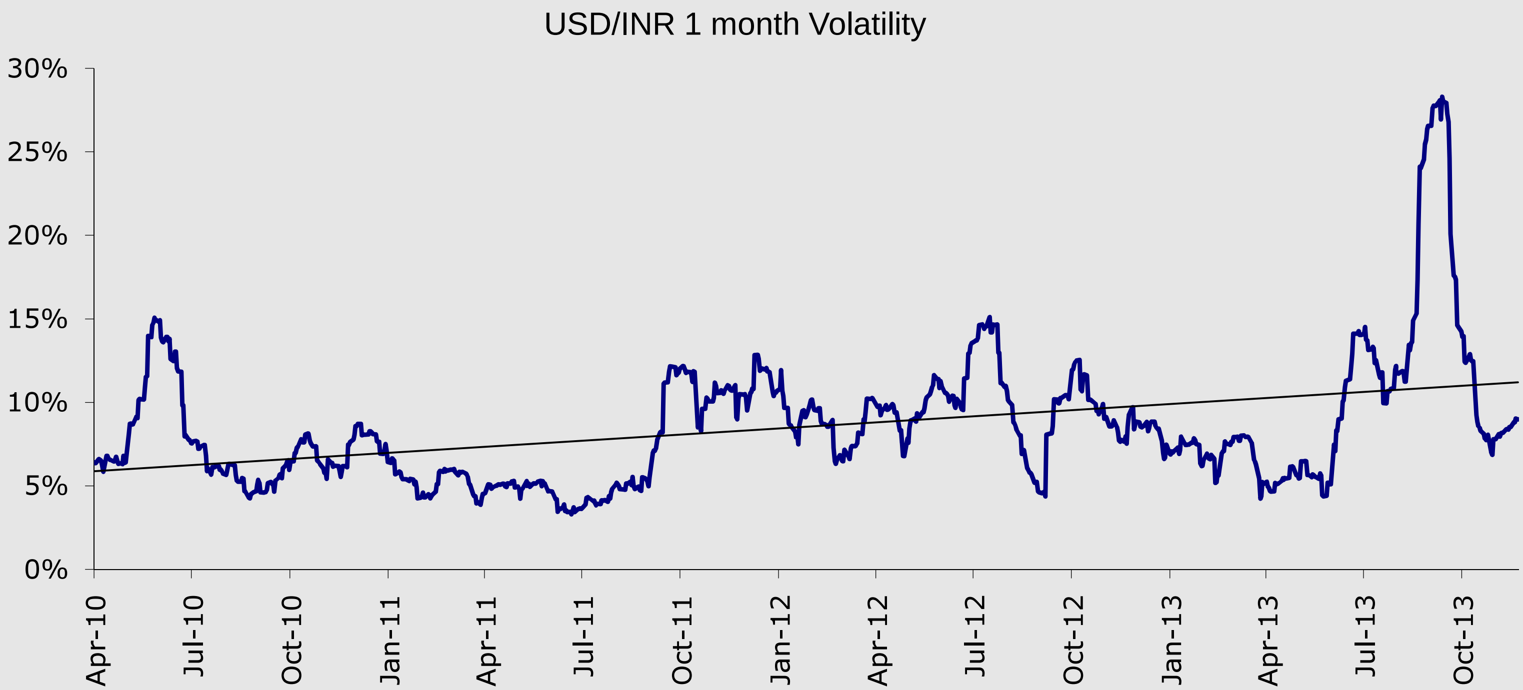
- Historical approach to FX risk
- Volatility -New Reality
- High volatility – Impact on financial management and planning
- Traditional risk management approaches – pros and cons
- The ideal approach to FX risk management

# Historical Approach to FX Risk




Mecklai Financial
WHERE RISK MEETS ITS MATCH
AN ISO/IEC 27001:2005 COMPANY

# FX Risk : The New Reality




High Volatility

*Erodes* business value and profits- thereby jeopardizing the key objectives of financial planning i.e. wealth and profit maximization

Mecklai Financial
WHERE RISK MEETS ITS MATCH
AN ISO/IEC 27001:2005 COMPANY

# High Volatility-Impact on Financial Management and Planning

## Impact on Business front

- Volatility can erode business profitability
- Huge FX losses can take years to recoup
- Pricing and Costing decisions are very difficult to make
- Accounting impact gets accentuated

## Treasury pitfalls

- High volatility means high cost of hedging
- Expected to protect risk AND capture opportunity
- Knee-jerk reactions and wrong decisions are frequent
- Inability to take quick decisions can worsen the problem

# Traditional Risk Management Approaches
## Pros & Cons

| Max/min Fixed Hedge Ratio | Hedge on BL or Invoice Date | Discretionary Hedge Strategy |
| --- | --- | --- |
| Hedge a minimum fixed ratio (e.g. 50%) of the exposure | Hedging on accounting date | Hedging as per market view |
| ▪ Reduces the amount of open exposure<br>▪ Static Approach: not aligned to market volatility<br>▪ Exposed to market risk on open exposure | ▪ Avoids FX gain/loss in the accounts<br>▪ Not aligned to business contracts, pricing, co sting<br>▪ Inadequate protection against Economic/Cash loss | ▪ Optimal Strategy if views are correct<br>▪ Heavy reliance solely on market views<br>▪ Requires significant commitment of management time & effort |

Mecklai Financial
WHERE RISK MEETS ITS MATCH
AN ISO/IEC 27001:2005 COMPANY

# The Ideal approach to FX Risk Management
## From Business to Markets

Focus on the business and its risk footprint FIRST; and THEN develop hedge strategies aligned to business.

Step I – Risk Identification

When to Identify the exposure – Based on estimates, on contract or on accounting date. This depends on,

- contractual relationship with customer and suppliers
- Pass-through mechanism, industry standards
- Business certainty etc.

*Our Recommendation*

- Identify the risk as early as possible (striking a balance between how much in advance you can estimate and how accurately you can estimate) but latest when risk starts
- Do not wait till accounting date, always consider the famous dictum – *Cash is real ; profits are an opinion*

# The Ideal approach to FX Risk Management
## From Business to Markets

Step II – Risk Measurement

Benchmark rate should be defined for each exposure. This rate is outcome of the risk appetite, which depends on

- Annual budget rate
- Rate assumed for costing/ pricing
- Forward rate when risk starts
- Worst case rate acceptable to business

*Our Recommendation*

- The prevailing market rate (at the time of risk identification) should be adjusted with some margin for arriving at benchmark rate
- Margin should be decided based on the risk appetite.

# The Ideal approach to FX Risk Management
## From Business to Markets

Step III- Risk Monitoring

- Each exposure should be monitored with respect to market rate and its benchmark rate
- Exposures should be monitored on daily or on real time basis if required
- Automated monitoring system is recommended – level of automation based on the volume and complexity

*Our Recommendation*

- Along with benchmark rate, you should also compare the pre-decided 'Lock- in' levels (rate in favorable market movement) with prevailing market rate.

# What is an Ideal Hedging Strategy

Once the conceptual process is in place, we can decide the hedge strategy in detail ( which should be reviewed and revised periodically).

**Requirements**

- Protect the benchmark rate at all times
- Forwards and paid options as only hedge instruments
- Avoid hedging all exposure at a single rate/time
- Take advantage of favorable market conditions

**Hedge Strategy should provide for these hedge incidences**

**Initial Hedge**: Reduce exposure and protect from sudden movement in the market

**Protective Hedge**: Protect the Benchmark rate in adverse market condition

**Lock-in-Hedge**: To take advantage of favorable market condition

**Discretionary Hedge** : To take hedge based on market view and optimize the realization

## Easier said than done....
**is it?..not really**

| Give Preference to | What to avoid |
| --- | --- |
| Discipline | Market View |
| Policy /Rules | Greed/Hope/Fear |
| Making money from business | Trying to make money from FX market |

# Who is Mecklai

| | |
|---|---|
| **Undivided Focus** | We are a consulting company (HQ in Mumbai, India) **exclusively focused on risk management**; we have been in business for **over 30 years** |
| **Integrated Services** | We engage at all levels **from Board to Back-Office**, offering a full suite of services, ranging from **deep-dive consulting assignments to ongoing advisory**. |
| **Market Presence** | **Over 2000 corporate relationships**, nearly half of which have been in place for over a decade.<br><br>50 of the top 500 'India's Finest Companies' (ranked by Financial Express, February 2010) have benefited from our consultancy/ advisory services |

# Thank You!

Mecklai Financial
WHERE RISK MEETS ITS MATCH
AN ISO/IEC 27001:2005 COMPANY