FOREX RISK MANAGEMENT FOR CORPORATIONS

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INTRODUCTION TO CORPORATE FOREX RISK MANAGEMENT

When it comes to currencies, the process of hedging a foreign currency exposure means taking a position in the forex market that fully or partially offsets the risk inherent in the original exposure. This sort of forex trading is considered prudent currency risk management by a corporation rather than speculation.

International corporations that do business in foreign counties or with foreign companies often have significant forex exposures that they typically manage with a variety of well-established currency hedging techniques.

Why is this sort of forex hedging so commonly performed by large corporations? Well, such corporations tend to perform best if they focus their business efforts on taking risks in areas that they have developed considerable expertise and experience operating in. Following this strategy tends to improve their overall bottom line over the long run.

For example, a company like Microsoft would typically focus on taking risks in the technology sector, while General Motors would focus on taking risks in producing vehicles for consumers, and K-Mart Corporation would focus on taking risks in the retailing of goods.

In contrast, financial risks are typically best taken by companies that specialize in doing so, such as commercial and investment banks, financial trading corporations, and fund management companies.

Foreign exchange risk is an important financial risk factor for just about any corporation that does a significant amount of business in foreign counties. While such currency risks can and should be minimized by appropriate corporate structuring and planning, they can still occur during the course of doing business and generally require active management by the corporate treasury to mitigate these risks by hedging them appropriately.

COMMON TYPES OF CORPORATE FOREX EXPOSURES

A variety of different types of forex exposure can present themselves to the manager of a large multinational corporation that each requires a custom hedging program in order to manage the currency risk most appropriately.

Once the amount, currency and timing of the forex exposure have been determined, the next thing that should be assessed about the exposure is its certainty of occurring. This will help a corporate risk manager decide between using a committed hedging product like a forex forward or futures contract for a known currency exposure versus using a non-committed hedging product like a purchased option contract for a contingent exposure.

The following sections cover the three primary types of forex exposure that corporations may find themselves faced with.

Transactional or Contractual Exposures:

Perhaps the most basic type of forex exposure faced by corporations is the transactional exposure, which generally arises due to an actual transaction that will take place in the future involving a foreign currency.

Transactional exposures typically occur when making payment for or receiving payment for goods or services from foreign providers. They can also develop when receiving or paying dividends, when paying interest or principal on foreign debts, and when receiving interest or principal payments on foreign deposits or investments.

For example, a U.S. based company might have agreed to purchase $1,000,000 in raw materials from an Australian company that will be produced and delivered in three months' time and that they will need to pay for in Australian Dollars upon delivery. To hedge this transactional exposure, the corporation's forex risk manager could use a three month forward contract where they purchase Australian Dollars and sell $1,000,000 U.S. Dollars for delivery in three months' time.

COMMON TYPES OF CORPORATE FOREX EXPOSURES

Once the time comes for them to deliver the Australian Dollars to the raw materials supplier, they can then deliver the Australian Dollars that they received from this forward contract. This sort of transactional hedge effectively prevents any forex market movements from adversely affecting the price of the supplies being purchased from an overseas company in U.S. Dollar terms.

Furthermore, sometimes the contract governing the transaction has a currency clause contained in it that gives the corporate hedger a different or more complex type of forex exposure than a simple requirement to pay or receive foreign currency. Forex options can often be used appropriately to protect against the forex market risks such currency clauses can result in. This is especially true if the contract is contingent in nature because it has been offered to another party but has not yet been signed.

Translation or Accounting Exposures:

Another common forex market exposure faced by large corporations with foreign subsidiaries is known as translation or accounting exposure. This occurs due to the requirement to translate the sums in the accounting books in the foreign currency of the subsidiary into the home currency of the parent company.

This translation is typically done in order to report the results of the accounting books to shareholders in the form of the company's published financial statements or to its home country tax agency for tax reporting purposes.

Although the profits or losses that come from translation exposure are mainly significant for the company's reporting requirements, some major companies routinely hedge this sort of forex exposure, while others prefer to ignore it entirely.

COMMON TYPES OF CORPORATE FOREX EXPOSURES

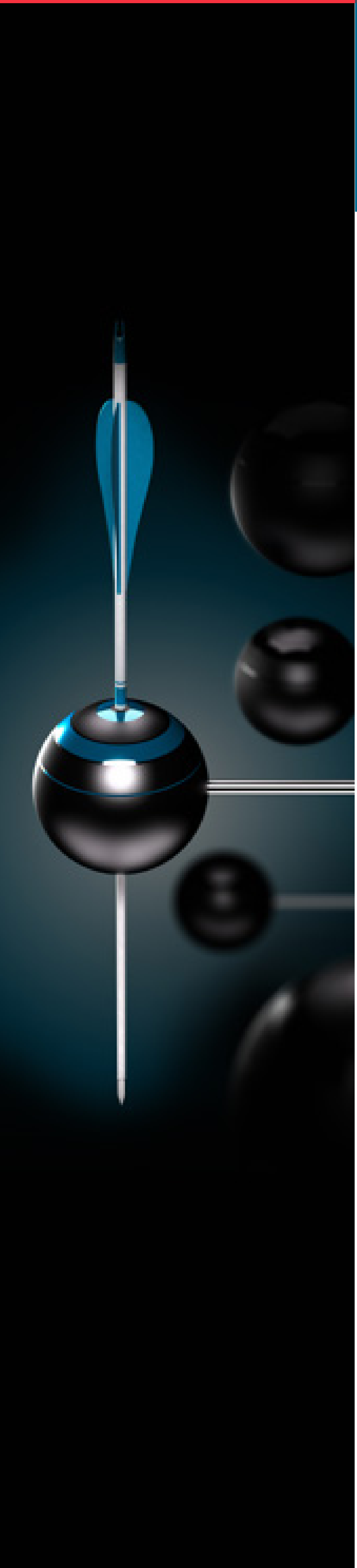
Because an actual foreign currency transaction of translated profits or losses is rarely involved in accounting exposures — and the amounts of the exposures are not always known in advance since subsidiary profits and losses can differ significantly from the amounts budgeted for — purchased currency option contracts are often used to hedge this common sort of corporate forex risk due to its contingent nature.
For example, a major U.S. based company with a subsidiary in the United Kingdom expects that subsidiary to show a net profit of GBP 1,000,000 over the coming year, which needs to be translated into U.S. Dollars in order to be properly reported to the company's shareholders and to the Internal Revenue Service. To protect the company against an anticipated decline in the Pound Sterling over the year, the corporate forex risk manager might purchase a one year Pound Sterling Put/U.S. Dollar call option with a strike price near the current spot market that will help to offset any accounting losses should the Pound decline.

Economic or Operating Exposures:

Perhaps the most complex type of forex exposure to accurately assess is the economic or operating exposure faced by a corporation. Despite the complexity involved, the impact of this type of forex risk to a company's bottom line and to its overall corporate value can be considerably higher than either of the aforementioned types of transaction or translation risks.

An economic forex exposure can have a direct impact on a company's value that is determined by its operating cash flows, i.e. its net income or losses, and the assets and liabilities it has. As a result, the value of the entire business with an economic currency exposure can be influenced significantly by one or more foreign exchange rates.

When those exchange rates fluctuate in the forex market, the domestic currency value of the company's foreign assets, liabilities and operating cash flows also fluctuates. Furthermore, while a company's foreign asset and liability exposure is relatively quantifiable, the operating cash flow exposure can affect the company's competitiveness in overseas markets, which can be considerably more difficult to quantify accurately.



CHOOSING APPROPRIATE FOREX HEDGES

The corporate forex risk manager has a number of well-established risk management products to choose from to protect their company against foreign currency exposures.

Forex Forward Contracts:

These are agreements between the corporation and a financial institution to exchange a particular amount of one currency for another at a particular date in the future and at a given rate of exchange. They are best used to hedge transactional exposures that are known in terms of their amount and transaction date.

Currency Futures:

These are public exchange traded contracts to exchange a given amount of one currency for another, and are used in much the same way as forex forward contracts, although the delivery dates of such contracts is not as flexible as with forwards. The most popular types of currency futures contracts trade actively on the Chicago Mercantile Exchange in amounts sufficient to hedge most corporate currency exposures.

Currency Options:

Both over the counter and exchange traded currency options are available that provide the purchaser with the right but not the obligation to purchase one currency and sell another at a particular exchange rate at some date in the future. Buying currency options can be used to hedge a contingent exposure like an accounting exposure, while currency options can also be used in popular combinations like the range forward to allow the corporation to express a forex market view for a known transactional exposure.

Foreign Borrowing:

Another method for a corporation to structure their business in such a way as to reduce their overall forex exposure is to determine which currencies they tend to be receiving, and then organize their borrowing activities to be in debt instruments denominated in those same currencies.

ASSESSING CORPORATE FOREX RISKS

Before a corporate treasury manager can begin to hedge their company's foreign exchange risks, they first need to know how to recognize them and determine what amounts they exist in.

Although customized corporate forex risk management systems may exist, a simple and widely available tool that can be used to begin assessing and computing your company's currency risk immediately is a spreadsheet program like Microsoft Excel .

The first step would be to make a column for each currency containing all of the long or short exposures to that currency you are currently aware of along, with what date they are associated with, if known, and a brief description.

The next step would involve seeing if any exposures might offset each other so that you can hedge them internally.

Next, those exposures that have no offset and are known, as opposed to contingent, can be hedged with forex forward contracts or with zero cost currency option combinations that allow you to express a market view on that currency versus your domestic currency.

Contingent forex exposures can usually best be hedged with purchased currency options, especially if the amount to be hedged is significantly in question or if the exposure may not materialize at all.

CORPORATE FOREX RISK MANAGEMENT TOOLS

Most large corporations that have significant foreign exchange risks would be wise to invest in some forex risk management tools to assist them in assessing their risk at short notice and researching each of the currency markets that their company has a significant exposure to.

First of all, the company could invest in either creating an in house currency position monitoring system tailored to their own specific needs or buying one designed especially for corporate hedgers.

Secondly, they should strongly consider obtaining a forex pricing and trade execution system, which is often called a forex trading platform. Some of these, such as Metatrader 4, are available free of charge from online forex brokers that support them and from their developers' websites.

When it comes to analyzing the market, a professional quality forex news feed can assist with your fundamental analysis, while a charting and technical analysis system can allow you to perform your own technical forex analysis for the currency pairs your company is exposed to.

MANAGING CORPORATE FOREX TRADING ACTIVITIES

A final warning regarding the need of corporate management to oversee the forex trading activities of its corporate treasury department seems advisable. In the past, a number of unmonitored corporate forex trading situations have resulted in unexpected and severe losses for companies that have adversely affected their bottom lines.

Those managers responsible for overseeing a corporate treasury's trading activities should be clear about the performance standards, trading limits and accountability expected of personnel responsible for executing forex transactions.

In addition to controlling trading position sizes as a form of risk management, they must also be prepared to manage counterparty credit risks and back office risks.

Finally, all net forex positions taken by the treasury department should be marked to market on a daily basis using a means of independent valuation and presented to the manager overseeing the department so that any unanticipated trading losses can be nipped in the bud.

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A FOREX MARKET OVERVIEW

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