Treasurers urged to hedge FX risks amid volatility uptick

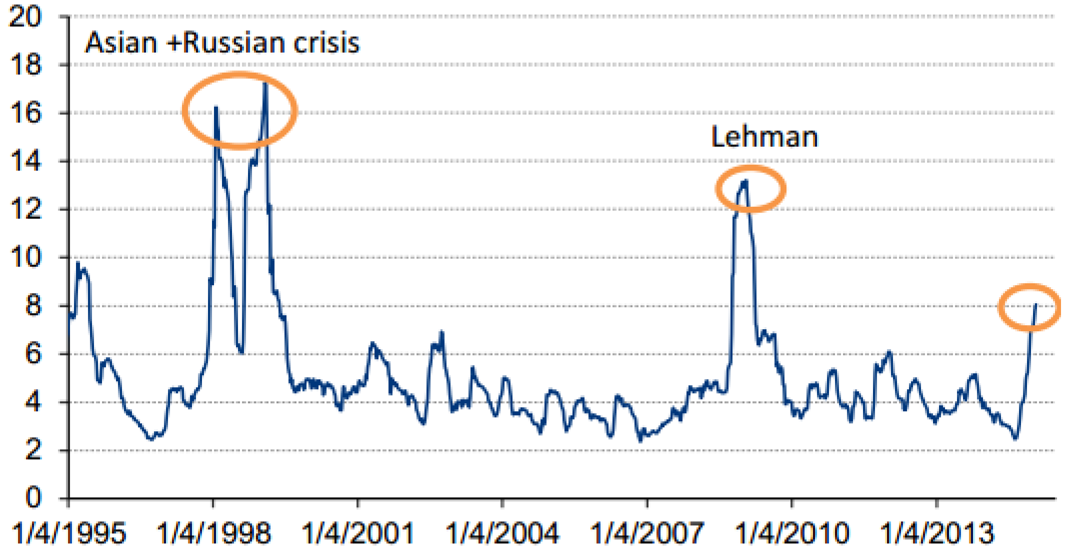
by **Paul Golden**

For corporate treasurers, currency volatility is heightening the importance of updating FX hedging policies, amid rising costs.

In a client report issued earlier this month, David Woo, head of global rates and currencies research at Bank of America Merrill Lynch, referred to a growing consensus in the market that an unspoken **currency war** has broken out, which would make it more expensive for companies to take out insurance against currency flows.

According to Woo and fellow Bank of America Merrill Lynch strategist Vadim Iaralov, **FX volatility** is at its highest non-crisis level for 20 years.

Chart 5: GDP-weighted range-based FX volatility



Source: BofA Merrill Lynch Global Research

David Blair, an independent treasury consultant based in Singapore, suggests many **corporate treasurers** will not yet have acted on recent volatility.

Chart 6: EUR/USD 3m implied vol

Source: BofA Merrill Lynch Global Research

"It generally takes them a while to change hedging policies, so I doubt if this year's heightened volatility has yet materially affected corporate hedging behaviour," he says.

This is despite evidence that acting quickly can bring rewards.

Honeywell International has recorded higher-than-expected earnings since it decided to resume a hedging strategy late last year, while currency hedges have helped Apple to guide revenue growth of up to 20% this quarter, according to the company's chief financial officer.

Rando Bruns, head of group treasury at pharmaceutical company Merck, says currency volatility is affecting the company, although the overall effect so far has been positive.

"We are long in all currencies apart from EUR and CHF," he says. "Overall, the depreciation of the EUR is to our benefit, although this is partly offset by weaker **emerging market currencies**.

"At the moment it is good for us to have relatively low hedging rates of our exposure, although at certain times we might increase our hedging in order to lock in attractive foreign-exchange rates."

Other US-headquartered companies with a sizeable presence in Europe, such as Abbott Laboratories, have seen the weaker euro act as a natural hedge since they are paying staff and buying equipment in the European currency.

Rando Bruns, Merck

However, Bruns also observes that options have become more expensive in recent months due to this increased volatility. Merck's future anticipated cash flows are hedged up to three years going forward, while hedged balance-sheet exposures are typically less than one-year duration.

"There is a strong possibility that currency volatility will remain high for the foreseeable future," he adds.

Blair refers to anecdotal evidence that FX spreads for both spot and forward have edged up over the past 12 months, adding: "Based on the timing, I think this reflects higher capital costs at banks coming from the regulatory tsunami, although FX volatility may add to the problem."

Some of the steps treasurers can take include trying to pass FX risk to counterparties, he says.

"Transaction hedge duration should be based on the pricing cycle," he adds. "Economically, hedging targets stable margins – at least from an FX perspective – so businesses should hedge the full duration of their commercial pricing cycle.

"If component pricing can be renegotiated quarterly, procurement hedging should be three months. If price lists are fixed for one year, sales hedging should be 12 months."

Blair shares the view that currency volatility will increase in the foreseeable future, with the US looking at tightening while the EU and Japan engage in more quantitative easing.

"The **Swiss National Bank dropping its currency ceiling** has put a big question mark over other euro-pegged currencies, which will, at a minimum, drive volatility," he says.

Non-core risks

The rising cost of hedging non-core risks has encouraged Jan Vermeer, founder of Belgian treasury consultancy firm Treasury Services, to develop a service he says takes a portfolio-based approach to identifying, measuring, quantifying and centralizing risk that differs from services based on value-at-risk.

"Value-at-risk is more suitable for organizations that are forced to run a risk [such as investors or assets managers] rather than those looking to hedge risk," he says. "The portfolio-management approach will minimize the external transactions required to hedge risks, thus reducing costs."

Vermeer says the service – which he expects to launch within the next few months and will be aimed at companies with turnover between €100 million and €1 billion – will use exchange-traded futures as hedges, since they have the lowest bid-offer spread.

"The software will propose the ideal hedge irrespective of its internal policy and will enable corporates to run simulations," he says.

For smaller enterprises looking for a hedging option, Vermeer says there have been some interesting developments around micro-futures, which enable the hedging of amounts as low as €12,500.