How Should You Hedge Your Foreign Exchange Risk?

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It takes just a tiny glimpse of uncertainty in the financial markets to send businesses scrambling to hedge their exposure. Then come the inevitable questions: why, what, when, and how? Part of the overarching goal of financial risk management is managing foreign exchange (FX) risk. And by "managing", we mean conducting proper due diligence and navigating various elements within the firm (and the market) to create the most appropriate and implementable FX hedging strategy. This article explains the basics.

Why Should I Hedge?

For some firms, the approach is purely reactive. For example, a bank covenant could obligate a firm to hedge a specific fraction of its FX exposure. For others, the program is more proactive – to prevent a threshold breach, let us say. Over the long run, though, firms often encounter both.

The "why" is typically addressing the need to protect the firm against the potential impact of FX volatility on the P&L. Hence, returning to the risk appetite, tolerance, and capacity is vital to answering this question. Then dive into your objectives to identify the triggers and metrics you must protect.

What Comes Next?

You should consider any hedging activity (FX or otherwise) holistically. We have seen instances where the Investment Division hedges its FX exposure without considering the exposure sitting with the Treasury Division next door. Some FX exposure offsets other exposure; a firm could have FX payables and receivables that almost cancel each other. If so, then answering the "what" question becomes straightforward, due to the net zero exposure in this case.

Once you identify a net FX exposure, you can hedge it appropriately by understanding your "whys" (your objectives, appetite, tolerance, capacity, etc.). What is the optimal hedge ratio? No one answer exists for that but understanding the "whys" will help you determine the appropriate hedge ratio and solve for proper coverage.

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Lastly, every firm should explicitly answer, what is the appropriate hedging product? In general, vanilla hedging products (such as FX forward or basic options) will suffice. However, much also depends on the market itself and what hedging instruments it offers. Therefore, analyzing the depth and the market maturity of the currency under consideration is critical.

When Should I Implement?

Trying to time the market or catch a specific price should never determine when you implement a hedge. Instead, effective risk management implements a hedge as soon as the pre-identified triggers are activated.

That said, timing can be an important factor depending on the strategy that is appropriate for your objectives. For example, consider translation risk (changes in the exchange rate that affect the accounting value of foreign currency assets and liabilities). If we are hedging translation risk, then the strategy toward FX hedging could be less dynamic than other strategies. Alternatively, a more dynamic FX hedging approach is warranted if transaction risk is the concern. Transaction risk is represented by the FX impact on ongoing FX payables and receivables during the ordinary course of operation.

The "How" Is in the Details!

Some firms choose to hedge FX exposure via on-balance sheet hedging (i.e., no derivatives are needed). For example, funding the foreign operation with debt denominated in the same foreign currency might offset the FX receivables. However, the most significant risk in this approach remains when FX receivables or debt repayments are misaligned.

Alternatively, the firm could use derivatives to hedge its FX exposure. This approach has the advantage of customizing the hedge to match the actual needs.

A crucial "how" is the selection of a suitable hedge program. FX hedging programs can be static (implemented at the outset) or dynamically managed throughout the year. While static programs work well for short-term exposures with high certainty, dynamic programs distribute the implementation throughout a fiscal year to smoothen exchange rates' variability impact on earnings.

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Another equally important "how" is hedge execution. FX hedge implementation comes in various forms, but it is crucial to set an efficient hedging protocol to implement a fair and transparent strategy. The protocol ensures burdens such as slippage costs and undisclosed margins risks are kept to the minimum.

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