

Risk Management Policy for Corporates

Customer Presentation

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3 Questions

- ❑ Should you be concerned with financial risk?
 - We include commodity risk in this definition
- ❑ If yes, how would you measure it?
 - i.e. How much do you stand to lose and with what probability?
- ❑ How would you manage it?
 - Policy
 - Instruments

To hedge or not to hedge....

❑ An academic question

- (The majority of) corporate treasurers are convinced of the need to hedge
- Firm value (and share price) cannot be left at the mercy of the Efficient Market Hypothesis

❑ Hedging ensures earnings and cashflow stability

- Pleases rating agencies => can borrow more easily!
- Pleases analysts: translates into higher share price!
- Can even harmonize tax bill

Measuring Exposure

- ❑ Focus on cashflows
- ❑ Both contractual and projected
 - Contractual
 - ✓ Payables/Receivables (home and foreign currencies)
 - ✓ Interest and principal repayment on debt
 - ✓ Raw material purchases/ sale of finished goods
 - Projected

Simulations of the above over the planning horizon
- ❑ Quantify cashflow:
 - “business-as-usual”
 - Stress scenarios

Managing Exposure – I

The Instruments

- ❑ Categorize exposure (the market factors):
 - Foreign Exchange
 - Interest Rates
 - Commodity Prices
 - Other (e.g. Equity prices, customer credit quality etc)
- ❑ Use derivatives to change exposure profile
 - As articulated in Risk Management (RM) policy
- ❑ Analyse the impact on cost of capital and share price

Managing Exposure II

Risk Management Policy

- ❑ Sets out how derivatives are to be used within the organization:
 - Hedging philosophy
 - ✓ Minimise cashflow volatility or hedge cost or a combination of the two
 - What will be hedged
 - ✓ In what amounts and with what instruments
 - For how long will we hedge
 - Internal Control and Reporting
 - Decision Making and Implementation
 - The New Accounting Regime
 - ✓ FAS133 and IAS39

Hedging Philosophy – I Adding Value?

- ❑ Is the corporate treasury a profit centre?
 - Most treasurers would deny
 - => Should try to minimise cashflow volatility
 - Most would not hedge 100% of their exposures
 - => Minimise cashflow volatility subject to hedge costs remaining at an “acceptable” level
- ❑ Avoid speculative positions
 - Leave open positions based on market views
- ❑ But...try to increase net cashflow

Hedging Philosophy – II

Business Factors

- ❑ Independent of operating results
- ❑ Effect of taxes
 - Stabilising cashflows should have beneficial tax consequences
 - Played down in most treasuries
- ❑ Competitors' hedging decisions
- ❑ Correlation between risks
 - e.g. between Fx and commodity risk
- ❑ Effect on share price
- ❑ Performance monitoring

What will be Hedged - I

What Amounts

□ Rule-based

- Hedge (say) 50% of the exposure to each market factor using an equal mix of forwards, options and packages
- Dimensions cashflow volatility but could be expensive

□ View-based

- Based on forecasts from bank/consultant
- Usually a certain minimum is hedged anyway
- Additional hedging at the discretion of the treasurer
- Seems to be the strategy of choice

What will be Hedged – II

What Instruments

- ❑ Depends on level of sophistication
- ❑ Forwards and basic option strategies (e.g. collars and corridors) are simple to understand but expensive
 - Recommended for rule-based strategies
- ❑ Packages offer lower costs and may even enhance cashflow
 - But can spring nasty surprises!
 - Clear understanding is essential
 - Ideally suited to view-based strategies

Tenor of the Hedge

- ❑ Depends on accuracy of cashflow forecasting techniques
 - Management's long term views on business and economy
- ❑ Fx and commodity exposures typically hedged short-term
 - Between 3-12 months
 - Generally only transaction exposure hedged and not economic exposure
- ❑ Interest Rate exposures typically hedged between 3-5 yrs
 - A tenor for which one can take a view

Internal Control and Reporting

- ❑ Benchmarking realized rates
 - To annual / quarterly budget rate for Fx and commodities
 - Duration or Fixed-Floating Mix for Interest Rates
- ❑ Senior Management Reporting
 - at least quarterly
- ❑ Importance of counterparty risk
 - Especially for longer dated (>1y) hedges
- ❑ Frequent Revaluation
 - Preferably daily, at least monthly
 - Independent valuations
 - Cashflow-at-Risk more important than Value-at-Risk

Decision Making and Implementation

- ❑ For large multinationals, decision-making and strategy execution usually centralized in the corporate treasury at the headquarters
- ❑ For smaller companies with significant national / international presence, guidelines may be set-up at the HQ, leaving decision-making and implementation at the regional level

The New Accounting Regime Implications of FAS133 and IAS39

- Stringent guidelines for derivatives to qualify for hedge-accounting treatment =>
 - most derivatives will have to be marked-to-market at each quarter end and reported in Earnings
 - Includes derivatives imbedded in corporate debt
 - Onerous documentation and valuation methods
 - Will increase cashflow volatility
 - ✓ Exactly what derivatives were supposed to mitigate!

The New Accounting Regime Corporates' Response

- ❑ Many have chosen to eschew hedge accounting
 - “not worth the bother”
 - Accept higher earnings volatility
- ❑ Interest rates hedgers “penalized” most, currency hedgers less so
- ❑ Across-the-board decline in derivatives usage
 - Probably more due to low rates, stable exchange and view-based hedging

Conclusions

The corporate RM policy must clearly state:

- ❑ The objective: cashflow volatility vs hedge cost
- ❑ Which risks are faced and how they are to be measured
- ❑ What hedge instruments, what type, how much and for how long
- ❑ Who makes the decisions and who executes
- ❑ How the hedge performance will be benchmarked, monitored and reported
- ❑ The accounting implications: should the hedges be marked-to-market?

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