As markets evolve, corporate treasurers can lower both the risk and the cost of foreign currency transactions by reevaluating their hedging strategy.

In volatile global markets, corporations with cross border operations are paying ever-closer attention to their currency hedging strategy. For the CLP Group, one of the leading power companies in the Asia-Pacific region, foreign currency hedging is both strategic and day-to-day business. With operations and investments in Hong Kong, mainland China, Australia, India and Southeast Asia, CLP’s prudent risk management strategy requires the group companies to hedge a high level of committed FX transactions, as well as highly probable exposure.

“Proper risk management is important to mitigate financial market volatility, which can affect CLP Group’s earnings and cash flow—it gives us a higher level of certainty,” says Francis Ho, Group Treasurer of CLP Holdings. Perhaps more important, it provides a greater degree of certainty for CLP’s customers, who enjoy a stable power tariff and are largely protected from the possibility that adverse financial market movements will drive up their utility bills. “During the Asian financial crisis of 1997, customers in certain Asian countries saw substantial increase in tariffs because of currency fluctuations. FX hedging can reduce the chance of such things happening,” says Ho.

For most treasurers, hedging policy has traditionally involved moving funds into and out of the U.S. dollar. That is beginning to change as the dollar slowly cedes its position as the world’s staple currency. Emerging market currencies are internationalizing, providing corporations with the ability to settle invoices and even seek funding in an increasing number of local currencies—and giving them the opportunity to streamline their hedging strategy in the process.

“A good number of companies take the opportunity to do swaps in commercially viable terms to better manage their debt and payment obligations, but it’s also important for any company to diversify,” says Ho. “At CLP we welcome opportunities to further diversify from Hong Kong and U.S. dollar borrowings to other regional, third party currencies, so long as we can swap back a third party currency to the functional currency at cost effective terms.”

YUAN VISION
While the greenback is still the predominant currency, “we’re seeing more direct conversions, more crosses that companies can do business in without having to go through the U.S. dollar,” says Khoon Goh, ANZ bank’s Senior FX Strategist for Asia. “The most obvious one is currencies against the renminbi.” The internationalization of the yuan is being driven by the establishment of offshore RMB Business Centers, such as the deliverable CNH market in Hong Kong, and bilateral currency agreements with major trading partners and financial centers, such as Australia and, most recently, the UK.

Growing pools of offshore renminbi are enabling corporates who do business with China to consider transacting in the local currency instead of U.S. dollars—something previously only possible for companies with access to the onshore CNY market. Given China’s increasing dominance in global trade, it’s an invitation many corporations have been quick to accept.

“From a cost and transparency perspective it’s a lot more attractive for corporates to just deal direct with the renminbi—and from a risk management perspective, too,” says Goh. “When you’re having to deal with multiple currencies, where one currency could go one way and the other in the opposite direction, you’re very exposed to market movements—particularly on days when volatility is high. With direct conversions you pretty much know what the rate is and you’re able to lock that in.”
“You can deliver into Hong Kong now—which means you can effectively settle in Hong Kong—and that means suppliers have less currency risk on their side.”

– Simon Peisley, Bloomberg Foreign Exchange and Economics Market Specialist

For Simon Peisley, Foreign Exchange and Economics Market Specialist with Bloomberg, the yuan’s emergence is part of a broader, long-term trend among emerging market currencies, with the Thai baht and Myanmar’s kyat among the other denominations becoming more accessible to the region’s treasurers. “We’re seeing greater internationalization of emerging currencies and businesses can take advantage of that if they can get a handle on what’s happening and start to examine the alternatives,” he says.

SETTLING FOR LESS

Peisley points to Australia to illustrate how corporates conducting trade with China are benefitting by removing the U.S. dollar from their hedging strategy. “You can deliver into Hong Kong now—which means you can effectively settle in Hong Kong—and that means suppliers have less currency risk on their side,” he says. “Purchasers can benefit from this de-risking of the trade.”

Chinese manufacturers receiving U.S. dollars from their Australian customers routinely add around five percent to their bills as a protection cost against adverse currency movements. “Obviously that situation existed because there wasn’t a choice around how you could receive funds. From a manufacturer’s point of view the only way to hedge was to increase their invoice cost,” says Peisley. The importer not only got an inflated invoice, they also had to add a forward cost for the U.S. dollar hedge before arriving at their final Australian dollar price. “There’s a fair bit of slip. Effectively you’re crossing two and a half spreads, and every time you cross a spread it costs you money.”

Settling directly in renminbi takes one spread out of the equation. The manufacturer invoices in yuan, which the importer hedges into Aussie dollars. “There’s slightly over five percent reduction in the overall cost of the transaction, just because we remove the U.S. dollar leg of the currency hedge,” says Peisley. “Effectively both sides get a 2.5 percent discount, although the net result will probably be that the supplier gets a smaller discount and the importer a greater one, depending on their relationship. So it’s important to be on good terms with your supplier.”

With the U.S. dollar strengthening and the renminbi expected to weaken—dragging Asian currencies lower in its wake—now is a good time for corporate treasurers that have FX exposure to consider their hedging strategy. “While the U.S. dollar was continuing to weaken, it didn’t make sense to hedge too much, but it’s going the other way now so the need to act has increased,” says Goh. With high levels of volatility across all currencies, settling direct in renminbi becomes increasingly attractive. “If you don’t you are exposing yourself potentially to fluctuations in the renminbi against the U.S. dollar and in your own local currency against the U.S.—which can be quite harsh in the current environment.”

HEDGING OVERSEAS

Funding markets are also evolving, giving corporates greater opportunity to take advantage of lower interest rates in overseas markets and minimize the borrowing and operational costs of their cross border operations. Again, hedging is a vital element of the transaction, with cross currency swaps enabling treasurers to manage continuing FX obligations, such as repaying both the principle and interest from a bond while also financing operations in their functional currency. “If you’re a Hong Kong based company you might be borrowing in U.S. dollars due to liquidity reasons, but you still need Hong Kong dollars for everyday usage: if you want to buy something in Hong Kong, everything has to be payable in Hong Kong dollars,” says Don Tang, Fixed Income Market Specialist with Bloomberg.
As businesses internationalize and start to get exposure to more currencies there is definitely a need for treasurers to expand their knowledge on what’s happening to other currencies.”

— Khoon Goh, ANZ bank’s Senior FX Strategist for Asia

When entering into a cross currency swap, the corporation effectively becomes both a borrower of foreign currency and a lender of local currency, helping to hedge the risk on an ongoing basis. A more complicated hedge than the simple spot transaction required when paying invoices, corporate treasurers can benefit from tools such as Bloomberg’s Swap Manager, SWPM, which helps them to calculate the fair value interest rate for the second, local currency leg of the cross currency swap. “The good thing is once you enter this type of swap, going forward all the exchange for the U.S. dollar versus the Hong Kong dollar will be marked as of the initial exchange rate,” says Tang. “You use the spot rate as your future reference rate, so this is the perfect way for you to hedge. You don’t care about what happens going forward.”

While the U.S. dollar again remains the staple currency for such funding arrangements, as a resurgent greenback becomes more expensive to borrow in over coming years treasurers can use tools such as Bloomberg’s XCF calculator to help identify cheaper sources of finance in local currencies. For now the renminbi holds limited appeal as a funding source for most businesses as it is only accessible from Chinese banks or by issuing in Hong Kong’s “Dim Sum” bond market. However, as the currency becomes more convertible it may emerge as an important source of international funding. While the Chinese government has not set any dates, most observers expect basic yuan convertibility by 2015 and full convertibility by 2020.

BEST PRACTICE MAKES PERFECT

It’s that kind of regime change that corporate treasurers need to be across to avoid any unintended risk. “As businesses internationalize and start to get exposure to more currencies there is definitely a need for treasurers to expand their knowledge on what’s happening to other currencies,” says Goh. “However, it’s not really practical for corporate treasurers to be FX experts—they already have their day jobs—which is where partnering with the financial institutions you deal with is valuable.”

By working closely with banks and counterparties, treasurers can gain access to information on what’s driving the currencies they are transacting in, so they can make informed decisions on when it is appropriate to hedge and also get advice on timing and execution. “FX markets have been choppier than usual and even the currencies that have traditionally been stable have seen very large swings,” says Goh. “So staying flexible and being able to act fast is important. If you procrastinate you’ll find the market can move against you very quickly.”

In such volatile markets best practices are constantly in flux, which means treasurers should challenge the status quo on a regular basis. “We’re all human and we’re just going to find the easiest way to do things over time, but just because you’ve always dealt in U.S. dollars to a counterparty it doesn’t mean that’s the most efficient method,” says Peisley. “Often a change in regulatory regime, legislation or macro conditions can mean you need to reexamine your currency hedging regime.”

Again the key is to work closely with banks and other counterparties that have expertise in the market, absorbing their advice internally and assessing whether your current strategy is truly best practice in the prevailing environment. “There’s no reason to change for the sake of it, but there is a definite opportunity to make early adoption changes that will benefit your profit and loss,” says Peisley. “Just because what you did yesterday worked, it doesn’t mean it’s worthwhile for using tomorrow.”