The Hidden Risk of Cross-Border Operations

Faisal AlJasir
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As global economies steadily recover and overcome the coronavirus crisis's ramifications, organizations locally and across the globe have been dealing with the changing risk landscape since then. Foreign exchange volatilities are one of those risks that have produced some noise last year as more and more companies report negative impacts from volatile FX movements.

Oddly, volatilities in developed market currencies have been standing at around their lowest historical levels just before the pandemic erupt. As we navigate through the currency risk spectrum of this year, we can still see the post-pandemic effects on some of the heavily traded pairs locally, this is exhibited by the elevated levels of volatility as this year commences. Other than the pegged U.S dollar and GCC currencies, the currencies of Euro, Yen, British Pound, Swiss Franc, and Indian Rupee constitute a significant portion of the daily foreign exchange activity in the kingdom, both in spot and forward markets. To put volatilities into perspective, the levels of one-month implied volatility have increased by around 22% on average for these currencies as of 31st December 2020 (YoY).

Fortunately, at least for reserve currencies, the levels of these options-based volatilities have subsided from their most recent peak touched at the end of the first quarter of 2020. Nonetheless, the unprecedented shock at the time forced heavyweights such as the Euro and Japanese Yen to fluctuate in a similar fashion to those perceived as riskier emerging markets currencies, pushing the Euro volatilities at one point during the pandemic to surge more than 10%. These are volatility levels that can be compared to the pre-pandemic ones seen in currencies such as Brazilian Real.

FOREIGN EXCHANGE RISK

Living in a globalized world where the spread of products, technology, information, and jobs across nations is taking place at light speed, many organizations in different industries face the risk of financial impact due to currency exchange rate fluctuations. Foreign exchange risk is a major risk to consider for exporters and importers alike. As we refer to FX risk in this article, we usually mean financial exposure that arises from transaction or translation risks.

As the name implies, transaction risk can be considered as forecast risk faced by organizations transacting between jurisdictions and consequently affecting their operating margin. On the other hand, translation risk is the effect of exchange rates on the consolidation of foreign currency denominated financial statements, i.e., when assets/liabilities are converted at spot rates to the organization's functional currency. Hence, it is evident that one risk is exposing an organization to a potential earnings problem and the other to a balance sheet one. Both risks can be indicated in financial statements, either implicitly via the erosions of forecasted EBITDA, or explicitly through translation adjustments as a separate component of other comprehensive income. More importantly, both can produce a material impact that could overshadow positive business performance.

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As a first step, an organization must understand its foreign exchange exposure in order for it to accurately starts managing it. It is imperative to begin asking the right questions around the currencies that create material impact, establishing a precise mapping of the sources causing such risk at holding or subsidiary level, and applying exposure measurement to understand the magnitude and materiality on financial performance. Also, determining the type of risk, whether it is transactional or translational exposure, that is currently affecting the organization is pivotal. These crucial steps will allow an organization to formulate an effective hedging program that addresses its unique exposure.

At the holding level, having a holistic view of the overall exposure comes with its advantages. The holding entity could reduce FX exposure by exploiting any opportunities for natural hedging. This can be accomplished by aggregating and netting the individual exposures across operating units, so that positive exposure in some parts of the business is offset by negative exposures in others. Now addressing FX risk without any consideration to the interconnected nature between currencies would be a mistake. The extent that currency pairs are connected in value and will move together can be indicated by correlations. Thus, by having an extremely negative correlation between two pairs of currency, an organization can factor such risk diversification into its hedging strategy and avoid the cost of additional hedging. Having said that, it is worth noting that correlations in currencies are not stable and do fundamentally shift with the changing tides of sentiment and global economic factors, making it risky to solely rely on correlations-based strategies, especially in times of market stress.

CHOOSE YOUR STRATEGY

Once an organization performs its exposure analysis and measurement, it could be concluded that a substantial percentage of the adverse impact is the result of only a few pairs of currencies. In this instance, the hedging program should be targeting such exposure to the extent it provides the level of KPI protection desired. Further, the cost of hedging is an important factor to consider; some currencies have derivatives markets that are limited in liquidity, which would potentially confine the number of solutions available to hedge, making the question of cost-benefit tradeoff a viable one.

Whether the organization's key focus is centered around earnings and cashflow in a given currency or the effect FX revaluation has on its equity, FX risk can lead to many adverse events

It is essential to realize that hedging can also be achieved on-balance sheet, rather than using derivatives, by matching the maturity and currency on both sides of a given exposure. This is particularly useful in the case of translational risk stemming from foreign operations. To offset the risk of a given foreign investment, an organization could directly borrow in the same foreign currency lessening considerably the effects of unfavorable currency movements. Since we are speaking about matching, hedging via derivatives could introduce additional volatility in earnings as the fair value of the hedging instrument fluctuates. Organizations can reduce these volatilities by meeting the IFRS 9 requirements. The relevant models, in this case, are fair value, cash flow, or net investment hedge accounting.

Whether the organization's key focus is centered around earnings and cashflow in a given currency or the effect FX revaluation has on its equity, FX risk can lead to many adverse events that could hinder an organization from achieving its objectives. Management teams should be mindful of the ever-changing nature of this risk and ensure that proper risk-based processes are being followed whereas hedging strategies are dynamically being reviewed.

For more information, please contact Faisal AlJasir, Co-Managing Partner at Ehata Financial, ***faisal.aljasir@ehata.com.sa***

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