Identifying the Right KPIs for Your Hedge

Muadh Alhusaini
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In the complex world of financial risk management, one question frequently arises among professionals and companies alike: "What defines my hedge KPI (Key Performance Indicator)?" Understanding KPIs is crucial in risk management, as they serve as measurable values that demonstrate how effectively a company is achieving key business objectives. Interestingly, within the area of interest rate risk management, it's not uncommon to find companies with a 50% hedge ratio on their debt. However, a closer inspection often reveals a struggle to rationalize this figure, prompting a deeper exploration into the selection of appropriate KPIs for hedging market risk exposure. It's very important to carefully choose and evaluate the tools that will help us meet our hedge KPI goals. Therefore, clearly defining the KPD (Key Performance Driver) is essential.

The Appropriate KPI

The journey to identifying the right KPI begins with self-analysis—understanding why a company should hedge in the first place. Is the goal to ensure cashflow visibility, minimize costs, or something else? The answer to this question shapes the KPI selection process. In the context of interest rate risk management, often, the KPI limit is influenced by financial covenants imposed by lenders, such as the Debt Services Coverage Ratio (DSCR) or the Interest Coverage Ratio (ICR). The involvement of the company's board or a risk appetite framework is crucial in establishing risk tolerance and limit levels.

It's important to note that profit maximization should not be the primary goal of hedging. Instead, hedging focuses on protection, risk mitigation and providing clarity/control on the range of possible outcomes. Identifying the right KPI often involves examining lender covenants and internal risk thresholds related to the specific risk class under consideration. Once the KPI is identified, the company needs to look into what causes changes in the KPI, which will help in making decisions.

Linking the KPI and KPD

A comprehensive risk assessment is essential to effective financial risk management. This process involves identifying different sensitivities and the attribution of the chosen KPI(s) to the KPD(s). Once the KPIs are identified, the company needs to determine how these key indicators are influenced or driven by various factors, referred to as KPDs. This means understanding which specific drivers have the most significant impact on the performance indicators that the company is focusing on. In essence, this process is about making a detailed and informed connection between what a company measures as indicators of success KPIs and the underlying factors that affect those indicators KPDs. By doing so, a company can better understand and manage the risks to its financial health.

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Statistical approaches play a pivotal role in achieving favorable outcomes by utilizing risk metrics to grasp the extent of risks faced and evaluate their materiality. For instance, the effective application of Value at Risk (VaR) is instrumental in identifying how a KPD could impact the outcome of the KPI. Moreover, stress testing is critical for evaluating the resilience of derivative positions under extreme conditions, such as significant interest rate fluctuations or market disruptions. This analysis ensures that the hedging strategy remains robust under various scenarios.

Conclusion

An integral part of hedging market risk exposure is the ongoing monitoring and review process. Financial markets are ever-evolving, making a static approach to risk management ineffective. Regular reviews and adjustments to the KPIs and KPDs are vital in response to market changes, regulatory updates, and shifts in the company's risk profile. This dynamic approach ensures that the company's hedging strategies remain relevant and effective, safeguarding against market risk exposure in a fluctuating financial landscape.

For more information, please contact Muadh Alhusaini, Partner at Ehata Financial, ***Muadh.alhusaini@ehata.com.sa.*** *You can also read the article from the website* ***here.***

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