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# How should firms hedge currency risk?

## Currency hedging, at its best, gives a company the time to adjust its business

SNAKES & LADDERS
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How should corporations think about currency fluctuation? Currency exposure should be added up at the enterprise level. The key exposures generally come about because of import price parity of raw materials or products. Once the full exposure is known, the best attempt should be made, within the limitations of Indian capital controls, to lay off this risk. Currency risk management cannot allow a business to go on running poorly. What it can do is gain time, to change course.

Currency fluctuations are back on the radar screen of every CEO. What can firms do in order to manage this risk? Step 1 consists of knowing the extent of exposure. Some parts of exposure are clear: Direct imports, direct exports, foreign borrowing. If one would hedge those components, one by one, it seems useful.

The most important exposures are often not directly visible: They come from import parity pricing. As an example, the price of metals in India is no longer an Indian price. It is the world price, multiplied by the exchange rate. The exchange rate is present in the domestic metals price. The entire quantity of metals that is either the raw material or the output of a company is connected to the exchange rate, even if the transactions are purely domestic.

A person who sells metals to domestic buyers in India is exactly like an exporter: A 10 per cent INR depreciation means a 10 per cent increase in the sale price. Conversely, a person who buys metals from a domestic seller in India is exactly like an importer.

Every company needs to look at its list of inputs and outputs and isolate those where import parity pricing largely holds. A typical manufacturing company, which buys ₹50 of (global price) raw materials and sells ₹100 of (global price) finished goods, has a net export exposure of ₹50.

A projection must be made of monthly cash flows for a year, drawing these numbers together with the repayments (if any) associated with foreign currency borrowing. This gives the frame for exploring alternative values of the exchange rate.

Step 2 consists of choosing scenarios for the rupee. A good thumb rule is to look at scenarios of a rupee movement of about 10 per cent (on either side) over a quarter. This reflects the long-run average volatility of the rupee.

Step 3 consists of choosing a hedging strategy. If a company has the profile of an exporter (i.e. getting dollars at future dates), then it is wise to borrow in foreign currency (i.e. paying dollars at future dates) so as to neutralise that exposure. Such "natural hedges" are the best way to get hedging done.

Firms must ask whether their offshore counterparties, for imports or exports, can shift to rupee-denominated invoicing. This requires a price premium, but removes currency exposure for the Indian firm. The currency exposure is then shifted to a foreign firm, which may either bear it unhedged, or hedge this using the overseas rupee derivatives markets.

The last port of call should be the currency derivatives market. There are onerous capital controls and firms will often not be able to do rational things using these markets. But it is worth looking at the possibilities and doing rational hedging to the extent that it is possible. The rules surrounding currency futures permit more rationality than is the case with the OTC market.

The risks that cannot be hedged are borne by shareholders. An unhedged importer suffers a decline in the share price when the rupee depreciates. As an example, we see a different currency exposure embedded in the Infosys stock price as opposed to the TCS stock price, which may reflect different approaches to hedging by the two firms.

This three-stage process is the structured method through which firms should think about currency risk. There are three pitfalls that we should watch out for.

In India, there is often a narrow focus on hedging a few transactions based on what the regulations permit. This is counterproductive; one must always think at the enterprise level, where many exposures cancel out.

In India, firms often try to become speculators who will guess the course of the rupee. It makes more sense for each CEO to focus on her business, not to dabble in currency speculation, and just de-risk.

It must be understood that all hedging programmes lose money half the time. Hedging will not be a one-way bet, producing cash in bad times only. We should not lose nerve when a hedging operation loses cash in peacetime. These payments should be viewed as insurance premia.

At a strategic level, what can currency hedging do for a firm? Suppose a firm has the profile of an exporter and the rupee appreciates. That will give reduced profit margins. The currency derivatives can at best blunt the damage for some time, and thus protect the budget for some months. The hedging programme does not change the fact that the business is less attractive, that profitability has gone down.

When prices change, the business needs a fresh think. There is no running away from this task, of constantly rethinking what is to be done. Currency hedging does not change the need to constantly change course in the business. The most that currency hedging can do is to gain time.

As an example, a company may be protected against a 10 per cent rise or fall of the rupee for one quarter. This gives the management the time horizon of one quarter, in responding to the new set of prices. Within this time horizon, the management has to figure out how to change course.

The choice of the hedging horizon needs to be done from this point of view. If the rupee were to suddenly appreciate or depreciate tomorrow, how much time would it take for the business to get re-engineered to deal with that new world? The expenses of the hedging programme should be weighed against the amount of time that this gains for re-engineering the business.

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