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Treasurers can profit from playing spot and forward FX rates

Paul Golden July 31, 2024

After years of being off the table due to historically low interest rates, treasurers can now realistically look to profit from rate differentials between currencies.

Illustration: iStock

Optimization of forward points (the difference between the spot and the forward rate for a currency pair) enables companies to take advantage of these differences, which are driven by the

interaction between FX and interest rates. However, CFOs are often slow to change their currency management strategies to take advantage of market changes.

When setting their prices with an FX rate, corporates should use the forward rate instead of the spot rate – otherwise, they risk leaving a large amount of money on the table, especially with currencies that trade at an annual forward discount to the dollar.

Antonio Rami, Kantox

"When a company sells in a currency that trades at a forward discount, pricing with the forward rate is a disciplined approach that allows managers to avoid arbitrary markups that hurt the firm's competitive position," explains Antonio Rami, chief growth officer and co-founder of Kantox.

To reduce the cost of hedging stemming from unfavourable forward points, corporate risk managers can define their degree of risk tolerance and use conditional stop-loss orders to delay the execution of hedges.

Rami observes that if a 3% stop-loss order protects a worst-case scenario budget rate during six of the 12 months of a particular campaign, the cost of hedging is reduced by 50%. "The significance of such savings goes beyond that particular currency pair," he adds.

Sourabh Verma, co-chair of ION's hedge accounting technical taskforce and head of treasury product marketing, agrees that delaying hedge execution can be an effective strategy.

"The forward rate is likely to improve as the transaction date approaches, reducing the expected FX loss," he says. "However, markets can turn volatile quickly so corporates should consider putting conditional orders with a pre-defined corridor via their trading platform, which can automate the process of monitoring the FX rates and triggering hedge execution."

The precise impact on hedging costs will depend on the currencies' respective yield curve term structures. "Exotic currency pairs typically have a high cost of carry so unless a corporate has highly concentrated exposure to exotic currencies, delaying hedge execution can result in overall cost savings of 25% to 40%, considering exposures maturing within the next three months are almost always close to 100% hedged," says Verma.

Sourabh Verma, ION

All hedge products can be used to capture the benefits of a favourable forward curve to varying degrees.

Fixing a forward expiry or a window forward open to a future date allows the buyer to secure the positive interest differential up until that date. With window forwards, they can then draw down on an ad hoc basis between the open and maturity dates, maintaining flexibility while receiving an improved price relative to a completely open forward.

“We suggest clients enter into a layered hedging policy where there is a positive interest rate differential on their respective currency pair exposure to maximize the price benefit attached to the forward curve,” says George Roberts, head of dealing UK at Ebury.

Natural hedging

A traditional approach to offset the negative impact of unfavourable forward points and leverage interest rate differentials is natural hedging. “In addition, treasurers can implement dynamic hedging strategies,” says Sander de Vries, treasury director at Zanders. “With accurate exposure data, treasurers can use efficient frontier optimization to balance risk reduction and hedging costs.”

But Scott Bilter, principal at Atlas FX, cautions that creating natural hedges may result in paying the forward points in a different way.

“For example, taking out a local currency loan to offset a net asset position in a high interest rate currency reduces your forward point hedging cost, but you are now paying a high local interest rate on the loan,” he says.

“If the net position is due to a large receivables balance, then reducing payment terms (or enforcing existing terms if payers are frequently late, which is most common in high interest rate currencies) can be helpful.”

“Investing in tools to compute the efficient frontier typically costs a fraction of the potential savings in hedge costs”

Sander de Vries, Zanders

By evaluating value at risk (VaR) reduction versus hedging costs for the company’s currency exposures, a treasurer can either decrease hedging costs for the same VaR reduction or lower the VaR for the same hedging costs compared to a static hedging strategy using a fixed hedge ratio.

“Investing in tools to compute the efficient frontier typically costs a fraction of the potential savings in hedge costs,” suggests de Vries.

According to Sandra Koch, vice president of risk solutions at GTreasury, net investment hedges are frequently used to generate beneficial P&L impact.

"With respect to unfavourable forward points, impacts can be reduced by lowering the level of hedging activity or using efficient hedging techniques through VaR and CFaR [cash flow at risk], or considering alternative derivatives like collars – where cost of hedging is not locked in – in exchange for tolerating exposure within the collar strikes," she explains.

Abhishek Sachdev, Vedanta Hedging

The main way to negate unfavourable forward points is to consider option strategies suggests Abhishek Sachdev, chief executive of Vedanta Hedging. These can be vanilla (such as simple cash options) or more complex 'zero-cost' structures where protection is still obtained but there is some ability to benefit from favourable FX movements.

Being opportunistic and trading at the right time can help treasurers make the most of favourable market moves that may well exceed the impact of unfavourable forward points. However, this requires access to a proactive FX provider and high-quality analysis.

That is the view of Daniel Jack, head of institutional at Monex Europe, who advocates a combined strategy using spot FX, forwards, options, leverage, enhanced yield products and active cash management.

Dino Nicolaides, managing director head of treasury advisory for UK and Ireland at Redbridge, advises corporates to define their risk appetite and the extent to which key stakeholders would welcome the exposure to the relevant currencies.

"If such exposure is unwelcome, the next step could be to look at the credibility of forecast currency needs," he says. "There will be occasions where corporates decide to hold the surplus currency until required. It may also be worth exploring whether this exposure can be passed on to customers or suppliers."

Whether forward points have a positive or negative impact will also depend on whether the corporate is long or short that currency.

"For most companies hedging their balance sheet risk, forward points are a real cost – especially if they are locking in a depreciation on a month-over-month basis, although with the volatility of some currencies companies are happy to lock in a known depreciation instead of being subject to the market," says Amol Dhargalkar, managing partner and chief executive of Chatham Financial.

Before looking externally, it is important to examine exposures thoroughly to identify natural options that could reduce or eliminate the need for hedging. But Andy Gage, senior vice president of FX and advisory services at Kyriba, says this process requires the tools to analyze the underlying sources of exposure to determine whether internal actions can be taken to eliminate the exposure, such as selectively settling an outstanding intercompany balance.

"If you are relying on spreadsheets, you are merely collecting data for your hedge strategy so you may not have the detail necessary to identify potential internal actions," he concludes.

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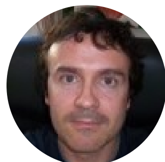

Paul Golden

Paul has written about finance since the early 2000s, with a particular emphasis on foreign exchange, treasury and wealth management. He is a regular contributor to several industry titles in addition to Euromoney.