Mecklai Financial
WHERE RISK MEETS ITS MATCH

THE MECKLAI APPROACH TO RISK MANAGEMENT

Having advised nearly 5,000 companies over the past 40+ years, we have learned a few critical things about risk management. Each company – and its needs – is unique in terms of its business model, margins, risk appetite, balance between managing cash and managing the accounts, and the management's general philosophy on risk management. Based on our understanding of these factors we articulate a customized risk management approach for each client which rests on three pillars.

Risk Identification: Know your risk

If the objective is to manage cash flows, Treasury must identify risk out to the longest meaningful tenor, building in elements like the frequency of changes in pricing, the possibility of passing through risk to customers or vendors, etc. For some companies – say, in IT or pharma or even auto components – risk should be identified over longer tenors based on estimated flows, since, in general, contracts are of long duration without any price variation based on the prevailing currency rate. On the other hand, companies in highly commoditized businesses, prices are set for each contract based on currently prevailing exchange rates and, thus, risk needs to be articulated for each business cycle from order to cash (in or out).

If the management gives a higher priority to P&L protection, the risk tenor would need to be from invoice to cash; this would result in longer tenor exposures not being effectively managed.

And finally, since the goal is always to carry as little risk as possible to market, the Treasury should fully utilize any natural hedge that exists, including implicit natural hedges in sales (or purchase) contracts. The natural hedge should be managed in such a way to ensure that the rates at which the naturally hedged receivables and payables are the same – in other words, the natural hedge should be spot neutral.

Risk Measurement: Define your boundaries

Once the risk is identified, it is important to define the worst acceptable rate for each exposure – set a 'Risk Limit'. This risk limit should be set keeping in mind the company's profit margins, volatility of the currency, risk tenor and forward points (hedge cost or premium earning). Certain Industries are blessed with comfortable profit margins and significant competitive advantage, so that their costings provide a significant buffer from the prevailing market rate; in such cases, a market-related risk limit should be set to ensure that such business advantage is never taken for granted or lost due to market movement.

While a well-defined risk limit provides cash flow certainty, it also enables the Treasury to try and capture opportunity from favorable movement while risk is contained within the defined limit.

Risk Monitoring and Hedging: Follow a hedge strategy that is not totally dependent on market views

One of the truisms of markets is that it doesn't matter who you are, how smart you are, or how much experience you have, the market will get the better of you over any reasonable period of time. Depending on your judgement of the market or your banker's views or, indeed, the views of consultants (including us) is a sure recipe for medium term failure, and possibly serious losses. Thus, market views should be used only very selectively, after risk has been contained.

In general, the Treasury should need to follow a structured approach to hedging where a certain percentage is hedged immediately on risk identification, after which open exposures are monitored daily, comparing the prevailing market rate with the risk limit set for each exposure and pre-set ‘Lock in Levels’, which are targets for opportunity capture. Additional hedges should be executed at pre-defined triggers whether the market moves favorably or unfavorably based on these rules. The trigger levels and related hedge percentages should be reviewed at fixed time intervals and may be modified depending on how the market is moving, and, of course, if there are any changes in business parameters. Treasury should use a combination of forward contracts and, depending on market volatility and the tenor of the risk, specific types of options.

For implementing this approach, we offer ‘hands-on’ Treasury Middle-office support, where we are responsible for

(1) daily risk monitoring and MIS,
(2) providing hedge trigger signals as per the strategy,
(3) reviewing the hedge strategy parameters from time to time, and
(4) reporting Treasury performance independently to management.

We can also outsource front office execution, based on a customized Mecklai-client technology interface with strong, integrated MIS, and take complete responsibility for a client’s FX risk management function to consistently deliver agreed performance benchmarks.