Rethinking Risk

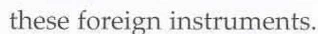
There is no such thing as a free lunch in hedge management, explains Jayanth R. Varma

Since the late 1990s, there has been a sea-change in risk management practices in corporate India. The overwhelming focus earlier on currency risk has given way to a greater consideration of currency, interest rate and commodity price risk. Risk management has also shed its transaction orientation and moved toward an analysis of operating and economic exposures.

The range of instruments used for risk hedging has expanded far beyond simple forward transactions to encompass a wide range of derivative products including, in some cases, exotic over-the-counter options. Of course, these changes have been most evident in the financial sector where regulatory capital requirements for market risk have prompted a more rapid embrace of sophisticated techniques and products. But the corporate sector has also caught up quite quickly.

Benign Environment

This has been facilitated by the emergence of a wide range of hedging instruments in India. Even where some products are not yet available domestically, the corporate sector can access instruments overseas thanks to the gradual liberalisation of exchange controls, which have brought foreign markets within easy reach. In some cases, Indian companies have been able to use their foreign subsidiaries or affiliates to access



these foreign instruments.

However, much of this growth in risk management has taken place in a benign economic environment. The economy has been booming, interest rates have been low, and the rupee has been relatively stable. The real test of risk management comes only in a hostile environment. In this sense, the risk management practices of the last few years have not yet undergone their true test.

The benign economic environment has led to a situation where risk management has been so successful – and even profitable – that some companies have started looking at risk management as a profit centre. Risk managers are being asked not just to mitigate risk, but to also enhance profits.

I believe that this is a dangerous trend because finance theory teaches us that there is no such thing as a free lunch.

If a company wants to reduce risk, it must necessarily pay a price for doing so. When managements pretend they are not paying a price, in reality they do not recognise the costs that the company is incurring, or the hidden risks that it is assuming (*see box*).

In most cases, it is easy to accept that risk management comes at a price. However, in some cases, while it may appear that risks are eliminated without any cost what has really been done is to exchange one set of risks for another. If the new risks that are being assumed are regarded as remote or insignificant, it is easy to delude oneself into believing that one has actually earned a free lunch.

The Ashanti Example

My favourite example of this phenomenon is the Ashanti Goldfields of Ghana, in West Africa. In the mid- and late 1990s, as the price of gold steadily declined, Ashanti hedged its future gold production on an increasingly larger scale to protect itself from further decline. For several years in the late 1990s, the highly levered Ashanti Goldfields survived only because of these hedges.

Over a period of time, Ashanti came to rely on the hedge book for a large chunk of its profits and there was greater pressure on the hedge book to deliver these profits. Ashanti shifted aggressively towards buying put options, which allowed it to retain the upside of a recovery in gold prices while protecting it from any possible price declines. As gold prices

drifted towards multi-year lows, these put options became increasingly more expensive.

Under pressure to deliver profits from the hedge book, Ashanti Goldfields resorted to selling call options to finance the premiums for the put options that it was buying. Ashanti turned a blind eye to the risk of selling these options because in a period of falling gold prices, it was easy to completely ignore the prospect of a rise in gold prices. So much so that Ashanti sold a large number of 'turbo' call options in which the quantity of gold that Ashanti had to deliver rose as the price of gold crossed certain thresholds.

Illusive Income

In September, 1999, 15 of the world's most powerful central banks came together to push up the price of gold. A dramatic rise in the price of gold, as well as in its volatility, caused a loss of $860 million in Ashanti's hedge book and pushed it to the edge of bankruptcy. The company was finally forced to effectively sell itself to South Africa's Anglo Gold.

In 1997 and 1998, it would have appeared that Ashanti's hedge book was really a profit centre that delivered a substantial part of the profits of the company while appearing to be actually reducing the company's risks. It looked like a genuine free lunch. But it was nothing of the sort.

All that Ashanti had done was to exchange its vulnerability to a fall in gold prices for a vulnerability to a rise in gold prices. The risk that it had assumed appeared remote and improbable while the risk it had eliminated was imminent and life-threatening. But when circumstances change, the perception of these two risks also changes dramatically and what appeared remote and insignificant suddenly became life threatening.

> When managements pretend they are not paying a price for reducing risk, in reality they do not recognise the costs

In India, too, so-called 'costless' options have become popular methods of hedging currency risks. These options are far from being costless. Since they involve selling some options to pay for other options, this strategy also involves exchanging one set of risks for another.

Speculative Advantage

Moreover, since the banks that trade in options also charge their own spread and profit margin, companies that want the options to be truly costless end up having to assume a risk that is greater than the risk they have eliminated. To describe this as risk management is less than honest.

In the past, it could be argued that the corporate sector had a comparative advantage in taking speculative positions in many financial markets.

For example, exchange controls meant that while exporters and importers could speculate on the rupee by taking and cancelling forward cover, it was very difficult for individuals and other entities to do so. A forward transaction required

Hidden Costs

Since some companies appear to argue otherwise, it is worthwhile to look at the many different ways in which risk is reduced and identify the costs that are incurred in each of them:

- When we use insurance to manage risks, we pay an insurance premium which is an explicit cost. The costs are not just the true actuarial cost but also the profit margin of the insurer.
- Some risks are mitigated by technological solutions. For example, the use of fire alarms and sprinklers reduce fire risks. Here again, the initial investment in these systems as well as their recurring costs are the explicit costs of risk management.
- Companies often transfer risk to their customers or suppliers by using escalation clauses and other contractual provisions. The costs in this case are not as explicit as in the previous two methods, but they exist. The company pays a price in terms of a less advantageous price or, sometimes, in loss of business.
- Sometimes, risk is avoided by steering clear of uncertain business segments. Here again, the costs are not so explicit, but they exist nonetheless. There is an opportunity cost in terms of foregone profits from these business segments.
- Finally, the use of derivatives also involves costs. Some costs are explicit as in the case of an option premium. Sometimes, the cost is an opportunity cost as in the case of forward contracts that compel the company to accept the forward price even when the realised spot price is more advantageous. As in the case of insurance, the cost is not just the fair cost but also the bid-ask spread or the profit margin of the derivatives trader.

the existence of an underlying transaction, and it was the corporate sector that had this entry ticket into currency speculation.

During this era, speculation against the rupee consisted largely of exporters lengthening their receivables and leaving them uncovered while importers covered most of their payables.

Speculation in favour of the rupee consisted of importers stretching their payables and leaving them uncovered while exporters covered their receivables.

Today, foreign institutional investors with access to equity and currency derivatives have the ability to speculate on the currency. The growth of participatory notes and the offshore (non-deliverable) forward market in the rupee provides speculative avenues to many other foreign investors.

It would be short-sighted to hold risk management hostage to the vagaries of hedge accounting requirements

Thus, an Indian company seeking to indulge in currency speculation has to compete against hedge funds and other institutions with specialised skills and competence in this field. The assumption that the corporate sector has a comparative advantage in speculating on the rupee is now clearly false. In this altered scenario, it does not make sense for a company to stray from its main business and get into currency speculation.

Having argued that risk management should not be regarded as a profit centre, I now turn to discuss its true role. I would emphasise three strategic aspects of risk management.

Strategic Role

Risk management is a substitute for equity capital. Put differently, equity capital is the ultimate risk management tool because when all other tools have failed, the resulting losses are absorbed by equity capital. In this case, risk management choices are essentially capital structure decisions. It also means that a company with high levels of debt needs to have more refined risk management systems as the equity cushion is too thin to absorb large risks.

Risk management must ensure

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that company strategy can be implemented in the face of cash flow uncertainties. When capital markets are imperfect, it is necessary to protect the firm against cash flow shortfalls that could derail its strategy. Unless capital markets are perfect, it may be very difficult or expensive to finance these shortfalls as and when they arise. This means that risk management should be more focused on risks that are serious enough to potentially disrupt the strategic goals of the company. This suggests the use of stress test scenarios as the proper benchmark for risk management goals.

Risk management needs to rely on both financial hedges and operating flexibility. Financial hedges are usually the first line of defence against adversity as they act very quickly when there is a change in the environment.

Changes in operating decisions take time to implement and, therefore, show benefits only with a long time lag. But once they kick in, they provide a long lasting solution. Financial hedges, however, are usually short term in nature because hedges that go out far into the future are often too expensive or illiquid.

Accounting Obsession

This gives us three reasons why risk management decisions are ultimately strategic decisions:

- They are essentially capital structure decisions, which are themselves strategic
- Their goal is to prevent a disruption to corporate strategy, and
- They are intimately linked to operational flexibility, which is strategic in nature.

An excessive focus on accounting considerations and an exclusive concern for smoothening quarterly income can, therefore, be dangerous. It is to this danger that I now turn my attention.

As Indian financial reporting practices have converged on international accounting standards, the Indian corporate sector has become overly concerned with accounting for derivatives. Both the US accounting standard (FAS 133) and the international accounting standard (IAS 33 and 39) represent compromises between fair value accounting and historical cost accounting. They require fair value accounting for derivatives while sticking to historical costs for most other items.

To reduce the inconsistencies arising out of this uneasy compromise, these standards introduce the notion of hedge accounting, which allows hedges and the hedged items to be accounted for consistently under certain circumstances. These standards are in some sense a transitional arrangement on the path towards a more comprehensive embrace of fair value accounting.

> The challenge for CFOs is to reshape risk management systems to become an integral part of strategic planning

They are, therefore, far more complex than either consistent fair value accounting or consistent historical cost accounting.

This means that companies with an obsessive focus on reported quarterly earnings find their hedging policies being dictated by accounting considerations alone. I think this is a mistake. Risk management is strategic in nature and it would be short-sighted to hold it hostage to the vagaries of hedge accounting requirements.

Some companies have gone further down this path and seem to define the goals of risk management as the elimination of uncertainty regarding short-term earnings. Capital markets are sophisticated enough to see through short-term income volatility and focus on longer term growth prospects.

Managements, however, tend to think that capital markets are short-term oriented and try to satisfy this imagined need for stability in quarterly earnings. Risk management, which is geared towards such objectives, fails to perform its strategic goals. It becomes an exercise in earnings management that does not add any significant value to the business.

Way Forward

Risk management in corporate India is, thus, at an interesting juncture. It has grown enormously in terms of technical sophistication and range of hedging tools used. Yet, most corporate risk management systems are inadequately integrated into strategic planning. In the process, risk management threatens to become the sole preserve of either derivative specialists or of accountants.

In the coming years, the challenge for CFOs would be to reshape risk management systems so that they become an integral part of the strategic planning process. Risk management would then be driven by strategic goals rather than by transient market opportunities. At the same time, risk management systems that have evolved in a benign economic environment need to prepare for a potentially more hostile and turbulent environment. ■

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