



Managing market and liquidity risk in an increasingly uncertain world

A focus on Emerging Markets and Frontier Currencies

Central Banks globally have hiked rates to tame inflation or to stabilise markets, and the expectations about future monetary and fiscal policies are currently dominating the dynamics of the market outlook.

Global uncertainty coupled with concerns around specific local dynamics has resulted in massive deterioration of liquidity in some of the frontier markets Nigeria, Egypt, Africa, Middle East, ASEAN, included.

With uncertainty comes opportunity, and corporate treasurers are constantly reviewing the needs and challenges of risk management for long term projects in niche markets.

Standard Chartered is helping its clients to explore best practice for emerging markets (EM) risk management policy, through cost effective hedging strategies, the evolution of carry costs, looking at optimal ways to build up a hedging portfolio, and implementing balance sheet hedging programs.

Adapting to shifting outlooks due to market uncertainty and shocks

Corporate treasuries are looking to review exposure to market shocks and changes in the rates environment and understanding how internal review can be optimised when identifying exposures.

A client of Standard Chartered shared an example of how they do this: “We closely monitor the risk exposures and hedge where possible by optimising hedging costs to avoid business impact. Keeping the FX-Risk in an early stage in mind and structuring the business accordingly”.

However, organisations vary in their approach, and in a recent poll conducted by Standard Chartered, they heard that corporates either:

1. Have changed hedge ratios or tenor of hedges or added new currencies to existing hedging programs
2. Their approach is unchanged with limited EM hedging focus for now
3. They have not reviewed, but EM risk management is BAU and “bread and butter” activity for the company

In running analytics for their corporate clients, **Oksana Pidkuyko, Managing Director, Head of Client Analytics, Markets at Standard Chartered** is seeing similar themes and focus areas in discussions linked to EM risks with companies globally.

“We are definitely seeing clients continue to review their hedging policies and programmes in response to the market shocks we have seen in the last few years, and there is increased demand for analytics to develop more dynamic and flexible hedging strategies”.

Emerging markets foreign currency (EMFX) hedging has always been a major concern for companies due to significant associated costs, however unhedged EMFX risk has proven to be even more expensive.

Interest rate hiking cycles embarked on by the Federal Reserve System and other developed markets to tame high inflation, coupled with a low-volatility environment, has challenged this paradigm, and presents attractive hedging opportunities to mitigate EM risk.

“We have seen significant increase in demand from corporates to add more EM currencies risk management to their existing balance sheet and cashflow programmes. We’ve seen notable devaluations in the last year and liquidity scarcity in a growing number of EM markets trapping cash and eroding significant value,” says **Pidkuyko**.

“At the same time, we are seeing greater availability of hedging tools such as Non-Deliverable Forwards (NDFs) and options for a number of difficult markets”.

Solutioning to manage exposure

One of the ways to manage exposure for corporates has been to review their contracts and limit exposure to a specific currency, but if that’s not fully possible then they have to find optimal solutions to manage it in a cost-effective manner. Standard Chartered has helped its clients with this by working with them across:

- **Balance sheet perspective:** Reviewing which currencies should be hedged going forward, and identifying appropriate hedge ratios where, with a number of corporates, working on portfolio analysis and efficient frontiers specific to their exposures
- **Options consideration for cashflow programmes:** Helping companies develop frameworks and identify optimal instrument, tenor and hedge ratios

And last but not least, an interesting trend they have recently seen is increased focus on earnings risk management specific to EM exposures that were not hedged previously.

Considering challenges in EM markets are not only cost but also liquidity driven, what processes are currently used for long term exposure management linked to projects, so how can banks help in identifying optimal approach? One of Standard Chartered’s client’s shared that they:

- Analyse market conditions together with banks
- Find the sweet spot where spreads are fair, by avoiding taking too much interest rate risk
- Keep consideration of credit and capital linked charges in mind, stronger volatility in EM triggers often higher credit linked charges than in G10 markets
- Roll the position when the market shows opportunities – not waiting to the very last moment (e.g., use Axes)
- Bank support in finding sweet spots, updating on market conditions, trader insights, etc.

Standard Chartered has worked on this type of solutioning with other corporates too. The importance of active exposure management (not holding to maturity and restructures considerations linked to market moves) and the role it plays after initial execution of hedges, and looks at how that varies across sectors and regions.

In the light of the divergence of central banks policy trajectories in G10 and EM currency markets, they have recently seen a significant pickup in multinational corporates reviewing their existing debt strategy.

Currency mix strategy of debt could have an impact on interest costs, balance sheet volatilities, cash flows, as well as credit metrics like leverages. Standard Chartered has worked with a number of corporates on an optimal currency of debt strategy and review of Net Investment Hedging strategy of EM assets.

Ordinarily for corporates there could be a variety of uncertainties linked to long term project exposures that can arise during a project's bidding process or discontinuation, as well as later in the process, linked to forecasts accuracy.

The heightened uncertainty brings with it fear of hedging and fear of getting it wrong, especially for exposures that are 10-20 years in tenor. That's why risk management strategies which allow flexibility around the timing of the hedges and instruments choice introduce the way to deal with this type of risk.

A framework for risk tolerance

Pidkuyko shares that this can be achieved by establishing frameworks assessing market conditions, analysing, and comparing different strategies (Rolling short term vs Term exposures) and identify strategies that allow the treasury to achieve key objectives when balancing risk.

"For EM currencies specifically, we assisted a number of clients last year with solutions in managing exposure in a cost-effective manner, with considerations of how to manage long term risk with limited or no liquidity leveraging our franchise to find the best solution," she says.

"Starting with setting risk tolerance and quantifying the risk and then identifying appropriate hedge ratio (hedging 100% could be as risky as hedging nothing) and only then optimising tenor and instrument choice".

One client touched on a very important point: the importance of active exposure management, so after implementation of core hedges are identified, is the need to constantly re-evaluate and re-assess the most optimal strategy.

"As markets are dynamic and exposures are constantly changing and need to be re-evaluated, regular reviews have been an important focus area for many. It can also help optimise cost of risk management, and capture opportunities when we see significant shift in the shape of the curves and volatility as well," they say.

The client also shared what the most commonly used strategies for FX risk management are for them right now, and whether they would consider adding flexibilities in products to be used, if there is value in adding options.

"First of all, avoid FX-Risk where possible (contracts in EUR, USD) and use maximum netting potential. Currently we use options only in the bidding process for offer calculations and would be allowed to even hedge via options in this project phase. After contract effectiveness we hedge via FX-Forwards the expected cash flows or to the sweet spot tenors".

Seizing the opportunities

Pidkuyko also discussed how Standard Chartered has seen an increase in option strategies considerations recently, and what the key drivers are for companies.

Particular themes they have observed include:

- A greater appreciation of the value of options, especially when forecasts can be uncertain and with consideration on how to optimise Mark to Market.
- Current market volatilities for EM currencies have reduced significantly over the past year and is currently close to a four-year low. In addition, with USD rates elevated and near the peak of their hiking cycle, Forward hedging has become cheaper, and hedge benefit is seen in certain EM currencies. Both of those present an excellent opportunity for corporates to review their optimal strategy and identify an appropriate framework on how to balance cost and volatility.
- For some currencies like MYR, CNH, THB, TWD and KRW, beneficial carry may be utilised to reduce the premium by using an ATMS option compared to the ATMF alternative. This implies opportunities to protect the exposure at the current spot levels while being able to participate when the market moves in the favourable direction.

"There are ways to turn volatility into your friend rather than foe, as shared by one of the clients during a recent discussion, and that is through a flexible and dynamic hedging strategy that enables you to be nimble and quick in these markets," **Pidkuyko** says.

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