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Please respond to

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MANAGING FINANCIAL/POLITICAL RISKS

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I will be dealing with the risk connected or arising from international financial operations.
According to a banker's point of view when you trade financial instruments you face different risks which are normally classified in:

- Credit risk
- Political risk
- Strategic business risk
- Interest rate risk
- Exchange rate risk

These risks count differently depending on the assumption that not all the partecipants behave in the same way, not all of them are pursuing the same goals, not everywhere is possible to adopt the more appropriate instruments, because of local rules or limits.

As a matter of fact the financial risk may be reduced if and when the bulk of the company's business is carried on in a single currency, or when the market capacity of a given company is such that can impose its conditions leaving on somebody's else shoulders the risk linked to the underlying transaction.

The central problem of risk management is the following: how do you decide which risks are acceptable and what do you do about the other risk which come along anyway?
and again:
- which risks am I taking on?

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- which of those risk am I happy to take on and which ones would I like to avoid?
- can I pass on the risks I do not want to someone else?

Then you will be in a position to consider how much it will cost you to pass on the risks and to compare the cost with the disadvantages to you of holding on to the unwanted risks.

The private individual will do his best to stay away from risks he does not understand; if he can make choices, he will identify his objectives and look for instruments of which he can keep track.

The corporate treasurer is forced to deal with the unwanted risk arising from the company's main business, he has to know what risk he is expose to, how significant they are for the business and how to control them with the resources available.

The banker will take in great consideration the financial risk not disregarding the other co-related risks.

In any case the analysis requires:

- to be carefull thought,
- to be well definited in objectives procedures,
- to have the ability to measure results and relate them to objectives.

Talking only about financial risks we have to recognize two risks cathegories:

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- the one related to foreign exchange risk
- the second one related to fluctuations in rate of interests

The basic instruments which could be adopted, in both cases, are:

- spot contracts
- forward contracts
- swaps
- futures
- options

SPOT CONTRACTS:

imply assets and liabilities on the balance sheet and actual transfer of cash.

FORWARD CONTRACTS:

consider the fact that you want to lock in row the rate at which you will settle future engagements or requirements.
Interest rate protection for future identified periods can be accomplished via FRA's (future rate agreements) where two parties agree to exchange cash amounts to compensate for any interest rate movements between one date and another.
The difference is calculated comparing the agreed rate of interest fixed to day with the "real" rate relieved on the identified future value date.

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Options:

options look like speculation and the strategy is to cover a position at risk with a speculative instrument which may reduce the risk itself or increase your profit's chances.
If an insurance company in its re-insurance program knows that must pay a certain premium in a given currency for a future maturity, adopting the option establishes to day, through a cost, the top rate is going to pay leaving open the possibility of additional profit if the market turns in its favour.

Swaps:

is the more appropriate tecnique for long term assets and liabilities. The necessity to lock in a borrowing cost or a lending return could be achieved via the swaps - which consent to exchange floating rates against fixed ones comparing to funding flows and investment schemes in accordance with the company's strategy.
Similarly, a company which has fixed assets invested abroad, or long term foreign cash flows arising from a financial contract, will protect itself against currency losses by means of a currency swap.

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When a treasurer starts to use instruments such as futures or options as trading instruments rather than as protection we reach the "arbitrage" activity, that requires a lot of expertise and requires also a keen knowledge by senior management or keeping under control the relevant risks.

In certain occasions the financial manager is warmly invited to cover fields in which he has demonstrable capability rather trading into areas and techniques outside his experience.

Also, the intruments designed for risk protection can also offer profitable trading opportunities and can be combined in various ways to produce the desired effect.

Active risk management is supported by large body of mathematical theory and computer models. Unfortunately, much of this theory relies upon the continued presence of a predictable market.
Since markets are made up of buyers and sellers there can be problems in practice.

If we want to understand a little bit better what hedging means in financial area, we have to start from the definition of a dictionary: to hedge means "to protect oneself from loss by compensatory transactions".

If you want to avoid a risk entailed in a position that you are holding, you may undertake a new position which compensates the risk; in this case if you get a gain from the original transaction you will suffer a loss in the second one and viceversa.

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Just for the good sake of the exposition you may hear expressions like:

Simple currency hedging: when you match your receivables and payables in a currency for defined future dates; you avoid in this case the double negotiation sale of receivables and buying of payables.

Cross currency hedging: when you, a french businessman, arbitrage a receivable in a given currency in a payable in another currency.
If you have to receive US.Dollars in three months time and want to eliminate the exchange risk against sterling, you simply sell dollars for pounds on the forward rate; if the market moves does not imply further possibility of losses or profits because the rate has been fixed.

Bond hedging: when a Eurobond investor requires protection against changes in value due to interest rate fluctuations, decides to hedge using US Treasury Bonds, assuming that there are in the market exactly corresponding maturities.
The theory takes no account of transaction costs.
In addition to administrative charges and dealing spreads you must take in consideration accounting and tax treatment of profit and losses which is not always uniform and may create anomalies.
In addition the price of a bond is affected by many factors, not all of which can be naturally offset; using surrogate hedging instruments you introduce different and additional risk, trying to hedge multiple dimensions simultaneously is often unmanageable.

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HEDGING OPEN OPTIONS POSITIONS

Options contracts involve for the buyer a defined maximum loss and the possibility of unlimited gains, for the WRITER involves a limited potential profit and the prospect of unlimited losses.
Written options are most effectively covered by buying the equivalent option in the market, if such a possibility is not available in a given moment it is compulsory to take a portfolio approach to the option position, but again sometimes to hedge an option position in either the cash or in the future markets is not so easy.
For this reason a dynamic hedging process is necessary considering of course the relation between the exercise price and the price of the underlying investment.

MANAGING HEDGING

If we take for good that all hedgings are approximative, a company like a bank which is engaged in many business activity, and the hedges are managed by various officers; you come to the final concept that when you adopt different tecniques you enlarged the number of counterparties, you change the distribution of the risk but simultaneously you affect the credit risk profile as much as the market risk profile.
At the very least you really need more management time and a more reliable information system to ensure that control of the businees is retained.

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A) - information system must shows at any time balance sheet implications.

It is important for the transaction to:

- have an appropriate recording
- be marked to market
- identify the element of risks
- be understood by everybody
- be linked correctly
- respect the given limits

B) - Accounting treatment:

do not exist standards for a correct accounting. Different countries behave accordingly local rules and can be affected by legal aspects.

C) - Taxation:

same - practice and discretion substitue the law, cross border transactions could be charged with witholding tax, profits and losses can not be predeterminated.

D) - Regulation:

central bank are moving towards common basis, but a lot of work is still pending.

Hedging instruments are normally off balance sheet items and in future can be subject to capital adequacy provisions.

The lack of uniformity distorts business and encourage artificial structures.

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Harmonisation between products and countries is compulsory to make all these tecniques accepted and satisfactory.

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