PARA BELLUM ADVISORS

CORPORATE TREASURY · MULTI-ENTITY GROUP

One USD Loan, Ten Currencies

SCENARIO TYPE	Corporate treasury, multi-entity group
ASSET CLASS	FX, cross-currency debt
RISK FOCUS	No group view of currency exposure, USD loans inside local-currency businesses, currencies that can't all be hedged the same way

Illustrative case study.

THE SITUATION

A family-controlled industrial group headquartered in Asia reported in USD and ran operating companies in ten countries, from frontier markets to Australia and a small European business. Most of the companies had been acquired rather than built, and they had kept the banks, systems and finance teams they came with, so each one managed its own currency risk with its local bank. Four of them had borrowed in USD while earning in local currency, and those positions had never been added up at group level. The CFO received ten sets of financial statements each month, but no view of the exposure.

That gap came to light when the currency in one of those markets fell by about 40% over two years. The operating company there had a USD30m loan and earned almost all its revenue in local currency, so by the end each interest payment, and the repayment itself, needed about two-thirds more local currency than when the loan was drawn. In the monthly accounts this appeared as a sharp rise in finance costs, and the local commentary put it down to higher rates. It was some months before group treasury traced it to the currency, and by then the board's question was how many other loans like it the group was carrying.

Putting together an answer for the board took treasury about five weeks. The ten finance teams kept their records in different formats, some in local currency and some in USD, some in accounting systems and some in spreadsheets, and one company had no loan schedule at all and had to rebuild it from the loan agreement and its bank statements.

WHAT THE USD LOAN COST

When a company that earns local currency borrows in USD, it takes on a currency position as well as a loan. The local accounts revalue the loan each month, but in this group the revaluation was booked in finance costs alongside the interest. It was reported, then, but as a funding cost, and it was never managed as currency risk.

The case for the loan had looked sound when it was drawn. USD borrowing cost about 7% against about 20% for local-currency debt, a gap of 13% that on USD30m looked like about USD8m over two years. As the currency fell, the local interest it avoided was worth less in USD each time, so counted in USD on the day each payment fell due, the saving came to about USD4m. Against that, compared with having borrowed locally, the fall added about USD12m at today's exchange rate to the cost of repaying the loan, about three times what it had saved. The gap between the two interest rates was the market's price for the currency risk. A forward to hedge the loan would have cost close to the same 13% a year, which priced in a fall of around 11% a year once the gap compounds, plus a charge for the bank's credit line. The currency fell by about 22% a year, and the company had taken the lower rate without buying the protection.

WHY THE GROUP COULDN'T SEE IT

The group can't state its position

Exposures sit in ten sets of books in different formats and have never been consolidated.

Currency losses look like interest

Booked in finance costs, the loss goes to the people who review funding costs, not the ones who review currency risk.

Hedging is bank by bank

Companies hedge with whatever product their local bank offers when a problem comes up, with no group view on how much to hedge, with what, or through whom.

The paperwork comes after the decision

In emerging markets, bank documents, credit lines and onshore registrations take months. A group that decides to hedge first and sets up second finds it can't trade when it wants to.

TEN CURRENCIES, FIVE KINDS OF PROBLEM

Treating the ten currencies as one problem would have given the wrong answer for most of them, so treasury grouped them before anyone talked about hedging products. Australia and Europe were liquid G10 markets with every instrument available. Three emerging-market currencies could be hedged once the bank documents and onshore paperwork were in place, though in one of them forward liquidity thinned out beyond about three months, and another moved hard on politics and commodity prices. The high-inflation currency could be hedged, but the carry was well over 10% a year and onshore limits capped how much could be done. The two frontier currencies couldn't be hedged with derivatives at all: both had capital controls, and neither had a usable forward market. The last two needed little: both were tied closely to the USD, one by a peg, so they were in effect USD exposure, with the peg itself the thing to watch.

The grouping set the treatment for each. For the high-inflation loan the test was the unhedged cost over the loan's remaining life against the certain cost of hedging it. Leaving it open was allowed, provided it was a decision taken with those two numbers on the table.

THE OPTIONS

Each option has a cost:

- Add group reporting and leave hedging with each company. Cheapest, but nothing changes how decisions get made.
- Build a group exposure map and currency policy first, then hedge where markets allow. Takes months, and banks need documentation and credit lines in place before they will trade.
- For the USD loan in the high-inflation business: hedge it with forwards matched to the loan's payment dates, at about 13% a year, refinance in local currency at about 20%, or repay it from group cash and fund the business with equity.
- For the Australian business: a cross-currency swap that turns its USD loan into AUD debt, with the floating rate fixed in the same trade if the board wants rate certainty too. It uses more of the bank's credit line than a forward, and the bank prices that in.
- For the two frontier currencies, where derivatives aren't available: USD invoicing where local rules and customers allow it, and low local cash balances.

WHAT THE BOARD CHOSE

The board started with the map: revenues, costs, intercompany flows and every loan, by currency and by company. Gross exposures across the ten companies came to about USD400m. Netting the natural offsets inside the group (one company's receivables in a currency against another's payables in the same currency) brought that to about USD150m, well under half the gross figure.

Management of the high-inflation business preferred to keep the USD loan, since refinancing at local rates of around 20% would nearly triple its reported interest cost. Group treasury's concern was different. Repaying the loan from group cash would fix the local company's books, but the group would still own a business whose value in USD fell with the currency, and nothing short of local-currency debt, or forwards doing the same job, would offset that, at about 13% a year. The board repaid the loan from group cash and recapitalised the company with equity, which crystallised the loss in the local company's books and ended the revaluation swings there. At group level the currency exposure was the same as before. The board decided against paying 13% a year to cover it, and minuted it as currency risk the group had chosen to carry, to be reviewed against the cost of local debt each year.

It also set a group currency policy with a treatment for each currency, swapped the Australian loan into AUD, and moved the frontier businesses onto USD invoicing and regular cash sweeps where local rules allowed. It chose two or three core banks for derivatives, with competing quotes required above a set size, and had documents and credit lines in place in each hedgeable market before the first trade. The trade-off was about six months of set-up work, new bank documentation, a realised loss on the high-inflation loan, and a currency position the group now held on purpose rather than by accident.

> **THE LESSON**
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> *Every USD loan inside a local-currency business was a currency position. None of them had been approved as one.*

TEST IT ON YOUR OWN NUMBERS

- List every loan in a currency other than the borrower's revenue currency. What does a 20% move do to the cost of repaying each one, and how does that compare with the interest it has saved, counted in the same currency?
- Add up exposures by currency across all entities and net the offsets. How does the net number compare with the gross?
- For each currency you would hedge, can a bank trade it with you today under your current documents? If not, how long would set-up take?

In a business that earns another currency, one fall in that currency can cost more than a USD loan ever saved in interest. If you couldn't say today what that would cost your group, that's worth an exploratory discussion with Mike Duncan.

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