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Contemporary Issues in Finance
The use of derivatives

Martin Upton

To help me explore the issues of financial risk management and, in particular to show how financial risks are managed in the business world, I'm delighted to be joined by Neil Henfry, the Group Treasurer of Boots, the United Kingdom's leading health and beauty retailer and Paul Outridge, the Head of Treasury at De La Rue, the world's largest commercial security printer and paper maker. Managing company risks involves an active relationship with the banking sector... and here to represent that sector I'm pleased to have Hor Chan of the international banking group ABN Amro. When we talk about managing foreign exchange exposure, we say that, before you need to use derivatives like foreign exchange swaps to manage that exposure, you should look at alternative – what we call internal techniques to manage your currency risk. Now, does this go on in the real world? What's the experience at De La Rue?

Paul Outridge

Yes, most certainly it does. Natural hedging, as we'll call it, essentially matching currencies of payables and receivables, is a key first line in managing currency exposures because that can be done at no cost. It reduces your net exposure and therefore reduces the volatility that you need to manage as part of that risk. Another key feature, because foreign exchange forward contracts are very much a short term option for smoothing the flow in terms of volatility, but what is also key is looking longer term in terms of more strategic ways of managing risk. And for us, particularly for currency risk, is, for example, where do we situate our manufacturing plants? A key area for us and which is one in which we've recently implemented, is to move some of our manufacturing sites away from Europe into low cost dollar denominated regions in the Far East. Now, not only does that help to reduce our cost base, it also helps to reduce our currency exposures as well, because many of our key markets for some of our machines are in the US and we are therefore managing naturally to hedge our dollar exposures by sourcing products in a dollar denominated region and selling, obviously, in North America. So, that provides a natural hedge to us which reduces our net exposure and therefore reduces the actual number of forward contracts and derivatives that we need to use.

Martin Upton

Hor, it's again slightly different from a banking perspective, isn't it? Because companies like Boots and De La Rue – they could be your customers when it comes to hedging transactions, when it comes to the use of derivatives. How would you describe the relationship you would have at ABM with those types of customers and how would you be using derivatives to manage your own risks?

Hor Chan

Well, I think from the point of view of dealing with customers like Neil and with Paul, of course, we are suppliers of the financial hedging instruments and market makers in those, so of course if they wanted to use a swap or a forward they could call us and we would tell them at what price or at what rate we could provide that hedging instrument. And the point is that we are there to provide liquidity in the market – we provide both a bid price and an offer price, if they wanted to unwind their hedge as well. But for us as a bank I think the real change for us in terms of using derivatives in the last few years has really been the advent of credit derivatives and that's really helped us to manage our credit portfolio in a much more active way than we ever did even five years ago. And, as I mentioned earlier, that really is the biggest credit risk that we have.

Paul Outridge

Can I come in at this point? Because if I wasn't happy with the credit worthiness of an issuer, I wouldn't buy the bond in the first place. So why do I need to access the credit derivatives market to manage credit exposure which perhaps I didn't want in the first place?

Hor Chan

I think that there are different ways of acquiring the assets in the first place. Sometimes we're given the risk, in a sense, by a client who asks us for a price and then sells to us, of course, on the bid side, hopefully some asset which has credit risk which we aren't really happy with, so we may want to hedge that. But, more often I think, where credit risk arises is where we deliberately take on the exposure. We would deliberately lend money to a client, or we may think that their bond which they've issued is a good investment. But, of course, circumstances change. The markets move, credit worthiness alters with business cycles and so on. So, something may happen which would mean that we're less happy, perhaps, with the credit risk which we have and we want to hedge that. And, of course, on occasion it's very difficult, especially when you've given a loan, it's very difficult to go back to the client and say – we'd like to pull your loan now; we'd like our money back please – because I'm sure Neil and Paul would not be very happy if I tried to do that. So, what we would do instead, of course, is merely hedge it using a credit derivative and that's the way we can get around having to go back to the borrower saying… you know – we're not so happy with you nowadays.

Martin Upton

And the most common derivatives in use are credit default swaps – is that the case?

Hor Chan

That's right.

Neil Henfry

Can I come in… because corporates are not necessarily that thrilled about the development of the credit default swap market. But it gives a very visible price on your bonds and your funding. So, if you've issued a five year bond, you've now got a very visible price that's very volatile. In the old days you used to issue bonds to investors and they used to sit on them and there was hardly any trading went on in them. Now there's a credit default swap market, it's a very visible traded market. It's often got hedge funds acting in it and so you can get some very volatile pricing in that market. And, of course, if you then try and issue new bonds into it the reference market is the credit default swap market, not how your bond is trading in the kind of real world. So to go back to that example of Philip Green with Marks & Spencers, all the retailer bonds, credit default swap markets went, maybe, up a hundred basis points, or over, within a day. And so it can make things very difficult.