



You've Hedged the Exchange Rate. But Can You Get the Currency?

Why exchange-rate risk, convertibility and access to hard currency are not the same thing

A company can hedge an exchange rate successfully and still suffer a substantial foreign-exchange loss.

A hedge can protect the price at which a currency is exchanged. It cannot guarantee that the currency will actually be available.

That distinction can easily be overlooked when companies invest, acquire businesses, undertake major capital expenditure or expect cash distributions from markets where access to hard currency cannot always be taken for granted.

For a corporate or investor contemplating a material overseas exposure, there are therefore three questions worth asking:

Have we hedged the exchange rate?
Will the foreign currency actually be available?
Can we move that currency to where it is needed?

In other words: **exchange-rate risk, convertibility risk and transfer risk.** A conventional FX hedge principally addresses the first.

The Three Layers of FX Risk

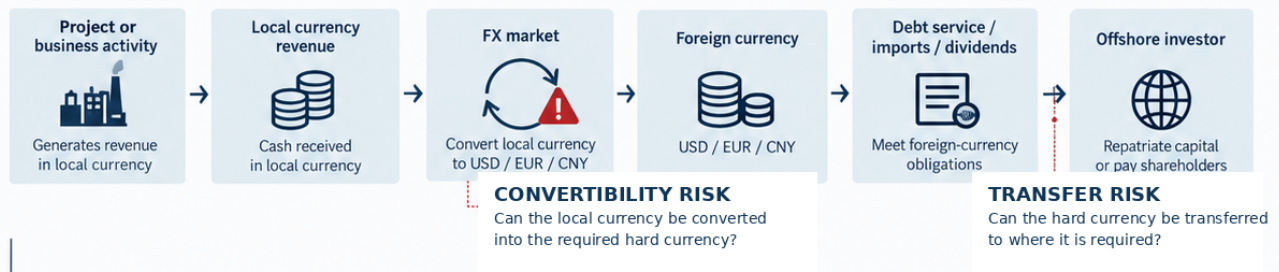
An exchange-rate hedge can address the price of a currency. It cannot guarantee that the currency will be available, or that it can be transferred.



A HEDGE CAN PROTECT ONE LAYER OF FX RISK. IT DOES NOT NECESSARILY PROTECT THEM ALL.

The Hard-Currency Chain

A hedge can protect one link in the chain. It does not necessarily protect the chain.



THE CHAIN IS ONLY AS STRONG AS ITS WEAKEST LINK.

Three layers of FX risk

Most treasury discussions naturally begin with the exchange rate.

A company knows it will need to buy or sell dollars, euros or another currency at some future date. A forward, option or swap can fix the rate or limit the financial consequences of an adverse movement.

Exchange-rate risk is the risk that movements in the exchange rate alter the value of the underlying cash flow.

Convertibility risk arises when a company has local currency but cannot readily convert it into the required foreign currency.

Transfer risk arises when foreign currency has been obtained but cannot readily be remitted outside the jurisdiction.

A conventional FX derivative primarily addresses the first. It does not necessarily solve the other two.

When protection against currency risk isn't the same as currency liquidity

One of the less obvious lessons from emerging-market infrastructure is that contractual protection against currency risk should not automatically be confused with access to the underlying currency.

LKA encountered this directly in a large African infrastructure investment during a period of severe US-dollar scarcity. The investment benefited from political-risk protection designed to address currency inconvertibility and transfer restrictions.

Such protection is intended to respond to specified circumstances in which local currency cannot be converted into hard currency, or hard currency cannot be transferred out of the host country. But it should not be confused with a facility that continuously supplies foreign-currency liquidity into the local market.

In this case, the protection provided a contractual mechanism for dealing with the currency restriction. The practical problem remained the ability to source sufficient USD liquidity on equivalent economic terms when required. The result was that protection against the specified currency event did not necessarily eliminate the economic consequences of hard-currency scarcity.

The precise outcome will depend upon the terms of the hedge, guarantee or insurance contract involved. The broader treasury lesson is more general:

Protection against an exchange rate, convertibility event or transfer restriction should never be assumed to be the same thing as guaranteed access to foreign-currency liquidity.

A hedge can protect the price of currency. Political-risk protection can protect against specified convertibility or transfer events. Neither necessarily creates liquidity in the underlying FX market.

A hedge can protect the price of liquidity. It cannot create liquidity where none exists.

When the problem becomes bigger than the project

The issue becomes more significant when the same mismatch exists across an entire economy.

For decades, many major infrastructure projects in developing economies have been financed in US dollars and other hard currencies. There was good reason for this: infrastructure requires large amounts of long-dated capital, while domestic banking and capital markets have not always been capable of providing either the required quantum or tenor.

But many of those assets generate their revenues predominantly in local currency. One foreign-currency financed project therefore creates a future claim on the country's hard-currency earnings. Multiply that structure across an economy and those claims become substantial.

They compete with sovereign debt service, essential imports, trade finance, dividend remittances and other private-sector demand for foreign currency.

When exports are strong and international capital continues to flow into the country, the structure may function perfectly well. When commodity prices fall, international financing dries up or foreign investment slows, the underlying mismatch can become painfully apparent.

The economy may have plenty of local currency. What it doesn't have is enough dollars.

Commodity exports don't necessarily solve the problem

It might seem that a major commodity exporter should be protected from this problem. Not necessarily.

Oil, copper, cobalt and other commodities may generate substantial hard-currency export earnings. But headline export revenues do not tell us how much of that currency is actually available to the wider domestic economy.

There may already be competing or prior claims on those receipts - for sovereign or corporate debt service, imported equipment, offshore operating costs, foreign shareholders or other contractual commitments. Under some resource-backed financing structures, future commodity-related receipts may also be pledged or directed toward debt repayment.

A country can be a substantial commodity exporter and still experience an acute shortage of freely available hard currency.

For an overseas investor or corporate treasurer, the important question is not simply how many dollars the country earns. It is: **How many of those dollars actually reach the market in which we will need to obtain them?**

What if we replace the dollars with renminbi?

The growing role of Chinese financing has introduced another variation on the issue. Some borrowers have sought to reduce dependence on US-dollar financing by borrowing - or refinancing existing liabilities - in Chinese renminbi.

That may be entirely rational where equipment is being purchased from China, revenues are received in renminbi, or CNY financing is cheaper or more readily available.

But merely changing a loan from USD to CNY does not eliminate the underlying currency mismatch. If the project earns local currency but must service debt in renminbi, it still has to acquire a foreign currency.

The question has simply changed from **Where will the dollars come from?** to **Where will the renminbi come from?**

Changing the denomination of the liability can change the risk. **It does not necessarily remove it.**

Why this matters to a UK corporate

None of this is relevant only to African infrastructure.

Consider a UK company acquiring an overseas business. The acquisition price might be hedged months before completion. A manufacturer may hedge forecast purchases from an overseas supplier. An infrastructure investor may hedge expected project distributions. A UK parent may expect dividends

from an overseas subsidiary to service obligations elsewhere in the group.

On a treasury spreadsheet, each exposure may appear appropriately hedged. But the commercial cash flow remains fundamental.

Will the underlying payment actually occur? Will it occur when expected? Can the local currency be converted? Will sufficient foreign currency be available? Can the proceeds be transferred?

What happens if conversion is delayed for three or six months? What happens if an official exchange rate bears little relationship to the rate at which meaningful amounts of currency can actually be obtained?

And perhaps most importantly: Does the derivative still have to settle if the underlying cash flow doesn't?

If it does, a hedge intended to reduce financial risk can itself create a substantial liquidity requirement at precisely the wrong time.

Hedge the exposure, not the spreadsheet

Effective FX risk management therefore starts before choosing the derivative.

The underlying exposure needs to be understood first: its amount, timing and certainty; the jurisdiction in which the cash arises; the currency in which revenues are generated; how those revenues will be converted; where the required hard currency will originate; and how the derivative behaves if any of those assumptions change.

Only then should the hedge structure be determined.

The question for a corporate treasury team should therefore not simply be: **What exchange rate can the bank lock in?**

It should also be: **What exactly are we protecting, where will the hard currency come from, and what happens to the hedge if the underlying cash flow doesn't behave as expected?**

Sometimes the appropriate solution will be a straightforward forward. Sometimes an option provides better protection against an uncertain exposure. Sometimes progressive hedging is preferable to fixing the entire exposure at inception.

And sometimes the most important currency risk cannot efficiently be transferred through the derivatives market at all.

Independent challenge

Banks provide essential liquidity, execution and structuring capability.

But a bank and its corporate client necessarily approach a transaction from different perspectives.

The bank is pricing and executing a financial instrument. The corporate needs to understand how that instrument behaves **together with the underlying commercial exposure**.

That requires considering hedge ratios, timing mismatches, settlement mechanics, liquidity requirements, termination provisions, credit charges and alternative structures - not simply comparing forward rates.

The objective isn't to eliminate every conceivable risk. It is to understand precisely: **Which risks have we transferred? And which risks do we still own after the hedge has been executed?**

Ultimately, the question is not simply whether the exchange rate has been hedged. It is whether the underlying currency will be available, transferable and in the right place when the hedge has to settle.

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LKA Advisory

Drawing on more than two decades of experience advising corporates, investors and infrastructure sponsors on material financial-market exposures, LKA Advisory provides independent advice on **foreign exchange, interest-rate and commodity risk**, including hedge strategy, bank pricing and execution.