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Managing foreign exchange risk with derivatives[☆]

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Abstract

This study investigates the foreign exchange risk management program of HDG Inc. (pseudonym), a US-based manufacturer of durable equipment. Precise examination of factors affecting why and how the firm manages its foreign exchange exposure are explored through the use of internal firm documents, discussions with managers, and data on 3,110 foreign-exchange derivative transactions. Informational asymmetries, facilitation of internal contracting, and competitive pricing concerns appear to motivate *why* the firm hedges. *How* HDG hedges depends on accounting treatment, derivative market liquidity, exchange rate volatility, exposure volatility, and recent hedging outcomes. © 2001 Elsevier Science S.A. All rights reserved.

JEL classification: G32; D81; F31

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1. Introduction

While the risk management strategy of non-financial firms has been the subject of intense theoretical and empirical research, very little is known about the actual hedging practices of multinational firms. Using a field study and proprietary data, this paper conducts a detailed investigation of a firm's hedging operations and of its motivation for engaging in financial risk management. In the Spring of 1998, I spent approximately three months in the treasury department of HDG Inc. (pseudonym).¹ During this period, I observed the implementation of foreign exchange (forex) risk-management decisions while conducting extensive discussions with treasury personnel and senior management, reviewing internal documents, and collecting historical data on all 3,110 individual foreign currency derivative transactions for the 14 quarters from 1995:Q1 to 1998:Q2. HDG's forex derivatives are written on 24 different currencies. Of these, 15 are hedged for the whole sample period (full-sample currencies) and 9 enter the sample during the observation period (partial-sample currencies).

Using this information, I address three general research questions. First, *how* does HDG structure its foreign exchange hedging program? Since existing literature contains little on how non-financial corporations structure their internal risk management programs, answering this question provides insights into the operations of the hedging program and affords a framework for more in-depth analysis of HDG. In general, HDG's policies and practices are consistent with the guidelines proposed by the Group of Thirty (1993) for derivative end-users and with the risk management practices of large multinational corporations (see, e.g., Lewent and Kearney, 1990; Davis and Militello, 1995; Callinicos 1999; Pearl et al., 1999).

Second, *why* does HDG manage foreign exchange risk? By observing the daily operations of the group and their interaction with senior treasury and foreign managers, I am able to report on observed motivations for the firm's risk management program. Traditional academic explanations for why a firm would manage hedgable risks (such as minimizing taxes and avoiding financial distress) do not capture the primary motivations of HDG. Instead, hedging appears to be motivated by more subtle explanations relating to information asymmetries between investors and management, competitive strategies involving pricing decisions, and efficiency gains through improved internal decision making and evaluation. For example, the primary focus of the forex hedging group is the

¹ As a condition for undertaking this study HDG required that I enter into a non-disclosure agreement. Specifically, I am not able to expose the true identity of the firm. I can only describe the firm as an "industry-leading manufacturer of durable equipment." In regards to specific data, I am not able to identify particular currencies, nor can I report disaggregated data (e.g., sales by country by quarter, though "average sales in currency X" is permitted). A general restriction prevents me from disclosing any information that would allow a resourceful person to identify the company.

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