Gm hedging essay

What is GM's foreign exchange hedging policy? GM's foreign exchange hedging policy has three primary objectives. Its first objective is to reduce cash flow and earnings volatility. Specifically, management hedges the company's transaction exposures and consciously ignores any balance sheet exposures (translation exposures).

Second, GM aims to minimize the management time and costs dedicated to global FX management. The company employs a passive FX management strategy since an internal study determined that the investment of resources in active FX management had not resulted in significant outperformance of passive benchmarks. The third objective is to align FX management with the firm's core automotive business. The passive policy adopted by GM is to hedge 50% of all significant foreign exchange commercial (operating) exposures on a regional level (General Motors North America, General Motors Europe, General Motors Asian Pacific, and General Motors Latin America, Africa, Middle East). Each regional treasury center is required to use particular derivative instruments over specified time horizons.

The guidelines are as follows: forward contract to hedge 50% of the exposures for months one through six and options to hedge 50% of the exposures for months seven through twelve. In general, at least 25% of the combined hedge on a particular currency is to be held in options in order to assure flexibility. What do you think of GM's foreign exchange policy? More specifically, what are the questionable aspects of GM's policy? GM's strategy for its foreign exchange policy consists of clear objectives and FX management alignment with operational activities. The company's passive hedging strategy is reflective of GM's policy to focus on its underlying

business rather than speculate on the movements of FX. From this standpoint, GM's treasury department is provided with specific guidelines in their functions.

For example, each regional treasury center is required to use particular derivative instruments over specified time horizons. GM utilizes forward contracts to hedge 50% of its exposures in the first 6 months and options to hedge the other 50% in the following six months. The use of specific derivative instruments provides efficient, effective, and standardized guidelines to each treasury center. The fluctuation of the delta hedge ratio between 30% and 45% with a tolerance of +/- 5% gave treasury centers some flexibility due to the practical difficulties with exactly matching the benchmark. However, it is clear that each center acts according to the controls and standards set out by GM policy makers. Furthermore, the 25% option requirement of the combined hedge on a particular currency assures flexibility because options provide the holder with the right to exercise, but not the obligation.

Another key element of GM's hedging strategy is its differentiation between capital expenditure, operating and financial exposure. Hedging depends, specifically, on the type of exposure. As previously stated, operational activities are hedged at 50% of the notional exposure. The rule of thumb, however, is 100% for financial and capital expenditure exposures except 50% hedge ratio for dividends. The separation of each exposure and hedging according to predetermined benchmarks demonstrates management's understanding of the different volatilities associated with each activity. GM has implemented screening mechanisms to closely monitor all hedging

activities and any deviation from current policies requires approval from the Treasurer's Office.

GM's policy, however, does have several questionable aspects. For example, the company does not employ full centralization when hedging FX risk. Exposures are managed regionally and hedged separately. Although offsetting exposures may exist among the different regions, the company hedges its exposures in a decentralized manner.

It is, therefore, conceivable for GM to either over or under-hedging depending on the division. If GM hedged its exposures at headquarters, some FX inflows and outflows would cancel each other. Since there are costs associated with hedging, any over-hedging would result in extra costs for the company. Also, the company's passive strategy may not be suitable for every division. Since certain divisions may operate in different markets, the risk across each region could vary.

For instance, the Canadian dollar is recognized as being less volatile than the Argentine Peso. Therefore, the hedge ratio for operating exposures should be higher for the Argentine unit to reduce the earnings volatility. Finally, the infrequency of committee meetings should be examined. Currently, the committee meets every quarter. It can be argued that this committee should increase of the frequency of these meetings, especially when the treasury department is asked to approve a deviation from current policy which would substantially impact operations.

By increasing the number of meetings, GM could re-assess its policy to employ strictly forward and options to hedge. The tools used by each

regional treasury center should be analyzed more frequently. Alternative hedging tools should also be considered to maximize the firm's hedging activities. For example, GM could utilize futures to eliminate credit risk associated with forward contracts and counterparty risk. What types of CAD exposure does GM have and how should they be hedged according to the corporate hedging policy? As previously stated, the policy adopted by GM was generally to hedge 50% of all significant foreign exchange commercial (operating) exposures on a regional level.

Currently, GM's passive hedging policy calls for hedging 50% of the CAD 1. 7 billion cash flow exposure projected over the subsequent twelve months. In addition, GM has a CAD 2. 1 billion net monetary liability that is not hedged.

This is in accordance with the company's policy to leave any balance sheet exposures unhedged.