Managing FX Risk in Turbulent Times

Observations from Citi Treasury Diagnostics

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Corporate treasurers are currently feeling pressed by threats not only familiar and anticipated, but also new and unexpected. Results from Citi Treasury Diagnostics reveal that 2016 saw a continuation in a number of corporate treasury trends–centralization, improving processes and procedures, and the use of more sophisticated risk management techniques. At the same time, there are clear signs that many companies need to do more given the potential for higher volatility in the foreign exchange (FX) markets.

***Citi Treasury Diagnostics (CTD)** is an award-winning benchmarking tool designed to help companies assess the effectiveness of their treasury, working capital and risk management practices against industry peers and best-in-class companies. It equips treasury departments to identify opportunities to deliver more value to their firms.*

Introduction

Against the backdrop of great social, economic and geopolitical change, 2016 proved to be a challenging year for corporate treasurers, particularly from a risk management perspective. Relatively benign periods of market activity were interrupted by the occurrence of significant market movements. Most notably, results from both the Brexit referendum and the U.S. presidential election jolted markets out of complacency and drove a resurgence of volatility in the FX markets, consequently exposing the earnings of many multinational corporations to even greater uncertainty.

In the wake of Trump's election victory and the Brexit vote, the year ahead will likely be fraught with additional events that may cause turmoil in the currency markets and further disruption to corporate earnings. The upcoming elections in three of the founding member states of the European Union (France, Germany and the Netherlands) as well as the uncertainty posed by a Trump presidency could result in dramatic and unpredictable swings in the global financial markets. These dynamics have heightened the importance of having a well-designed and integrated FX risk management program in place, bolstered by an equally robust technology infrastructure.

This report sets out key findings from Citi Treasury Diagnostics as to the various approaches corporate treasurers have recently taken to identify and manage their FX exposures, as well as the tools and techniques used to mitigate those risks amongst a more challenging operating environment. The question remains, however: are corporates doing enough?

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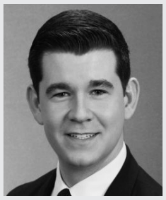

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Executive Summary

The findings presented in this report are based on a comprehensive review of survey results gathered from nearly 150 Citi Treasury Diagnostics participants. The respondents come from organizations representing a diverse range of sizes, industries and geographies. Participant companies varied in turnover size—ranging from less than 1 billion USD to greater than 25 billion USD—and represented all sectors of the economy and all regions across the globe.

Key findings include:

- FX risk management practices vary significantly by region, particularly around objectives, the emphasis placed on types of exposures, and the approaches used by corporates to hedge risks
- FX risk management policies are broadening in scope to include more strategic and tactical methodologies, such as assessing the impact of FX on indicators such as Net Debt to EBITDA
- While reducing earnings volatility remains a priority, the number of corporates actively taking measures to mitigate FX volatility in earnings is relatively low
- Over half of the companies surveyed do not differentiate between emerging market (EM) and developed market (DM) transactional hedging practices
- While many organizations have existing FX risk management programs in place, companies tend to leverage traditional strategies, practices, products, tools and technology
- Some corporations have focused on leveraging cash management processes, such as pooling and cash flow forecasting, to improve the effectiveness of their risk management programs
- Corporations continue to deploy various constructs to achieve greater centralization and more effectively manage FX risk, however, natural risk management techniques, such as netting, appear to be a missed opportunity among a number of companies
- Despite the increasing recognition of technology as an important enabler to meeting risk management objectives, over half of survey participants reported that their treasury management system (TMS) does not support financial risk management processes

Foreign Exchange Risk Management

Regional Variations

While survey results reveal a number of key practices and processes to be remarkably consistent across regions, the data also shows that there are significant regional differences, perhaps driven by variations in regulatory environments and traditional market practices. FX risk management objectives, for instance, vary widely by region. Companies in the Americas (59%) and Asia (68%) were more likely to focus on reducing risk to both cash flows and earnings, while those in Europe (62%) placed more emphasis on reducing risk to just transactional cash flows for different subsidiaries within their organization's consolidated entity.

Data also shows that the emphasis placed on the types of exposures differs from one region to the next. Companies in Asia (63%) and Europe (61%) were more likely to hedge net monetary FX-denominated assets and liabilities than those in the Americas (42%). Similarly, only 29% of Latin American-based respondents reported hedging forecasted FX-denominated exposures, verses 58% in Asia, 76% in North America, and 85% in Europe. While the number of respondents who reported hedging against translation risk is remarkably low across the board (13%), among companies that do, those based in Asia were three times more likely to hedge against earnings translation risk than those in Latin America, and two times more likely than those in Europe and North America.

Regional variations also appeared in the approach that corporates use to hedge forecasted exposures. While Latin American-headquartered companies favored opportunistic hedging (24%) versus those in Asia (11%), North America (13%) and Europe (14%), rolling hedges were widely more popular in Europe (32%) and North America (26%) than in Asia (17%) and Latin America (12%).

Policy

Roughly 90% of companies surveyed reported having a formal written FX policy in place. One of the most striking observations has not only been in the number of policy reviews undertaken, but also the expanding scope of the policies themselves. A recent development, for instance, has been the broadening of the scope of FX risk management policies to include more strategic and tactical methodologies. Many senior managers from both treasury and corporate finance now recognize the need and importance for a policy that addresses the impact of FX on broader-based performance indicators such as Net Debt to EBITDA.

While the catalyst has varied, broad-based USD strength, benign commodity and interest rate environments, and accounting-based earnings volatility due to system limitations are often cited as factors driving companies to reassess their FX risk management policies.

"We've identified the need for broader policy review, largely a result of unexpected FX volatility deriving from our intercompany portfolio."

Americas multinational CTD participant

Hedging Practices

While the majority of survey participants already had mature FX risk management programs in place covering a large portion of their exposures, many companies still reported material impacts on their earnings due to FX volatility. At first glance, this would seem somewhat surprising given that nearly 60% of respondents declared 'reducing earnings volatility' as a key risk management objective (Figure 1). Upon closer consideration, however, survey results show that only a small number of companies (13%) actually directly hedge earnings translation exposures. Thus, while reducing earnings volatility may be a priority, the number of corporates actively taking measures to mitigate this risk is quite low. This suggests that other considerations, such as the potential for derivative P&L volatility or the reluctance to hedge non-cash items, for instance, have taken precedence over the desire to reduce FX volatility in earnings.

Figure 1.

Risk management objectives

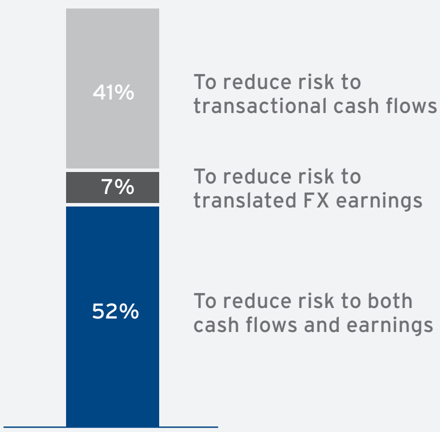
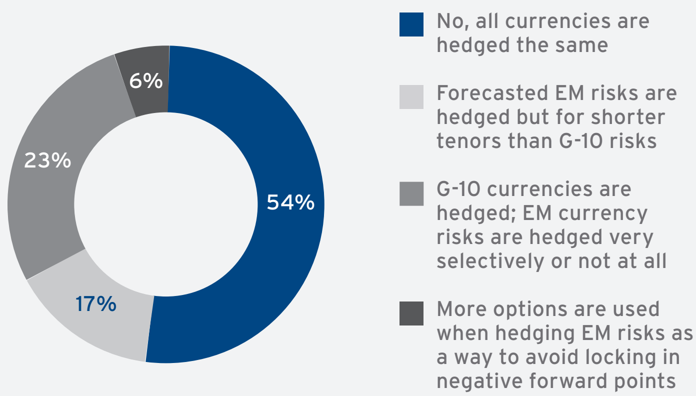


Figure 2.

Managing EMs differently than G-10 currency risks



Based on survey findings, it is also fairly clear that the overall FX risk management approach for many corporations has remained largely unchanged compared to earlier years. From a market perspective, despite the acknowledged difficulties of hedging emerging market exposures, over half (54%) of corporations surveyed use the same approach for hedging both emerging market and developed market transactional exposures. A further 23% reported having a policy of only hedging EM exposures very selectively, if at all (Figure 2). Costs were reported as the primary concern.

Perhaps reflective of the narrow range of the trade-weighted dollar index (TWDI) over the past 12 months, survey results show little change in the overall hedging approach followed by most companies. Broadly speaking, 65% of participants continued to follow a layered, rolling or equivalent strategy to hedge forecasted cash flows. Additionally, many hedging programs continue to be short-term in nature, with only 10% of respondents indicating that their 6-12 month exposures are hedged more than 75%. Due to these shorter-term hedging durations, the number of companies actually realizing significant economic and risk reduction benefits has been limited. Going forward, companies should consider investigating the benefits of extending their hedging tenors.

With respect to balance sheet exposures, 70% of survey participants reported hedging more than 50% of their net monetary FX-denominated assets and liabilities. Apart from costs, another commonly cited reason for hedging less than 100% of existing FX-denominated assets and liabilities was the difficulty in accurately tracking exposures. This once again highlights the importance of technology as a key enabler to more effectively and efficiently achieve risk management objectives.

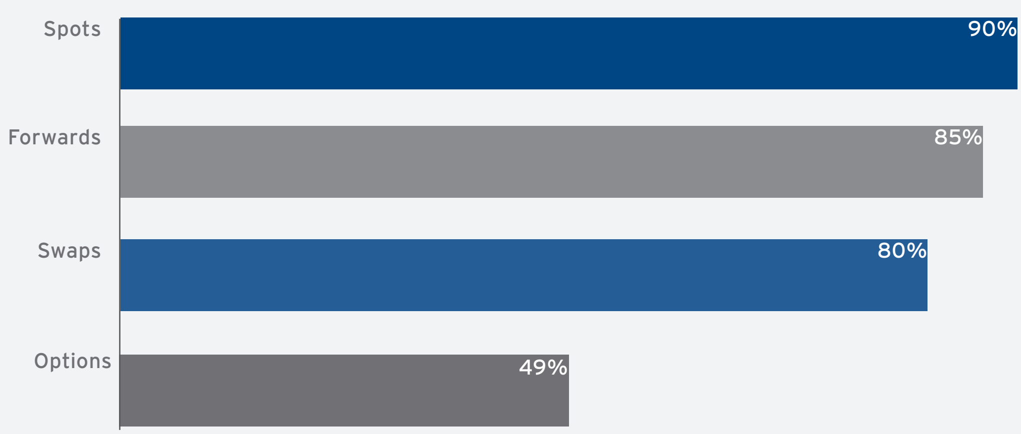
> *"Managing foreign earnings risk is increasingly becoming a major concern and challenge for us."*
>
> Americas multinational CTD participant

From a product standpoint, spots (90%), forwards (85%) and swaps (80%) remain the most commonly permitted financial instruments per corporate risk management policies (Figure 3). Slightly less than half (49%) of survey participants reported option-based strategies as being permissible, and, of those, the number of companies actually using options is relatively low (31%), perhaps driven by the prohibitive costs of premiums or due to a perceived lack of benefits. However, in the face of increasing uncertainty and instability, many companies could benefit by including a greater variety of instruments, for example, zero-cost options, in their hedging practices as a means to optimize their wider FX risk management programs.

Unsurprisingly, the majority of corporations continue to quantify and assess FX risks in terms of absolute moves in currency rates. Often those with more complex exposures reported applying more advanced risk tools such as value-at-risk (18%) and portfolio analyses (20%), which, in their view, captured volatility and correlation effects in order to better represent the FX risks to which a corporation is exposed. Risk attribution can then be evaluated in a more robust manner with an end goal that treasury's scarce resources are focused on the most significant risks and hedged in the most cost-efficient manner. Ultimately, while it remains true that statistics will never be a panacea for all FX risk management concerns, these quantitative modelling techniques and tools can be valuable to a corporate treasurer to apply when formulating a risk management strategy.

Figure 3.

Policy-permitted financial instruments



Cash Management Processes

For many corporations, traditional cash management processes can be leveraged to manage both on-balance sheet and forecasted transactional FX risks. Cash pooling, for example, traditionally used by companies seeking to mobilize global cash, can also reduce, or even entirely eliminate, the need to perform certain FX transactions. It is then, perhaps, not surprising that over 80% of respondents reporting pooling cash in some capacity, either physically or notionally.

Similarly, cash flow forecasting, which can provide visibility into future aggregate cash positions across currencies, can be invaluable in helping companies identify natural offsets and opportunities for internal hedging, thus reducing the need for external FX transactions. According to survey results, 90% of participants reported forecasting their cash flows, among which 91% reported linking their forecasting process with intercompany lending and repatriation requests. Somewhat surprisingly, given the importance placed on effective cash flow forecasting, nearly 80% of survey respondents reported that inputs are compiled manually, perhaps reflecting another opportunity where companies can further harness technology to better manage risks.

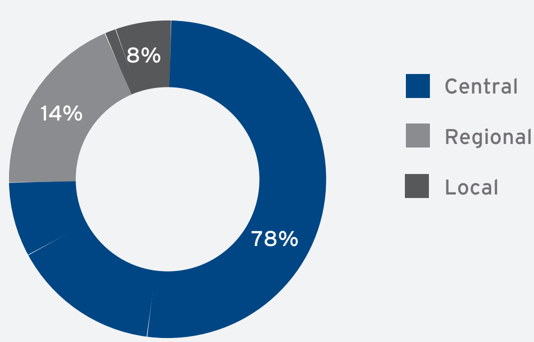
Centralization

Survey results show that the trend of centralization is still ongoing. Most of the companies surveyed (78%) reported managing risk on a centralized basis (Figure 4). Results also reveal that corporations continue to deploy various constructs to achieve greater centralization and more effectively manage FX risk, with over half (56%) of respondents using an in-house bank and 75% adopting a shared services model. Surprisingly, netting, which aggregates intercompany treasury and commercial flows and increases oversight of FX exposures globally, is only used by 47% of companies as a way to improve currency risk management. In this regard, netting exposures across entities as a natural risk management technique appears to be a missed opportunity among a number of corporates.

While organizations with centralized models generally report more benefits and fewer challenges than those with a decentralized model, it should be noted that this is not always the optimal approach. The current tax environment, for example, is prompting many corporations to reconsider managing commercial flows in a non-centralized manner. Particularly, in light of the changes to global tax rules under the OECD's Base Erosion and Profit Shifting (BEPS) initiative, some companies may decide to revert back to managing various components of enterprise risk at the local level.

Figure 4.

Level of risk management



Technology

Despite the increasing recognition of technology as an important enabler to meeting risk management objectives, over half (51%) of survey participants reported that their treasury management system (TMS) does not support financial risk management processes. This is a surprising observation given that nearly three-quarters (74%) of companies reported having a TMS or enterprise resource planning (ERP) treasury module. This suggests that there is scope for corporate treasurers to extend the usage of their TMS/ERP from its current state.

From a FX risk management perspective, the ability to aggregate risk data from a single source is an area of key importance. And, while an enterprise's supply chain and resulting financial data—maintained on a single ERP system—remains the nirvana for many corporations, only 51% of respondents stated that systems have been consolidated into a single-instance, global ERP.

"Technology continues to be a core priority within treasury going forward."

European multinational CTD participant

One area where corporations have seen success, however, has been in addressing shortcomings in connectivity, which, according to many companies, is as much, if not more, of a priority as addressing traditional risks. Survey results show that the vast majority of companies (86%) have treasury systems that interface with corporate and legal entity ERP and general ledger systems in some capacity.

Conclusion

With the resurgence of volatility in the marketplace, the corresponding effects on FX markets will continue to present serious challenges to companies around the globe. While large corporates generally have FX risk management programs in place, many have remained with traditional strategies, practices, products, tools and technology. From our advisory work, we see leading corporates taking a more proactive and flexible approach to risk management by adapting to changing market and business conditions. Given today's changing market conditions and dynamics, the question is whether those who are maintaining the status quo can really afford to continue doing so.

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