WHITE PAPER

# Top 10 Mistakes That Companies Make in FX Risk Management

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The problem of how to best manage foreign exchange volatility has plagued multinational companies for decades, and is usually cited as one of the top concerns amongst Treasurers. Rapidly changing business models make life especially difficult for those who are tasked with managing a company's foreign exchange risk, and many pitfalls await those who are ill-prepared. What follows is a "Top 10" list of some of the most common—and costly—mistakes multinational companies make when trying to manage their FX risk.

## 1 MAINTAINING THE STATUS QUO

FX groups often have a lot of inertia around their current practices, and fear of change can be a major obstacle. Because the stakes can be so high, the perceived "safety" of maintaining any current approach "because we've always done it this way" can be prevalent. The problem with this is that many things have likely changed since a certain practice was established, and various assumptions that may have been true many years ago are no longer true today. FX policies tend to be implemented or updated over time in response to huge FX losses generated by exposures that weren't previously considered or well understood. You wouldn't wait until to your house burned down before buying insurance, so why wait until your company suffers a significant FX loss before putting in place the proper processes and procedures that could have prevented it in the first place? A world-class FX organization will think and act proactively, learn from the mistakes of others, and seek qualified expertise.

## 2 TAKING A VIEW ON THE DIRECTION OF CURRENCIES

Do you or your business partners take views on currencies in order to determine your revenue or expense hedging strategies? Chances are that if you ask five different banks where they think a currency rate will be in a year, you'll get five different forecasts, and the average will be pretty close to the current spot rate. If there happens to be widespread agreement by the banks on their directional views, this actually has a better chance of being a contrary indicator than a good forecast. A successful hedging program shouldn't be influenced at all by directional views, or by the most recent trends that have occurred. Too often a hedging program is terminated because it's "losing money" just before the underlying exposure begins to lose value and the hedges (now non-existent) would have had offsetting gains. The success of a hedging program needs to take both the underlying exposure and the hedge into consideration when determining its effectiveness. Trying to guess what would happen to only one side of the equation is not effective risk management.

## 3 NOT ENGAGING ENOUGH WITH BUSINESS PARTNERS

If you hedge your company's local currency revenue exposure, do you understand the competitive environment in the various geographies where you do business, and the specific pricing dynamics? Do you have any pricing power if there is a huge move in FX rates? Whether your primary exposures are revenue or expense related, there are several factors that would influence how much and for how long you should hedge, whether to use options or forwards, whether to layer in hedge rates, how to interact with sales/procurement in terms of quoting/purchasing in local currency, and other considerations. A company may also need multiple strategies for differing product lines or businesses. A good way to test if a hedging strategy makes sense is to "stress test" it with different "What if?" scenarios, which should include some modeling on how you and your competition, suppliers, and/or partners would react. If you can't live with the results of a significant currency shock in either direction, chances are your hedging strategy needs some adjusting.

## 4 HAVING AN AVERSION TO LOCKING IN LOSSES

This problem often occurs with balance sheet hedging. Let's say you receive new information on an exposure a week after you set your monthly accounting rate. The nature of this information is such that you should enter into an outright forward to adjust your hedge. But if the currency has moved out of your favor compared to the accounting rate, the adjustment hedge will lock in a loss. Too often in this scenario, no adjustment is made, and an excuse such as "our forecasts are never accurate" is used to avoid locking in the loss. An FX policy needs to be in place that takes the emotion out of risk management (i.e. if the exposure as identified by a certain process is beyond a minimum threshold, it is hedged—period). Volatility is a function of time, so a week's worth of unfavorable volatility can turn into a month's worth of far more unfavorable volatility. "Hope" is not a strategy. If an exposure is material, hedge it.

## 5 HAVING A POOR BALANCE SHEET FORECASTING PROCESS

Forecasting is inherently difficult, but forecasting the non-functional currency portion of a balance sheet is especially problematic. Many companies make this more difficult than it has to be by having a decentralized process with people around the globe attempting to forecast various entities' balance sheets line item by line item. There is often limited accountability or ownership of the balance sheet actuals, which is a big problem. The best way to derive the relevant balance sheet exposure is to take the latest known actual exposure and build upon it with income statement inputs, which tend to have more ownership and accountability and should therefore have improved accuracy. This is ideally done in a centralized manner, and is based on legitimate forecasts as opposed to "stretch goals" or consistently, overly optimistic views. Any forecast input that doesn't prove to have a fairly equal chance of being too high or too low over time may need to have a "haircut" or "markup" applied.

## 6 CREATING UNNECESSARY VOLATILITY FROM LIQUIDITY MANAGEMENT

Forecasting and hedging the balance sheet in an optimal manner can help avoid unnecessary volatility from spot or forward trading during the month, when managing a company's liquidity needs. The local currency balance sheet of a USD functional sales entity, for example, is unaffected by EUR Accounts Receivable turning into EUR cash, as these are both Net Monetary Assets (NMA). If a company wanted to convert any excess EUR cash to USD (which WILL affect the EUR NMA), an ideal balance sheet hedging process would result in an equal and offsetting adjustment to the outstanding balance sheet hedges. This utilizes an "even FX swap" as opposed to only a spot trade or an outright forward. Whether this activity occurs on a company's "netting day" or any other time during the month, using even swaps to manage liquidity needs avoids unnecessary spot rate versus accounting rate impact, and eliminates the need to guess on collections or payables timing.

## 7 RELYING TOO MUCH ON SPREADSHEETS

Unless your entity structure and level of FX exposures is extremely simple, using only spreadsheets for FX risk management can lead to a host of problems. Multiple dimensions such as currency, time, entity and exposure line items can quickly go beyond the two dimensional capability of spreadsheets. Linkages to multiple spreadsheet tabs or other spreadsheets can be extremely fragile and error prone (copying wrong line of data, flipping the sign of an exposure, version control issues etc). Too often, a monster spreadsheet can only be navigated by the person who built it, which might be good for their job security, but not a good ongoing risk management solution for the company. An investment in the right platform to support all the complexities of FX exposure management is very likely a worthwhile one.

## 8 PAYING TOO MUCH WHEN TRADING FX

FX trading is incredibly profitable for banks, and in many cases they are being compensated well beyond what is necessary for the risk they are taking. They will obviously try to make as much profit as they can, so it's extremely important that the person on the other side of the trade understands the market dynamics. At a minimum, someone on the corporate side executing FX trades should always know where the market is when they are trading. Don't assume you're getting a good price without live data in front of you. Trading off of "fixing rates" is the best way to get the most transparency from the banks. If it's not practical to wait to until the next fixing rate to trade, make sure to bid out the trade to multiple counterparties and to get two-way prices. Even a two-way price will likely be skewed, based on the side the bank might strongly suspect you'll be looking for, and there are numerous trading solutions that allow for anonymous trading. Lastly, make sure you're not trading externally more than necessary. While most companies net their exposures by currency, they often don't take an additional step that can increase efficiency: utilizing "internal trades" between different hedging portfolios or entities where possible.

## 9 RELYING SOLELY ON AN ISDA FOR MANAGING YOUR COUNTERPARTY RISK

ISDA (International Swaps and Derivatives Association) agreements have been commonplace for many years, but as Lehman demonstrated in 2008, these almost always benefit the banks more than the corporate side. Lehman went from being a mid-single A credit to bankrupt over the weekend, which would be difficult to imagine happening on the corporate side. Anyone that had an ISDA (specifically the CSA or Credit Support Annex to the ISDA) that required collateralization from either counterparty at BBB or lower, for example, got precisely nothing from Lehman before they were gone. Depending on a company's liquidity situation, they may benefit by utilizing a third-party collateral manager and exchanging collateral beyond a tolerable threshold with their counterparties. In addition, for those who hedge their balance sheet exposure, there is often a minimum "core" exposure that is rolled over month after month which could be moved to a futures exchange, such as the CME, reducing counterparty risk. Knowing how to take counterparty risk off the table quickly by utilizing a futures exchange can be a valuable tool to have if there is another major financial crisis around the corner.

## 10 NOT UNDERSTANDING YOUR FX RESULTS IN A TIMELY MANNER

If it's the end of the quarter and you need to close the books in a few days, can you adequately explain the FX results to senior management with confidence? A company making some of the previous mistakes listed above would likely not be able to answer "yes" to this question. There is inevitably going to be a mismatch between the underlying exposures and the hedges meant to neutralize them for a number of reasons. Intra-month adjustment trades, forecast deviation, mark-to-market calculation errors, forward points, and incorrect and/or catch-up re-measurement entries can all affect your results to various degrees at different times. The ability to quickly isolate these factors is critical in understanding your results and providing a quick feedback loop for your next period's hedging. Attempting to do this without the right tools can be a frustrating exercise, and can feel like trying to find a needle in a haystack.

## PROTECT YOUR COMPANY WITH PROPER FX RISK MANAGEMENT

Trying to mitigate FX risk without the proper policies, procedures, tools and understanding of the market dynamics is a very risky proposition. While the above is not a complete list of all the challenges faced by FX departments today, a company that is able to avoid these problems—either on their own or with help from outside resources where needed—would go a long way towards creating a world class FX organization.

## About the Authors

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