How Corporations Meet Today's FX Market Challenges

by Hennie de Klerk, CFO, TreasuryOne

Corporate treasurers and CFOs everywhere are confronted with the seemingly endless volatility and uncertainty that afflicts the global foreign exchange market. The weakness of the commodity sector, the general collapse of equity markets and the lack of clarity about the timing and scope of the next moves of influential international authorities such as the Federal Reserve Bank and the European Central Bank add to the confusion and promise no early respite. Treasurers and CFOs are tasked with protecting the value of their companies' foreign profits, earnings, and investments – and this task has never been more demanding than it is today.

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Companies and corporations which are engaged in global commercial operations are naturally exposed to FX market fluctuations, impacting export-based revenues, import costs, and the value of overseas business and financial investments.

Measuring these exposures can be a demanding technical exercise, perhaps involving the management of large and complex arrays of foreign currency bank accounts, committed future payable and receivable flows, and the most uncertain projected flows based on future sales, investments, and expenditures. Analysing these exposures requires sophisticated data management tools, to produce dependable reporting, and the identification of viable and effective hedging strategies to mitigate the underlying risk. Finally, the hedging programme should be executed by professionals whose market expertise enables them to plan and perform the required market interventions at the best available rates, in compliance with the organisation's financial risk management policy.

These complex requirements need a combination of several different kinds of expertise, plus robust and effective technology support to produce dependable consistent best practice results. For many cost-conscious finance organisations, the continuing challenge is to fulfil foreign revenue and investment value protection within overall budgetary constraints.

This article outlines some of today's corporate treasury tools which provide practical help to meet these objectives.

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FX risk management – technology overview

Technology underpins effective FX risk management through the provision of effective communications, process management, and analytical tools which can liberate financial professionals from the need to struggle with data processing operations, and from working with inaccurate data.

Today's treasury technology can take care of complex issues such as managing the reporting of accounts from a network of diverse international banks, dealing accurately with different message formats and security and communications protocols. In contrast, spreadsheets lack the robustness and dependability demanded by contemporary audit standards to manage high-value financial functions such as treasury. Treasury management systems (TMSs) provide the core functionality for defining and managing controlled and transparent treasury management operations, and for providing FX risk management decision support.

Modern TMSs take advantage of technical advances such as Software as a Service (SaaS) and web-based technology outsourcing to deliver cost-competitive solutions which take advantage of the economies of scale based on technical resource sharing and centralised service provision. Treasuries can enjoy cost-effective technology services for daily processing, reporting, and risk analysis without the burdens of managing hardware, software and communications.

FX exposure measurement – the cash position

The automated cash position is derived by collecting the up-to-date balances from a global network of multi-currency bank accounts. This information is consolidated into an accurate real-time cash position, with all natural offsets applied. In addition to providing treasury with the basis for effective cash mobilisation, it reveals the core FX exposure situation across the organisation.

Also, integration with the company's ERP and accounting system enables the reported FX exposure position to be adjusted to reflect all committed foreign currency payable and receivable flows, broadening the analysis.

FX exposure management – forecasting

More and more companies are now achieving high-quality medium-term FX exposure forecasting to extend risk visibility into the future. This involves using technology to gather commercial forecasts from a global network of operating subsidiaries and joint venture entities. The forecasts are automatically consolidated into future FX risk reports, using a time horizon dependent on the underlying nature of the business. Forecasting operates best in an environment in which performance objectives are set, and in which the central finance function feeds back actual data to the participating subsidiaries to support forecast quality improvement. Technology plays an essential role in operating a truly effective forecasting environment, to handle the necessarily complex data management requirements.

Hedging policy

Designing, implementing and operating a formal treasury policy is an important corporate treasury management function, and it is one which is regularly mandated in treasury and finance department audit reports. The policy should feature some items relating to FX risk. These include rules about hedging procedure, indicating the levels of net exposure that must be mitigated by executing hedging transactions in the market. The policy should define what proportion (up to 100%) of exposures must be hedged, what level (if any) of mismatch is permitted, and which instruments may be used. Typically corporate hedging uses forward contracts and non-deliverable forwards, and some more sophisticated treasuries take advantage of lower cost option strategies to cover some or all of the risk. Hedge effectiveness may be monitored by IFRS testing protocols. TMS technology is used to analyse exposures and propose specific hedging structures, to administer the hedge transactions, and to support the requirements of hedge accounting where implemented.

Hedging strategy

Effective FX hedging depends primarily on planning a program to achieve the required level of risk elimination cost effectively, and in compliance with policy. Corporates increasingly work with expert third parties, to construct an optimal action plan to eliminate the true exposures revealed by effective cash positioning and forecasting. The process must reflect the cyclical characteristics of the corporate's business, and the expected behaviour of the market based on the relevant fundamental conditions, for example, global economic indicators such as GDP and inflationary expectations, combined with the impact of potential policy shifts. So achieving best practice hedging strategy design depends on the quality of business and FX market expertise available for the exercise.

Hedge execution - dealing

Market operations, of course, require a specific technical expertise, needing experience and understanding of the key tactical factors which enable dealers to judge the timing of interventions to achieve the best available price performance over time. Corporate dealing is a distinct discipline from proprietary and speculative FX trading, where the primary objective is to generate profits; the vast majority of corporate treasuries simply deal to mitigate the risks of naked FX exposures, and hence to protect the value of the company's foreign assets and income.

Dealing is another area in which corporates often partner with trusted third parties to execute FX transactions effectively. Alternatively, many corporates use electronic dealing platforms to achieve automated FX order execution with authorised bank counterparties, in line with policy and current dealing limit utilisation.

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In-house banking

Many large multinationals have centralised many of their treasury operations into global or regional in-house banks, usually based on the group treasury function. In-house banks are centres of excellence which assume some of the traditional functions of commercial banks, such as operating virtual bank accounts, and centralising cash management, funding and investment actions to enhance cash and risk visibility, minimise external borrowings and optimise interest income/expense performance. In-house banks can provide central FX dealing functions, enabling corporate subsidiaries to secure superior risk management services and dealing rates, and eliminating the costs and risks of running multiple dealing operations in the group. Typically, cover requests and deal details are inter-communicated between subsidiaries and the in-house bank via secure web connections, on a 24x7 basis.

The details of permitted operations for a specific in-house bank depend on the regulatory and legal environments relating to them and their clients – the corporate subsidiaries.

Traditionally the cost/benefit equation for in-house banking has worked best for large institutions, but today's highly efficient treasury services operations and web-based, scalable service delivery have brought the facilities and benefits of in-house banking into the budget range of many medium-sized organisations.

In addition to enhanced FX hedging operations, many corporates benefit from in-house banking activities such as cash concentration, which streamlines FX exposure reporting by consolidating balances, and multilateral invoice netting, which streamlines the settlement of multi-currency inter-company invoices, cutting external FX dealing requirements to the minimum, and settling each subsidiary's net position by single debits or credits (translated to their functional currency) to their in-house bank account.

Synthesis

So, where does a specific corporate treasury or finance department fit into this analysis of corporate FX risk management? Size is not in fact the primary determinant: the key issue is each organisation's board level perception of the importance of FX risk to their bottom line performance. Finance history is littered with the corpses of companies who got it wrong, assuming that recent patterns of market behaviour would continue into the future, or that 'natural' offsets would be indefinitely sustainable. Today's market volatility emphasises the immediacy of the issue.

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Hennie de Klerk founded TreasuryOne (www.treasuryone.co.za) in June 2000. Hennie has more than 20 years' experience in the field of international treasury services and treasury technology. He takes a hands-on approach both with clients and the TreasuryOne management team, helping to ensure the sustained delivery of world class solutions and services. Hennie has built the company on his commitment to unlock financial value, and to become a primary business asset for TreasuryOne's clients.

Apart from his passion for treasury, Hennie is an avid racing driver, and currently competes in the Donaldson Cross Country Championship. He is a regular expert speaker at treasury conferences, and is the author of numerous articles about different aspects of international treasury management.

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We have seen that large multinationals usually have the necessary resources to support the substantial in-house operations for running in-house banks, with the required professional teams and technology departments. But what of smaller enterprises, which are painfully aware of the FX risks threatening their profitability and even viability, but which must operate under significant budget constraints?

The prospect today is more positive than ever before, because of the possibilities which are now available through contemporary web-based treasury technology, and through partnerships with treasury services companies which can provide affordable and complementary resources to deliver a complete and fully effective FX risk management solution.

The details of such a solution will vary in every case. For example, one company might need expert services in designing and executing an effective FX risk management strategy. Another might need back office resources to handle the technicalities of hedge administration, settlement, regulatory compliance and reporting. A third might need access to a powerful and flexible TMS to provide best practice technical support for securing, controlling and reporting its treasury operations.

The challenges of setting up and operating a full internal treasury function to manage all aspects of FX risk as outlined here might seem daunting. In practice fully cost-effective solutions can now be realised by working with a properly qualified professional partner. The modest cost should be seen as an insurance premium providing real protection against the seemingly endless turbulence of the FX market. The clear benefit is the effective protection of the value of the organisation's foreign revenues and investments. ■