Communicating FX Risk Within the Firm

Carolinas Cash Adventure Presentation

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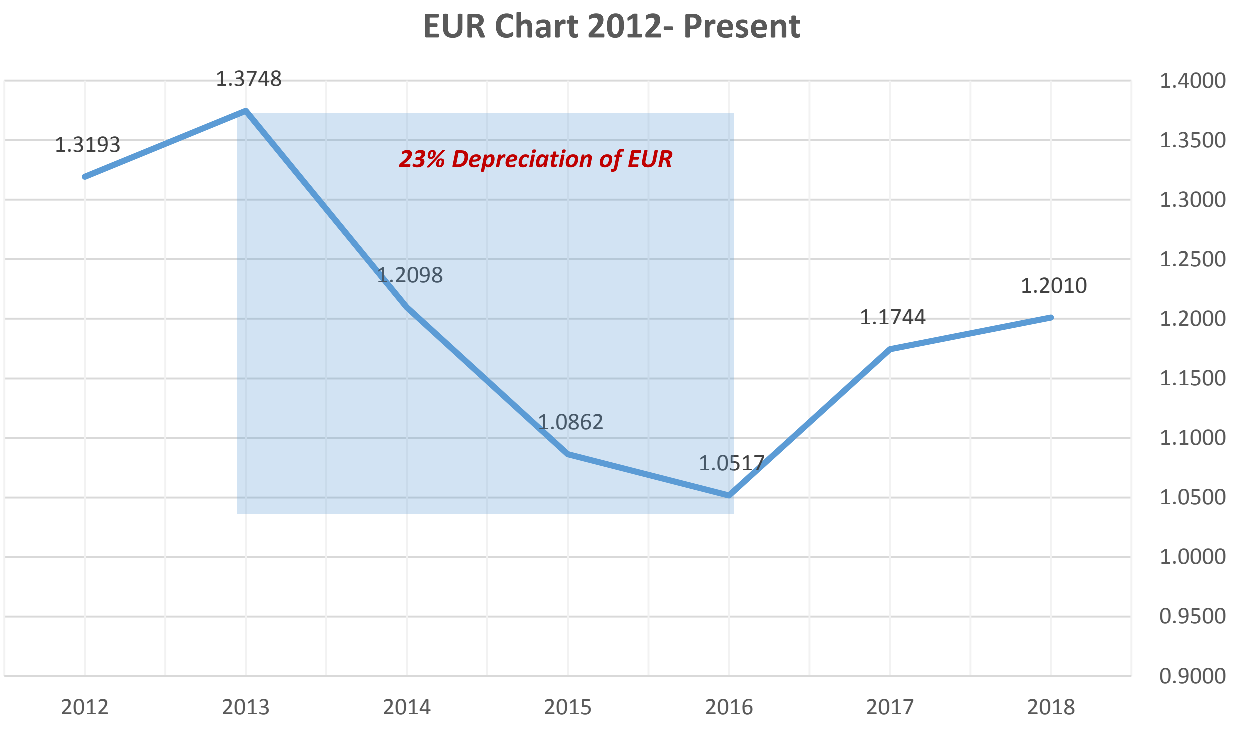
Foreign Exchange Risk – What Drives Exchange Rates?

Factors that move exchange rates include:

- Fundamental data about a countries level of business activity, inflation, employment levels and growth.
- Political events such as elections.
- Impact of other markets such as equities, commodities or interest rates.
- Technical analysis of the market.

How to filter through all the non-stop economic data and determine relevance?

- Rule of thumb is to answer what the indicator or measure tells you about a country in terms of:
    - Growth
    - Inflation
    - Central Bank Policy



Foreign Exchange Risk – An Overview

Description

A corporation that is involved in international business will be exposed to currency risk. Currency risk can manifest itself in various part of the company, such as foreign payables and receivables, intercompany financing, cross-border acquisitions, dividend repatriation.

Functional Currency Concept
(as defined by ASC 830 (FAS 52))

An entities functional currency is the currency of the primary economic environment in which the entity operates normally.

<u>Not a choice, but based on:</u>

Cash Flows, Sales Prices, Expenses, Finance, Inter-company Transactions

Typical FX Exposures

Type	Description
Balance Sheet Items	Foreign payable and receivables
Forecasted Exposures	Forecasted revenue and costs
Earnings Translation	Translated foreign net income into consolidated financials
Net Investment	Translated foreign net investment (equity) into consolidated financials
Cross-border M&A	Pre-and-post acquisition FX risk related to cross border transactions.
Contingent Exposures (i.e., Bid to Award)	Risk is contingent upon winning a contract or project.

Foreign Exchange Risk – Is Hedging Speculation?

Hedging vs. Speculation

A **FX hedge** is a risk management strategy used in limiting, or mitigating, the probability of loss from fluctuations in the market price of an exchange rate.

Speculation is to profit from betting on the direction in which the market price of an exchange rate.

	Underlying Exposure	Hedge	Net Position
Speculation	Long (+1)	0	Long(+1)
Hedge	Long (+1)	Short (-1)	0

How a Company Defines Risk Determines Their Approach:

- **Avoidance** Ignoring the risk, attempting to place on another counterparty, reactive, usually results in losses
- **Passive** Disciplined approach, prudent hedge selection, defined minimum and maximum hedge ratios, not looking to gain but protect
- **Active** Incorporates directional views (speculation) into a risk program, due diligence and management of positions is important

Priority #1 – Establish a Foreign Exchange Risk Policy

Establishing a foreign exchange risk policy provides the foundation for your risk management effort.

The policy should contain:

- Clearly articulated risk management objective
- List the types of exposures to be managed
- Detail the hedge products and techniques that are approved to be used
- Provide rules as to how risks are quantified and hedges are selected
- Define benchmarks and how the risk management program will be evaluated
- Detail responsibilities, roles and authorities
- A date to complete an annual review of the policy

Identify Risk and Set Hedge Program Objectives

Foreign exchange risk is something that can be:

- **Identified**
- **Measured**
- **Managed**

Measure & Collect Data

- Consistent approach and trusted method is key to minimize inaccurate data.
- Balance Sheet Items – straightforward, relevant and will impact earnings.
- Forecasted Items – more prone to error especially in situations where changes in the company have taken place (i.e., acquisition, divestiture, etc).

Setting Hedge Program Objectives

- **MOST IMPORTANT PART OF ANY HEDGE PROGRAM – What do you want the hedge program to achieve?**
- Should be aligned with Company's overall business objectives
- Must be realistic and measurable.

Typical Corporate Hedge Objectives:

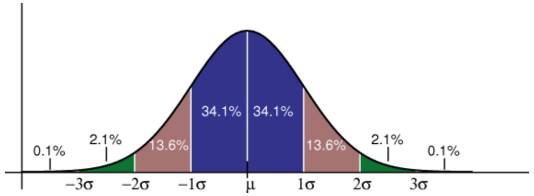
- Minimize risk to cash flows
- Minimize FX gains/losses to balance sheet items
- FX earnings in consolidation
- Minimize variance in budget rates

Risk Quantification & the 4-Step Process

Risk Quantification Methods

- **Scenario Analysis**
  Hypothetical market moves along a scale are used to measure potential losses or gains on exposed positions.

- **VAR (Value at Risk)**



  Common method that provides a number that expresses the maximum expected loss for a given time horizon and for a given confidence interval

- **CFaR (Cash Flow at Risk)**
  Similar to VAR but incorporates correlations between currencies, isolates risk and allows for better hedge selection.

4-Step Risk Process (BEST PRACTICE)

1. **Identify** — Identify your exposures; know the source and impact
2. **Quantify** — Use VAR or scenario analysis to quantify your risk.
3. **Select** — Select the hedge allowed within your policy
4. **Evaluate** — Does the hedge meet your objective; effectiveness testing

Breakdown in Communication

One of the biggest challenges a company faces is how to communicate the enterprise wide risk they face to markets like foreign exchange, interest rates and commodities.

Some of the pitfalls and errors created by lack of communication:

- Failure to identify natural hedges with the company
- Not enough collective due diligence done before entering a country (i.e., Venezuela)
- Not understanding the FX risk your suppliers and customers face.
- Lack of knowledge as to how your competition hedges
- No discussion around how technology can enable and improve risk management at a company.
- Loss of margin on foreign sales contracts due to delay in notifying the Treasury department.

Company Activities Impacted by Foreign Exchange

Company Operation	Impact on FX
Purchasing	Negotiating contracts denominated in foreign currency or with currency clauses
Sales/Marketing	Negotiating pricing terms in foreign currency
Accounting	Calculating mark-to-market gains or losses; preparing documentation related to hedge accounting.
Treasury/Finance	Transacting and confirming FX trades; managing domestic and foreign accounts; making payments internationally
Financial Planning	Budget planning which includes determining budget rates for FX.
Tax	Determining gains or losses for tax; calculate foreign tax credits
Foreign Operations	Report all non-functional currency exposures; actively manage risk in a decentralized treasury environment

Formation of Internal Risk Discussion Group

Communication and consultation with external and internal stakeholders should take place during all stages of the risk management process:

- Facilitates a shared understanding of risk, flow and impact within the firm.
- Discussions lead to better reporting to C-level and Board
- Acts as a troubleshooting forum where challenges such as data collecting, reporting of foreign contracts and issues within the supply chain can be discussed.
- Meetings should be frequent and mandatory

Typical Discussion Agenda

- Global economic trends and outlook
- Group presentations of their risk
- Challenges
- Competitor updates
- Open discussion – including C-level participation
- Allocation of resources needed

Holistic Risk Management

- These forums should be used to discuss all market risks to the company and should include commodity and interest rate risks as well.
- This discussion helps determine the “relative” risk facing the company and different volatility factors and critical terms (i.e., amounts, tenors, etc) vary for each risk.

Foreign Exchange Risk Dashboard Report

Open communications around risk, specifically the impact from FX risk, in a company should ultimately lead to a consistent reporting to the C-level and the Board:

Suggested Items to Appear on Dashboard Report

- FX Exposure Summary
- FX Gains/Losses
- Hedged Positions/Hedge coverage ratios
- Exposure forecast variance
  Limits and compliance reports
- FX Accounting analysis and results (effectiveness)
  FX Activity Summary (new trades, closed trades, settlements)
- Risk quantification (VAR, CFaR, etc)
  Benchmarks/Key performance indicators (impacts to EPS, gross margins, credit covenants, etc)

Summary

- Foreign exchange risk isn't new - it's now more pronounced due to the interconnectedness of businesses all over the world and the volatility
- Good news is that FX risk can be measured, managed in a systematic framework.
- Risk management does not end with the execution of hedges but is an ongoing process.
- A forum that allows for open dialog of risk discussion among interested parties improves visibility into risk and improves forecast reliability – all of which please the C-level and the Board.

Questions?