FX Risk, the essence of the treasury function

Currency risk remains one of the major risk's treasurers are facing, even if it is a rather "classic" one. Fortunately, there are ways to manage this risk more dynamically and optimize management. This is a significant risk and yet often the subject of manual and managed processing with XL spreadsheets. Isn't it time to rethink this management with the right tools?

FX risk remains a major one

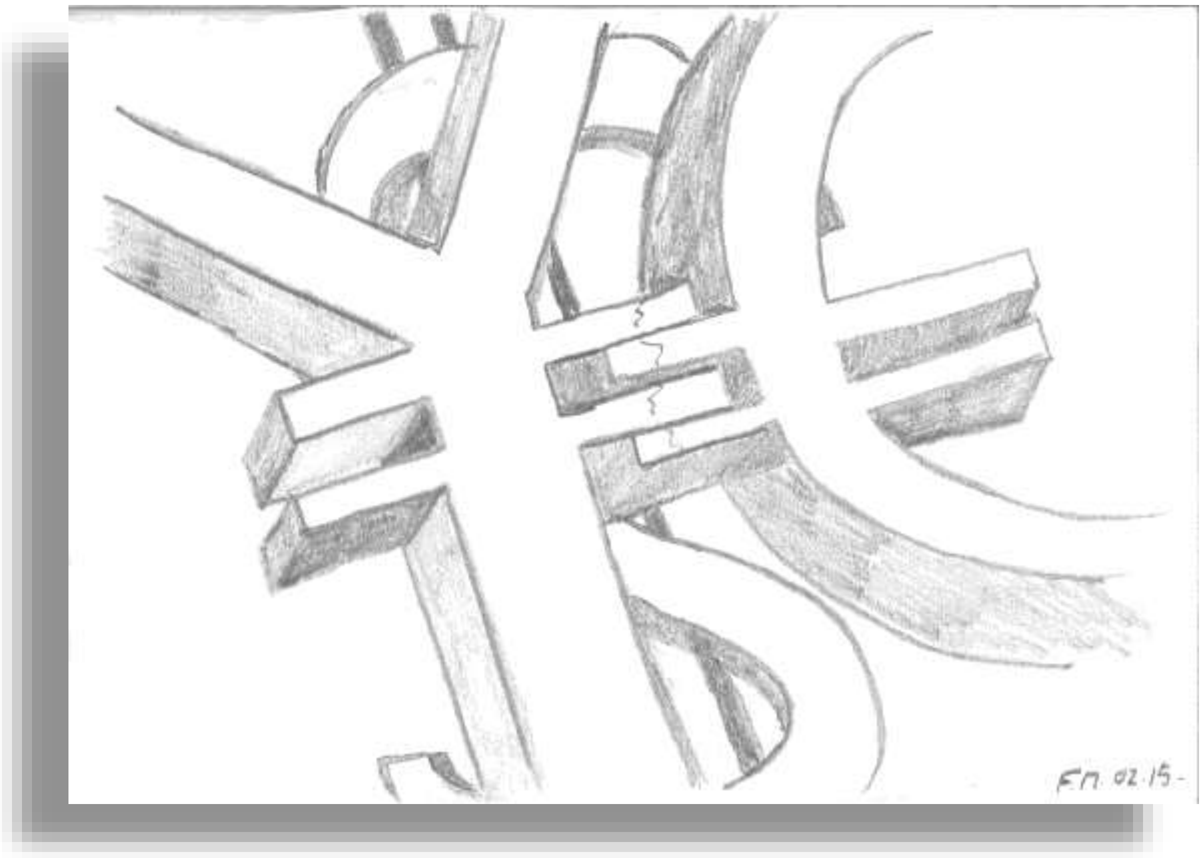
According to PwC's recent European surveys (i.e. 2017 & 2019) that foreign exchange risk remains the third-highest ranked risk for international companies. Certainly, the volatility of foreign exchange markets has been reduced in recent years. Paradoxically, despite a more than complicated and hectic economic, political and ecological context, the FX markets have remained fairly stable. Obviously, some currencies for various reasons have experienced ups and especially lows. But these are rather exotic currencies and major currency pairs have been relatively less volatile. The factors impacting exchange rates have sometimes surprised market participants. The triggers of movement and volatility have sometimes been other than those imagined or the usual ones. We also saw that FX rates were finally sometimes stable through circumstances that at other times had caused (higher) volatility. This is one of the many paradoxes of these current markets. Nevertheless, the exchange rate must be followed more than ever, treated and covered to optimize the financial situation of companies. Margins must be protected, and any single pip saved would boost operating results or avoid impacting P&L.

Paradox in FX risk management

FX risk management remains highly manual (and it is a second paradox although we entered the twenty-first century). It is manual despite the use of platforms and other Treasury Management Systems (i.e. TMS). What is often lacking is the automation of processes, the lack of means to automate systematic covers or small amounts and large volumes and the cruel lack of dynamic dashboards allowing simulations and expectations. The management of FX risk because of the adoption of international accounting standards (i.e. IFRS, formerly IAS) since January 2001 (for early adopters) has been greatly simplified, trivialized and popularized to enable the company to obtain the famous hedging accounting. Most treasurers have preferred to opt for simple FX financial products qualifying for cash-flow hedging and therefore avoiding P&L unnecessary / unsolicited impacts.

Again, shouldn't oversimplification have allowed even more automation and performance? Is it normal to have to develop a robot (i.e. RPA) in your corner to try to industrialize a simple and recurring carrying process? It is a paradox of the technological sophistication. Sometimes, this high technology development is unable to solve simple processes. The standardization of new SaaS / in-the-cloud TMS doesn’t help treasurers to adapt systems to their processes.

Treasurers are certainly partly responsible for it although they often lack time and resources to optimize FX management. However, we need to address this and provide solutions. I am pleased to see that Fintech's, such as KANTOX, have decided to provide the means of their ambitions to the treasurers. They understood the value of partnering with banks, as key partners. It's clever because I am, as those who read me know, a strong advocate of "co-creation" and cooperation between banks, fintech's …and corporates. Let's not forget the third important leg (i.e. treasurers) to solve the equation. Fintech's have many answers; but we treasurers have the questions. When one meets the other, progress is made for greater efficiency in risk management.



Increasing the efficiency of FX-related processes is vital

This is important because CFO's have made it a financial priority, because the treasurer must do "more with less" resources and finally because this task is highly consuming in terms of human resources. Currency management, like the management of excess liquidity, needs to become more dynamic in order to optimize and preserve operating margins. A challenge at the level of treasurer’s skills (providing they are open to new technologies and IT solutions). I see the available technology as an opportunity to revisit its FX management strategy (but also liquidity management) in a more optimal and efficient way. In addition, it is a fantastic way for a treasurer to better profile his/her role and be promoted within the financial department and eventually to help operations, a key ally.

FX RISK MANAGEMENT - TYPES OF EXPOSURE vs. TYPES OF HEDGING TECHNIQUES (incl. accounting treatment)

Types of FX risks	Types of underlying exposures	Types of Hedging Techniques	Accounting Treatment (if any - e.g. IFRS9)
Structural risks	Cash-flow forecasts / Budget	Hedging (through financial instruments)	Cash-Flow Hedge
Translation risks	Firm commitment (under IFRS9)	Not hedging	(Fair-Value Hedge) *
	(i.e. OFF-Balance-Sheet)		
Transaction risks	ON-Balance-Sheet	Natural Hedging	Net investment in foreign ccy
		Economic Hedging	

types of underlying exposures considered in the article, types of hedging instruments and ad hoc accounting treatment

(*) in practice FV Hedge isn't applied for FX as both legs are revalued through P&L because both are on-Balance-Sheet

Four-step cycle of the FX

The problem of the foreign exchange cycle begins with (1) the comprehensive and real-time capture of FX risk exposures, the consolidation of these exposures (2) the immediate execution of FX hedges aligned with exposures (3) the accounting, revaluation, reports and disclosures relating to these positions, in particular because of hedging accounting and finally (4) analyses (e.g. sensitivity analysis, efficiency, savings generated by dynamic hedging, etc..), assurance of compliance with coverage policies, defined, and dashboards and other reports for the "C-level" and auditors. Fortunately, there are solutions offered by Fintech's, together with banks, to automate what is still too manual. Unfortunately, because of the necessary export reports and various formats, as well as the specificity of each company, tools are often not robust enough. The “absolute” competitor and the most dangerous one remains the XL spreadsheets.

Automation saves time, money, strengthens internal controls and is more "opportunistic". Therefore, more automated dynamic approach of hedging may generate value. “Automation” can rhyme with “efficiency” (it seems obvious) and optimization of the result, if the management is dynamic. A machine can simplify the treasurer's task and free him from unattractive and risky operations (by their manual side). Whatever the TMS implemented, it is the capture of the exposures that often hurts. It is fragmented, on non-robust and varied tools and usually not interfaced. Forecasting, relevance and timing are essential too in the process of hedging FX risk. But the good news is that there are effective solutions to rethink your approach and optimize the result while being more aligned with the strategy. The value of the treasurer's function lies not in execution but in analysis and strategy.

François Masquelier, *Simply***TREASURY** - March 2020