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Information for finance and treasury professionals

Cover story

Four steps to managing foreign exchange risk in volatile times

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Four steps to managing foreign exchange risk in volatile times

In the not so distant past, global currency markets were relatively stable, perhaps giving a false sense of certainty to some treasury departments managing their foreign exchange risks. Currencies went up a little and down a little. Aside from a few isolated economic disasters that led to sudden depressed values for a particular currency, including Mexico's bank nationalizations in the 1980s and Argentina's inflationary woes in the early 1990s, many FX trading days were downright uneventful. However, the volatility the currency markets experienced in 2008 changed the way companies now need to view their foreign exchange risk profile.

Currency-related volatility poses challenges to treasury groups in many companies because of material profit and loss considerations, especially when currency fluctuations move unexpectedly in the double digits. Plus, treasury departments now need to anticipate risk and decide when to act over time. While no one knows where the currency markets are going to trade tomorrow, much less longer term, your company can mitigate its risk exposure. Four steps can help you assess and address the risks associated with FX volatility.

Step 1: Understand which foreign exchange risk exposures matter most. Managing FX risk begins with a firm understanding of your business priorities, as well as company policies and philosophies around foreign-exchange-related matters. For instance, many companies place their primary focus on protecting the value of booked or known cash flows. In other companies, the primary focus may be on assuring that the budgeted FX rate is protected against currency fluctuations. Or, a company may be more concerned about how FX volatility affects earnings from foreign subsidiaries. Some companies place a premium on protecting net investment values in foreign subsidiaries, while others choose to focus on protecting or expanding their competitive positions in certain markets. In these instances, market share may take precedence over predictable revenue or cash flows.

Step 2: Identify and understand the types of exposures. Your treasury team should familiarize itself with how changes in FX rates can alter booked or known cash flow. For example, cross-border payables, receivables, and dividends are all affected by volatility in the FX marketplace, as is the value of international investments or income. Additionally, you should be on the alert for events that may increase economic, political, and/or country risk. For example, if an upcoming election threatens political stability in a country to which you export goods, you may want to hedge that country's currency in case the political unrest affects its economy.

Step 3: Determine the level of risk. Think carefully about your company's appetite for risk as you determine appropriate

The new "normal" for currency markets

In late 2008, currency markets followed the volatile trajectories of other markets as the global economy took a pounding. In a matter of just two days, currencies like the Mexican peso and the Icelandic krona lost more than 20 percent of their values against the U.S. dollar. The Icelandic krona snapped back more than 28 percent over the following two days before embarking on a more gradual 30-day decline. Ultimately, the krona lost almost half of its value during the fourth quarter of 2008. Even a more historically stable currency pair like the U.S. dollar versus the Canadian dollar was not immune from extreme volatility. Over a one-month period, the Canadian dollar lost 25 percent against the U.S. dollar before staging a 12 percent comeback a week later. In this new era, we no longer view movement of 10 to 20 percent as outliers. This type of volatility over short periods of time has become commonplace.

risk tolerances. One company may require hedging all currency-related risk in excess of $1 million. Meanwhile, another company's minimum may be $100,000.

In addition, the process of assessing your company's appetite for risk can help identify more ways to help mitigate foreign exchange risk by working across subsidiaries. One way to do that is to find opportunities to net offsetting positions internally. Understanding the net exposure can help you stagger the timing of payments or receipts and allow you to avoid unnecessary currency trades.

For example, assume that a U.S. company (UsCo) has two subsidiaries: a German company (GermanCo) and a Swiss company (SwissCo). If GermanCo is receiving a British pound payment stream over the next three months and SwissCo has a similar amount of British pound payables in six months, UsCo may have an internal netting opportunity. An on-balance-sheet approach would be to have GermanCo place its British pound receipts in a pound-denominated account until SwissCo needs to initiate its British pound payable. At that time, GermanCo sells its British pounds to SwissCo. Without netting, GermanCo would have sold its pounds into the market when they were received, and SwissCo would have purchased pounds from the market when its payable was due. The currency market has developed a number of instruments to replicate this strategy with off-balance-sheet derivative transactions.

In most companies, internal netting can only be used for a portion of overall FX-related exposures. They must then look to the market to hedge or offset the risks that cannot be netted.

Step 4: Create an action plan. Once you determine which exposures you plan to target through hedging, there are several questions that you will need to answer:

- Who will execute the hedges?
- When will you initiate the hedges?
- What instruments should you use?
- What counterparty risk is acceptable?
- What is the internal management approval and oversight process?
- How frequently should you monitor these positions and exposures?
- How should you organize your internal controls (i.e., levels of approval)?
- Is the FX budget rate achievable? The FX budget rate should only fluctuate between a certain amount. For example, a budget of 20 basis points (BPS) for AUD to USD is $0.69 to $0.89. Anything more will require a different FX hedge.

Once you establish a process, review your results regularly. Although it may be unwise to modify investment actions to suit the strategy of the day, most companies find it helpful

to periodically assess and modify their strategies based on ongoing analysis of currency trends.

The goals of a solid FX management strategy should be twofold: Secure more predicable and stable financial performance and ensure no FX-related surprises on the balance sheet that would require unpleasant explanations to shareholders. Checking your risk management policy against economic forecasts and other trends will help expose and potential vulnerabilities you may need to address, ensure cash management remains as stable as possible, and establish a framework for the future.

Wells Fargo foreign exchange specialists can help you develop and implement a hedging strategy that makes sense for your business. Ask your relationship manager for more information.

This material is for general information only. Always consult your tax and legal advisors for guidance on how gains or losses resulting from foreign exchange activities may affect your company.

Ensure your coverage conforms to changing international insurance regulations

Analyzing your international risk exposure and needs, and making sure that your company has the right level of coverage wherever it operates, remains a major challenge for risk managers and CFOs of many companies.

Most U.S.-based multinational companies use worldwide insurance policies written by American carriers to protect their global operations. These types of policies typically offer centralized control and uniformity on coverage, limits, and deductibles for exposures around the world. However, if U.S.-based coverage is your only method to insure worldwide operations, your company might not have sufficient coverage.

In insurance terms, U.S.-based global policies are considered "non-admitted" insurance by regulators outside of the United States, and many countries do not recognize or allow these policies to act as legal insurance within their borders. If your company suffers a loss or has a claim against it in another country,

your global insurance carrier may not be able to respond on your behalf in the foreign country because the policy was considered non-admitted. For instance, the insurer may not be able to directly defend the insured in the country, post a bail bond, or otherwise pay for settlements or judgments)

Even when your global policy pays the claim in the United States, transferring the money to your subsidiary could be considered a capital infusion—and therefore taxable by the local government. Plus, using just a U.S.-based, non-admitted insurance policy in all countries can lead to fines, penalties, and tax liabilities because your U.S.-based insurer is not recognized as a legal insurance carrier by the foreign government.

In addition, some countries also have compulsory insurance requirements to ensure that companies are covered for certain types of events, such as industrial accidents and workplace accidents. Even if a country allows "non-admitted" insurance, a U.S.-based policy will not meet the local, compulsory insurance requirements.

In the past year, a number of changes in insurance requirements, laws, and practices in other countries underline the importance of continually monitoring your international insurance and risk management policies. We outline some of the recent changes to coverage requirements below.

Argentina now requires additional hazardous activities coverage

Last year, Argentina changed its local insurance law to require firms performing potentially hazardous activities to purchase coverage for remediation and cleanup of environmental damage.

The law classifies industries into three categories based on the potential environmental contamination damages they may cause to the community. Firms placed into the medium or high categories are required to purchase certain levels of insurance. Only coverage including approved wording can meet the new insurance requirement, so basic environmental liability coverage or environmental liability coverage purchased outside of Argentina does not meet the requirement. Businesses with operations in Argentina should review their environmental risk management procedures, and confirm if their activities mandate purchasing the environmental damage insurance required under the new law.

Germany announced an environmental damage act

The new act addresses damage to the environment rather than property damage or bodily injury and is designed to help prevent and remediate environmental damage to protected species, bodies of water, and soil. Polluters are required to pay for clean-up costs and other expenses associated with restoring damaged areas. Only the German state can bring action against a firm under this law.