Tools of choice

Executive summary

- A survey of foreign exchange risk management practices in prominent multinationals show that more than 90% of respondents work along a centralised treasury model which drives banking relationships. Add to this that FX management usually means minimising earnings volatility or mitigating transaction risk and a clear pattern emerges: the focus is often on hedging programmes and accounting standards.

Having a broad overview of the different risk management techniques and objectives used by corporations can help treasuries confirm or improve their current policies. To garner this knowledge, ACT and financial services company Citi have joined forces and conducted a study on foreign exchange (FX) risk management practices among some of the most prominent multinationals globally. With 287 participating companies, the 2008 ACT/Citi survey spans North America (29%), Europe (42%), Asia-Pacific (21%) and developing markets (8%) and covers a wide range of industries from consumer goods to auto and aviation, from industrials to healthcare and services.

CONCENTRATION IN SETUP AND EXECUTION Whether it's policy definition, hedge decision and execution, or back-office and control functions, the 287 companies' treasury departments appear to be highly centralised. More than 90% of respondents work along a centralised treasury model.

Subsidiaries' performance is predominantly measured in the parent's currency terms in Europe (73%) and North America (77%), with the rest of the world not showing any particular preference. However, few parent companies impose their domestic currency as functional currency globally (9%). While the commodity and energy sectors do make their domestic currency their global currency, most treasuries (74%) adopt local currencies as the functional currency for their subsidiaries.

Treasury centralisation has been a driver of concentration in banking relationships. Of the respondents, 60% of corporations maintain a primary relationship with between one and five banks. Treasuries working with more than 10 primary banks account for only 12% of the sample.

While treasuries rely on fewer banks for executing trades, electronic trading is a common practice for only around 40% of respondents. Personal relationships, better phone pricing and operational hurdles are still frequently invoked as reasons for not transacting electronically. Among users, the main platform remains FX All (47%) followed by single-bank portals (24%).

WHILE TREASURIES RELY ON FEWER BANKS FOR EXECUTING TRADES, ELECTRONIC TRADING IS A COMMON PRACTICE FOR ONLY AROUND 40% OF RESPONDENTS.

CONVERGENCE IN RISK MANAGEMENT OBJECTIVES For a majority of companies, FX management should either aim at minimising earnings volatility (47%) or at mitigating transactional risk (32%). Emphasis on earnings volatility is especially predominant in North America, where investors and corporations have traditionally been more sensitive to quarterly earnings reports. In general, the concept of earnings volatility is closely related to the annual fiscal/budgeting/reporting cycle, with most corporations managing either the FX impact on year-on-year quarterly earnings (42%) or the expected versus actual earnings gap (30%). All in, this is a determining factor for budget rates and hedge duration.

HEDGING PROGRAMMES AND ACCOUNTING STANDARDS
Among respondents, FX risk management is typically articulated around three hedging programmes driven by accounting standards and, more particularly, the various definitions of hedge accounting.

As shown in *Figure 1*, treasuries clearly focus on managing net

STEPHANE KNAUF AND **CATHY CHIANG AGLE** PROVIDE AN OVERVIEW OF THE ACT/CITI SURVEY ON HOW MAJOR CORPORATIONS ACROSS THE GLOBE DEAL WITH FOREIGN EXCHANGE RISK MANAGEMENT.

monetary assets and liabilities (in other words, foreign currency payables and receivables, cash items, inter-company loans, and so on) and forecasted exposures (that is, anticipated cashflows). While the former is irremediably linked to the concept of fair value hedging, the latter relates to cashflow hedging from an accounting standpoint.

The third hedge accounting qualification – net investment hedging – is a distant third, with only 24% of companies actively managing the currency risk born from the translation and consolidation of their foreign subsidiaries' net assets.

Consistent with this, only a minority of companies will look to manage currency risks where hedge accounting is not available. While earnings translation risk could eventually be mitigated via a cashflow hedging programme, hedging it as an aggregate prevents corporations from benefiting from a favourable accounting outcome. Managing risks such as contingent risk (bid-to-award, merger and acquisition transactions, and so on) or competitive risk face the same issue in practice. Despite being less usual or sometimes more difficult to assess and measure, these classes of risk are nonetheless potentially significant. It would, however, be unfair to conclude that accounting always outweighs economic realities in treasuries' decision processes. While a third of respondents declare that hedge accounting is a precondition for hedging, 25% are insensitive to the question and 42% will tolerate a limited earnings impact from derivatives used for hedging.

HEDGING INSTRUMENTS The forward outright is the tool of choice to mitigate currency risk and is quasi-systemically used for fair value and cashflow hedging programmes. While FX options are also widely used (51% of respondents), their application seems more specialised. In summary, they are used to manage uncertainty whether from a market's or an exposure's point of view. Cashflow or earnings translation hedging programmes have longer durations and typically rely on the quality of business forecasts. They are also more strategic than fair value hedging programmes and more likely to be tailored to a market view. As uncertainty gets extreme for contingent risks, options naturally become the favoured solution. Whether synthetic or direct, net investment hedging is a funding strategy. Not surprisingly, debt instruments and cross currency swaps will be more frequently used in that type of context.

THE FORWARD OUTRIGHT IS THE TOOL OF CHOICE TO MITIGATE CURRENCY RISK AND IS QUASI-SYSTEMICALLY USED FOR FAIR VALUE AND CASHFLOW HEDGING.

Figure 1: Companies hedging types of FX risks

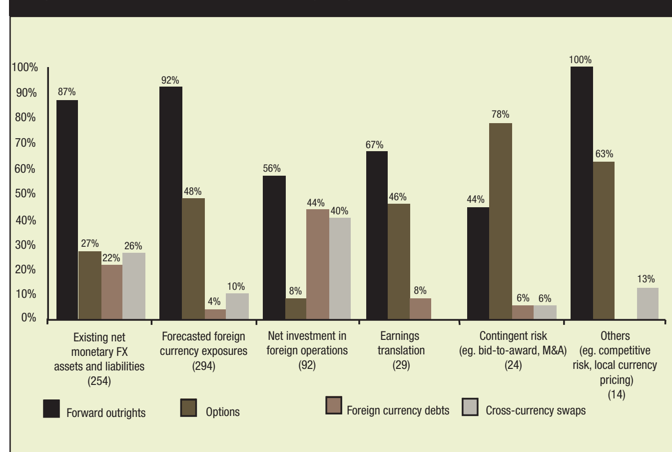
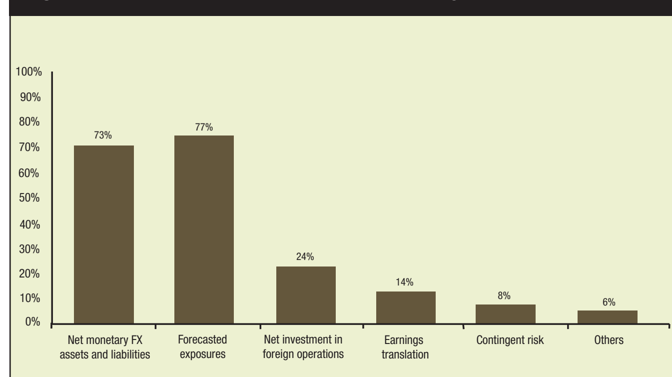


Figure 2: Main exposures to be managed



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Detailed results of the 2008 ACT/Citi Survey are available upon request or can be accessed at www.treasurers.org.