THE FAST CHANGING FACE OF FX

CHRIS HALL OF BFINANCE EXPLORES THE IMPLICATIONS FOR THE TREASURY DEPARTMENT OF DOING BUSINESS IN TODAY'S RAPIDLY DEVELOPING FOREIGN EXCHANGE ENVIRONMENT.

Viewed increasingly as a 'commodity' activity where the treasury function can add little real value, foreign exchange (FX) exposure management is nevertheless undergoing significant change. Regulatory and technological developments are forcing many corporates to reassess how they conduct FX hedging. New accounting regulations are increasing the need for reporting and monitoring of hedging transactions, while increased automation is seen as providing an opportunity to relieve the back office of confirmation and settlement burdens. In this article, we will look at some of the issues that are driving change in corporate FX management and their potential effect on controls and procedures in the dealing room.

THE CONTROLS AND PROCEDURES ENVIRONMENT. Although FX management policy varies from company to company according to such factors as risk appetite, organisational structure and origin of exposure, the controls and procedure environment for ensuring that transactions in the FX markets are executed in line with policy is more uniform. A firm's FX controls and procedures manual explains definitively what will be hedged, how and by whom, but should also ensure that FX dealing activity is performed without error by establishing a framework which predetermines every step of the process, complete with internal checks and balances. Traditionally, it is fundamental that a segregation of duties is imposed between the members of staff authorised to:

- execute the transaction over the telephone;
- confirm transaction details with the bank (either in writing, or electronically);
- settle the transaction by initiation of funds transfers; and
- record and account for the transaction.

All these activities are subject to strict guidelines, but the primary risks reside in the initial agreement to deal and the post-confirmation release of funds. The maxim that 'when a dealer is on the phone, he can sell the company' may be extreme, but it rightly indicates the potential scale of problems that can arise from an undisciplined dealing controls policy. As such, appropriate boundaries for FX dealing activities are established by a series of dealer limits (size of deals conducted by a individual dealers over a given period), transaction limits (size of individual deals) and counterparty limits (value of deals arranged with an individual bank).

Equally important is rapid and accurate confirmation followed by automated settlement. Instruction via telephone call back or fax is insecure but not uncommon. Electronic banking systems are able to guarantee security through password-controlled access, with some offering a dual signatory capability. As outlined, the principles that underpin controls and procedures are unlikely to change, but their practical application may be due for review.

AUTOMATION. With three well-financed rivals striving to outpace each other in terms of liquidity, functionality and critical mass, telephone-based trading is gradually being replaced by multibank online platforms. One of the claims of the 'eFX' triumverate – Atriax, Currenex and FXall – is that operational benefits will outweigh pricing benefits via the mystical power of straightthrough processing (STP): confirmation and settlement will be a hands-free operation as data is fed seamlessly from trading platform to treasury management system (TMS) to accounting software.

Phone-based trading has always left some degree of risk due to the fact that verbally agreed transactions do not always transfer accurately from brain to blotter. With the new multibank platforms, limits can be built in to prevent trader error or exuberance. Junior staff can be given passwords with personal dealing limits, while experienced dealers are freed up from non-value-added work to concentrate on the larger deals. This sounds like a great improvement. But the treasurer must be able to control the appropriate limits for individual members of the team, set appropriate tolerance levels and ensure that the deal capture facilities of online platforms facilitate continued supply of accurate records.

By pre-calibrating the dealing platform, settlement should become an automated consequence of the transaction. Should confirmation and settlement all but disappear, the back office may be given additional responsibilities for analysing positions, past transactions and market trends in conjunction with more involvement with the front office.

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TRADING EFFICIENCIES. With the impending automation of internal FX transaction processing, it is possible that the emphasis of controls and procedures policy will to switch the flow of information with external parties. Creating new mandates for new counterparty banks and updating existing ones to reflect changes in procedures and personnel are critical to an effective controls environment for FX dealing, but also hamper effective price discovery in the multibank environment. Multibank platforms offer corporates the opportunity to access pricing from a range of banks much wider than their current list of approved counterparties.

But if the deal is sufficiently large to move the market in a currency pair, for example, the treasurer will not welcome better access to pricing information at the expense of pre-warning the market. It is in the interests of the multibank platforms to resolve these issues and they claim that it will soon be possible to transact FX deals with non-relationship counterparties without having to change counterparty credit policy. In particular, a commoditised prime brokerage model is being proposed whereby a corporate, if it wants to transact with a non-relationship bank, could ask a relationship bank to provide the switch – that is, use its credit relationship with the bank to facilitate the deal. Prime brokerage could also help corporates to disguise their intentions when undertaking price discovery for an otherwise visible transaction by hiding its intentions behind the cover of its relationship banks. Although both corporates and banks have already been sounded out, the model has not yet been tested in practice and it remains to be seen whether either side is comfortable in a dealing relationship without the security of a mandate.

DIVISION OF RESPONSIBILITY. Centralisation continues to be a key trend in treasury, with advances in IT and communications facilitating the exertion of control from the centre. But this trend may actually be reversed by automated dealing platforms which offer the benefits of devolving responsibility without losing control.

Treasurers commonly increase control on the execution of FX policy by establishing an in-house bank function and netting systems with subsidiaries reporting into a central treasury management system. This is often attractive if there is insufficient volume or expertise to justify maintaining dealing and back office capabilities at the country level. But should the new generation of multibank FX dealing platforms succeed in marginalising the scope for error in the dealing room and removing manual intervention from the back office, this logic of current arrangements may be less compelling. Indeed, use of online FX platforms may pave the way for earlier identification and communication of exposures between commercial and finance staff at local operating unit level, with the central treasury taking on a monitoring role. It may also be easier to achieve full profit responsibility for the impact of foreign exchange movements on the results of individual business units. However, the centralised treasury that nets FX exposures internally before going to the external markets may see less attraction in devolving responsibility back to the regions.

REGULATION. Whether phone- or PC-based, it is critical that all transactions satisfy internal control and audit requirements. The additional information produced by online platforms must be used effectively to support decision-making, control processes and other post-trade activities, including the accounting implications of FX deals. In some ways, the technological and regulatory drivers of change in the corporate FX sphere have become linked. In particular, the need to be FAS 133/IAS 39 compliant has focused treasurers' minds on control and auditability issues. For its part, electronic trading should help the treasurer meet the additional reporting requirements. Electronic deal tickets not only prevent dealers mistaking millions for billions or dollars for euros, they can be designed to include fields that contain the information demanded by tighter reporting requirements.

Accounting practices are already changing in accordance with the rollout of FAS 133 and IAS 39. Under the new regulations, all derivatives and hedged transactions will be marked to fair value, with any changes in fair value recorded as income unless specific hedge accounting criteria are met. Moreover, the 'ineffective' portion of hedging transactions must be recorded as earnings.

The changes to hedge accounting can add a considerable burden to the treasurer. Initially, these changes demand a decision at the very earliest stage on which hedging technique and accounting treatment is appropriate for particular transactions. The treasurer will also need to take ownership during the life of the underlying commercial exposure and must adopt a hedging strategy that the firm is comfortable with. (Anecdotal evidence suggests that there is already a return to use of forwards at the expense of derivatives).

This involves continuous monitoring of the underlying commercial exposure and its realisation, measuring the efficiency of the hedge, and running alternative scenarios to verify the impact of volatility on the firm's accounts. The importance of accounting principles not only puts more emphasis on reporting of transactions but demands closer co-ordination between the treasury and finance departments.

Treasurers and finance directors are also preparing recommendations for the board on the effect of FAS 133 and IAS 39 on the company's accounts. The new regulations force companies to consider how the effects of the hedging policy appear on the balance sheet or the profit and loss account. Senior managers must understand the potential volatility these decisions can introduce and ask themselves if they are comfortable with it.

THE FUTURE. It is probably too early for changes in procedure to have been undertaken in many treasuries due to the new and unproven nature of the multibank platforms. However, a number of firms may already be familiar with the impact of single-bank platforms on error rates, especially for small- and medium-sized trades. Much is likely to depend on the support available from your TMS vendor. All the leading TMS firms are working hard to build the necessary interfaces to online trading platforms; only when these are up and running with the ultimate objective – dealing and confirmation becoming part of the same seamless process – be realised.

Even if controls can be built into the technology used to execute FX policy, there is still a need for all staff to understand the need for appropriate controls and procedures and, as such, I refer readers to the Association's *Manual on Corporate Finance and Treasury Management* and the *Treasurer's Handbook 2001*.

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