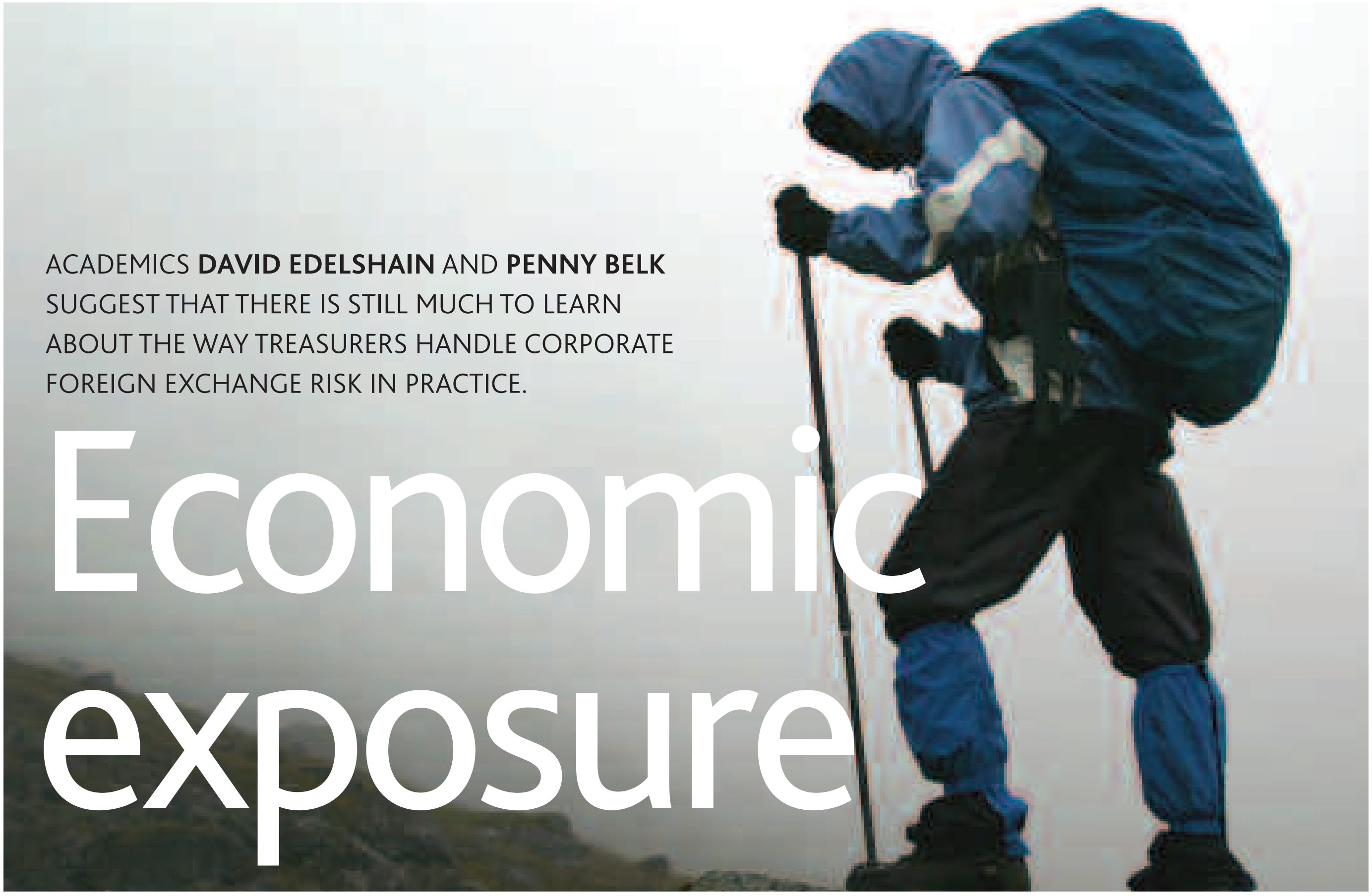

ACADEMICS **DAVID EDELSHAIN** AND **PENNY BELK** SUGGEST THAT THERE IS STILL MUCH TO LEARN ABOUT THE WAY TREASURERS HANDLE CORPORATE FOREIGN EXCHANGE RISK IN PRACTICE.

Economic exposure

Fifteen years ago as academics we were puzzled by earlier surveys of practice into the way foreign exchange (FX) risk is managed in large corporations. These surveys consistently reported that firms identified that transaction exposure – foreign currency denominated receivables and payables, loan payments, hedges and so forth – was their most important currency exposure. Transaction exposure is more important than corporates' economic or, as it is sometimes described, operating exposure. Nevertheless, according to our calculations, operating exposure – which covers operations yet to be contracted for, had and still has for the vast majority of firms – a much greater value than transaction exposure when measured in terms of the net present value (NPV) of anticipated future cashflows. In fact, we calculated that the NPV of the cashflow vulnerable to economic exposure was more than four times that to transaction exposure. How could so much more importance be ascribed to and priority be given to transaction exposure?

Could the problem lie with the greater difficulty of identifying and measuring economic exposure? Clearly it is not easy to identify the impact of exchange rate changes on inputs priced in domestic currency, but which originate in countries with a different currency. The same is true of sales we denominate in our domestic currency when we market them in those same countries. And what of those inputs and outputs further back or further down the supply chain, and those where competitive success or failure can be dependent on the country in which the competitor is located? And what of competitive tendering situations and other contracts that bind us effectively to receive or pay out foreign currency, but we do not know when? How far will we have discretion to amend our price lists in the face of an order?

Executive summary

- Economic exposure has a greater impact on the majority of corporates than transaction exposure.
- Treasurers must co-operate with managers working in various functions in the business to identify economic exposures.
- Financial instruments although highly effective do not cure the ongoing threat.
- There is increasing realisation that businesses need to collect more information about their transaction and operating exposures.

Once set out and described in this way, as these exposures were in the 1990 questionnaire survey *(see Box 1)*, respondents, for the first time, confirmed that economic exposure had a greater impact on the majority of respondent firms than did transaction exposure. At last we were relieved that what theory predicted would be found was being identified. Nevertheless, our concerns were not fully dispelled. Not only did our respondents report that they felt that they were doing a relatively poor job in managing their exposures, but the interview surveys were highlighting that treasurers were reporting themselves as being relatively highly risk averse when they were describing their own behaviour as very far from being so. Worrying enough was the confirmation that some 10% of treasuries were profit centres, but awareness that what was reported might be misleading despite the use of devices used to ensure that information provided is corroborated, has continued to haunt us.

EVALUATION DIFFICULTIES Everyone understands that what can be easily measured can be more easily managed. We are also all aware that immediate dangers take priority over more distant and often hypothetical ones. Transaction exposures can be quantified relatively straightforwardly and gains and losses on FX quite easily calculated, whereas the potential for loss, due to the possible failure of a future cash inflow to materialise because the putative sale might go to a foreign competitor pricing in 'weak' euros is very difficult to evaluate. No wonder, then, that transaction exposure often takes pride of place.

Treasurers must also be aware, however, that to identify economic exposures they must co-operate with managers working in various functions in the business. To get information on potential inputs they need to turn to operations; to get information on sales and competitors they need to turn to those in marketing; and to understand the likely shape of future cashflows in other currencies they will need to co-ordinate with planners and general management. Yet in the 1990 survey, respondents reported that only 10% of companies even consulted operations or marketing staff. Could the other 90% have had a clear idea of fully where their exposures arose?

The picture of the way currency exposure was managed that we obtained in our work at the beginning of the last decade was not more comforting. Given that survey respondents reported that treasurers were the most likely to be responsible for currency risk management in the corporations surveyed, we were not surprised to have confirmed to us that more corporations (some four-fifths) used financial instruments to manage their exposure than any other available methods and that more operational methods, like leading and lagging, had been eclipsed from their heyday of the 1960s and 1970s. What did surprise us was that respondents reported that these financial instruments were more often than other methods seen as most effective in managing currency risks. All we could infer was that a financial instrument was highly effective in doing the job that it was designed for. It eliminated or limited the risk in one or a set of specific transactions. But like an aspirin that for a while kills pain being experienced because a patient is suffering a brain tumour, the financial instrument does not provide a cure for what is in our case an ongoing threat.

Financial instruments, many now clearly understand, are ineffective in dealing with economic exposure and we were more relieved to see that there has been a steady growth in the use of strategic methods to deal with currency exposure. There is more evidence of the use of foreign currency denominated debt for example, and more thought given to how to balance the supply of, and demand for, different currencies in a business by locating activities in particular countries and by the use of acquisition and disposal strategies to achieve a better balance. But these were early days and Michael Earle at the London Business School reported finding most companies in the early stages of putting in place effective currency risk management. The surveys conducted by Lessard in the US, by Glaum in Germany and by Dumas in France, to give several representative examples, found similarly.

If business at that time had some way to go in improving their currency risk management, how have they fared more recently? There is a realisation that businesses need to collect more information about their exposures and that managers of different business functions need to provide each other with information. The growth of currency committees where multi-functional solutions can be devised is a welcome step. All too clear has been the danger of seizing upon sub-optimal, single-function solutions such as the employment of financial instruments alone that inevitably results from experience limited to specific professional experience. Those unfamiliar with the term 'bounded rationality' may even be unaware of the dangers of a partisan approach. But it is still unclear how much further we have to go. Treasurers receive training in how to manage currency exposure, and some believe that they still need more, judging from the overwhelming response that the primary lessons had come from the experience of dramatic losses from exchange rate movements.

LITTLE FAITH IN OUTSIDE HELP Worrying too was the finding that respondents had little faith in the expertise of those outside the business. Bankers were seen as of little help and focused on providing advice on which fees could be generated or in recommending the use of financial instruments with the same outcome. Little 'strategic' advice was on offer. Consultants fared little better. Yet, longer-term strategic advice seems to be the way forward. It appears logical that if the structure of the business determines the shape of its transaction exposures, which are largely to occur in the short term, then dealing with the longer-term shape of the business by structuring it appropriately will deal with both the economic and the transaction exposures that the business faces. So as from today's economic exposures tomorrow's transaction exposures will come, a greater focus on economic exposures is clearly justified.

Box 1 More exchange research needed

Some 15 years ago, quite separately, we both began researching the way FX risk is managed in large corporations. One of us carried out a questionnaire survey of practice in *Times 1,000* corporations, businesses with a turnover then in excess of £200m. Responses were received from some 180 respondents of which approximately 40% were treasurers. The other sought to interview treasurers specifically on their views on and practices in relation to exchange risk and as we became aware of each other's work we decided to exchange our findings, which has led on to closer co-operation and most recently to the launch of a further questionnaire survey to examine whether the way FX risk impacts and is managed has changed over the last decade and a half. Who better to survey than the practitioners?

We still need to know a lot more about practice and communicate effective ways of managing the issue to those in the profession and beyond. This means taking the time to communicate and giving priority to a subject that Coopers & Lybrand, forerunners to PricewaterhouseCoopers, have described as the issue responsible for more variation in corporate profits than any other. Some treasurers report to us that they receive on average half a dozen requests to respond to surveys every day and that they now suffer incurably from answering-survey fatigue. But if you want to know the current state of the art, then you need to help us academics to help you and provide you with the results of our latest survey.

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To participate in the Belk/Edelshain survey please go to www.cass.city.ac.uk/crm

See An exchange of views, page 15.