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ACT breakfast briefing

Setting the bar for FX risk management

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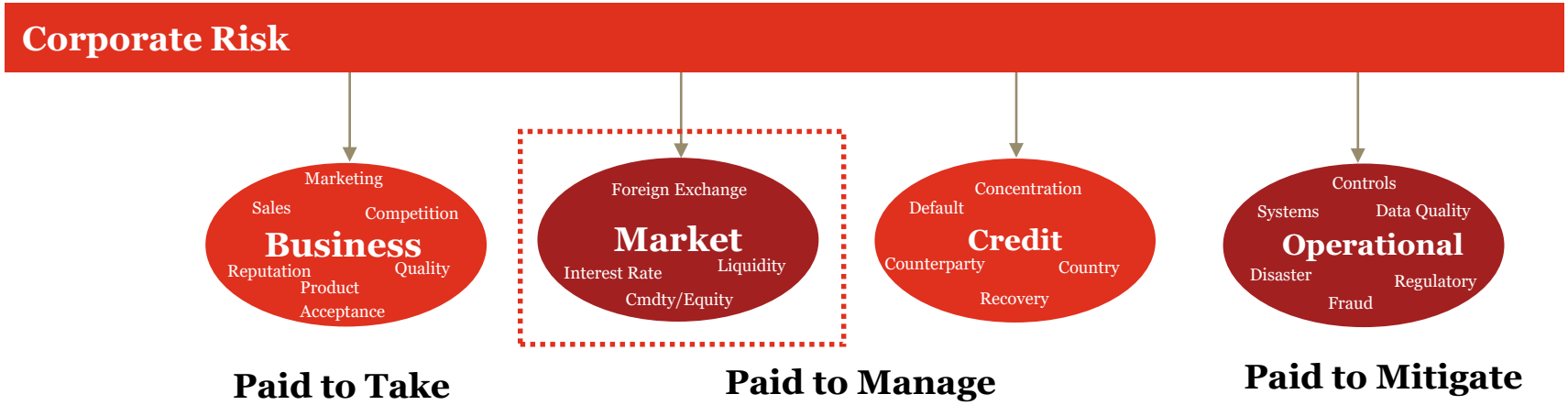
Issues in FX risk management

Corporate risks



- Business risk and market risk are normally the two key sources of risk that can affect a company's ability to achieve earnings or cash flows targets
- Corporations take business risk in order to generate profits and 'manage' the impacts of market and credit risk on the financial results
- Operational risk is a 'cost' incurred in the course of the business and as such is only mitigated

Issues in FX risk management

Market risk components

Market Risk

Market Risk Components	Other Components
Foreign Exchange	**Spread Risk:** The potential loss due to changes in spread between two instruments (ex. Spread Corporate vs Government bonds)
Interest Rate	**Basis Risk:** The potential losses due to pricing differences between equivalent instruments such as bonds and swaps*
Equity	**Volatility Risk:** The potential losses due to fluctuations in implied option volatilities and is often referred as 'vega risk'
Commodity	**Liquidity Risk:** The potential losses due to non-liquid markets

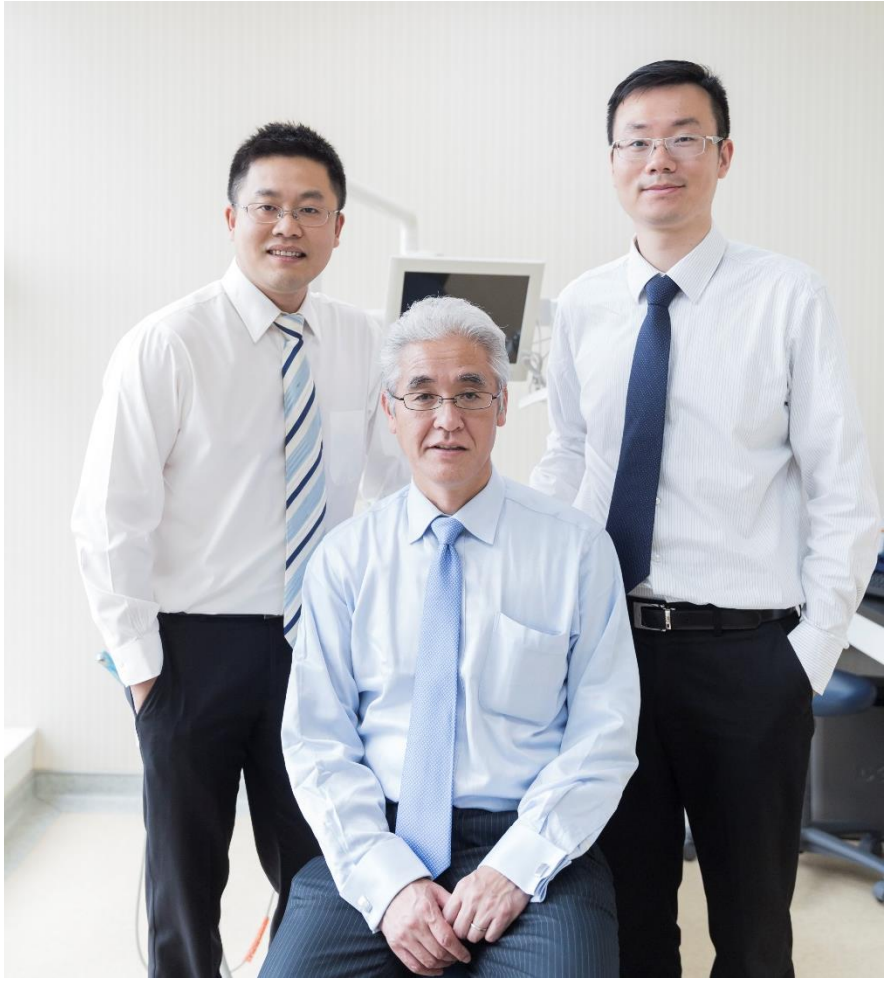
Issues in FX risk management
FX risk management objectives

The main objectives behind most corporations financial (market and credit) risk management strategy can be summarised as follows:

Protect the group against unforeseen losses, maintain earnings stability

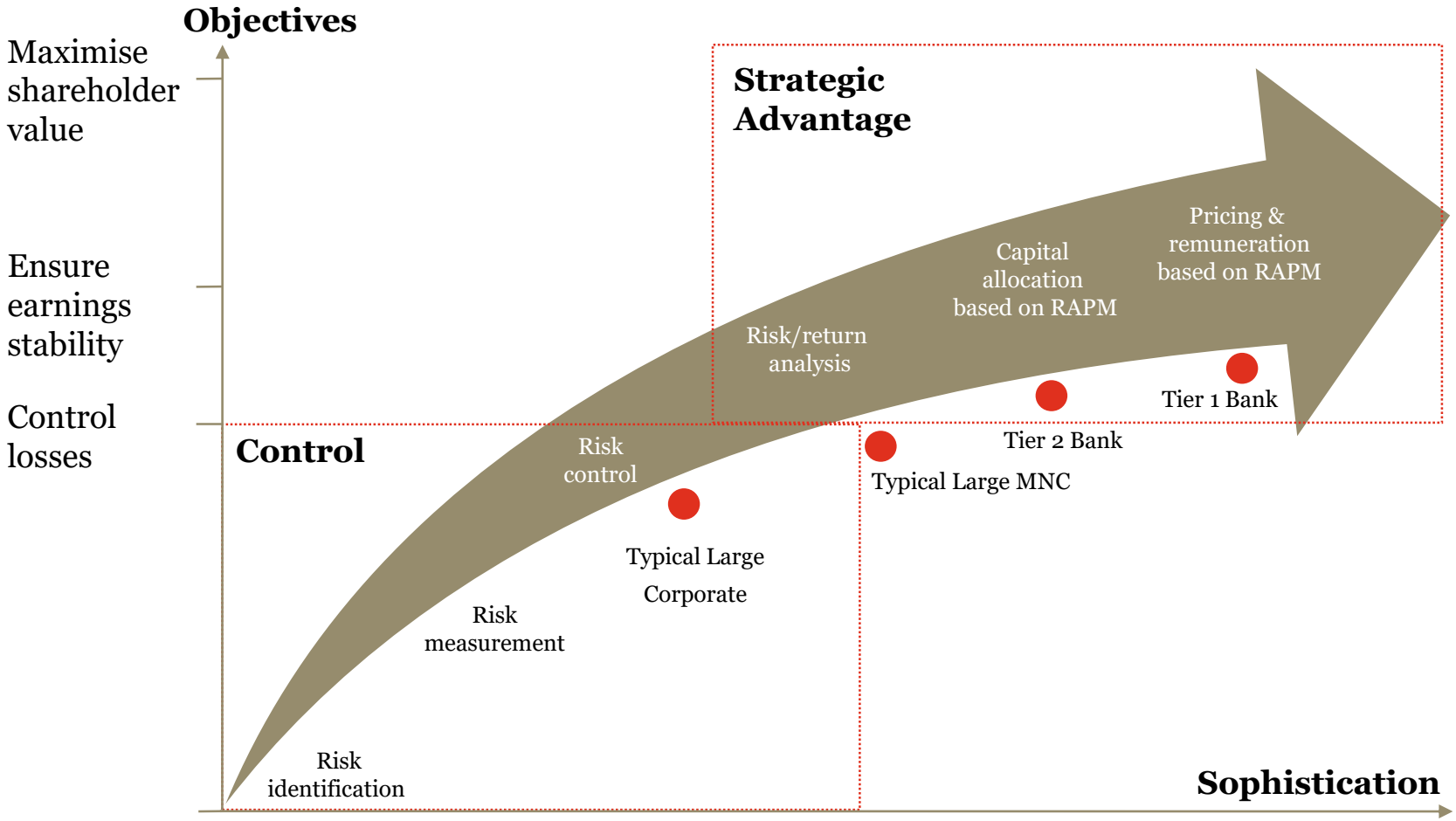
Or

Support in delivering shareholder value



Issues in FX risk management

FX risk maturity ladder



Foreign Exchange
Questions to the audience

Have you revisited and revised your Foreign Exchange policy in the last 6 months?

1

Have you changed your hedging approach?

2

Managing currency exposures

There is not always a right or wrong approach to managing FX exposures. It is important to clearly identify the hedging objective(s) and adapt the approach to ongoing changes in the business.

Define your risk exposures and risk appetite

The identification and quantification of the Group's material FX exposures is normally approached by an analysis and quantification of exposure by type and needs to consider cash, accounting and economic impact

Embed the policy, process and refresh frequently

This framework should formalise:

- Precision and horizon over which forecast (pre-committed/committed) and recognised exposures are managed
- Approved strategies and permitted hedges
- Responsibilities and delegated authorities, including the responsibility for businesses to report and confirm management of exposures in accordance with the policy and to report breaches of policy

Precision can increase over time

Grouping transactional exposures into monthly time buckets, by type is typically an efficient approach for identifying hedge requirements (where not possible to track individual transactions) and hedge a percentage of the total

Hedge accounting

Applying hedge accounting can help minimise accounting impact of timing and volume differences. Alternatively a coherent explanation supported by suitable reporting is often easier (internal and external)

Ensure reliable data

Often this requires a refinement in processes and reporting to provide the visibility and reporting of FX exposures and their management

Reduce exposures 'naturally' where possible

With reliable data and visibility of exposures it is easier to focus on the ongoing reduction of exposure levels through netting, natural offsets and other initiatives. This can include changing transaction currencies, timing and entities entering into transactions

Centralise exposures

Where possible transactions should be in the functional currency of entities entering into transactions. Where FX risk remains in entities these exposures should be aggregated and managed centrally

Timing vs. volume variances

Understanding the difference between timing and volume differences is essential. Often this is influenced by the precision of accounting for FX (e.g. daily rates vs monthly) and interplay with cash management and working capital cycle

Managing FX
Things to avoid

Maintaining the safe approach to do what you've always done

Don't try to second guess currency movements, follow your program

Not engaging regularly with business partners to understand local markets

Having a poor forecasting process

Not getting competitive quotes when you transact

Not understanding your FX results in a timely manner

Relying too much on spreadsheets without appropriate control

Not monitoring performance of your hedging program

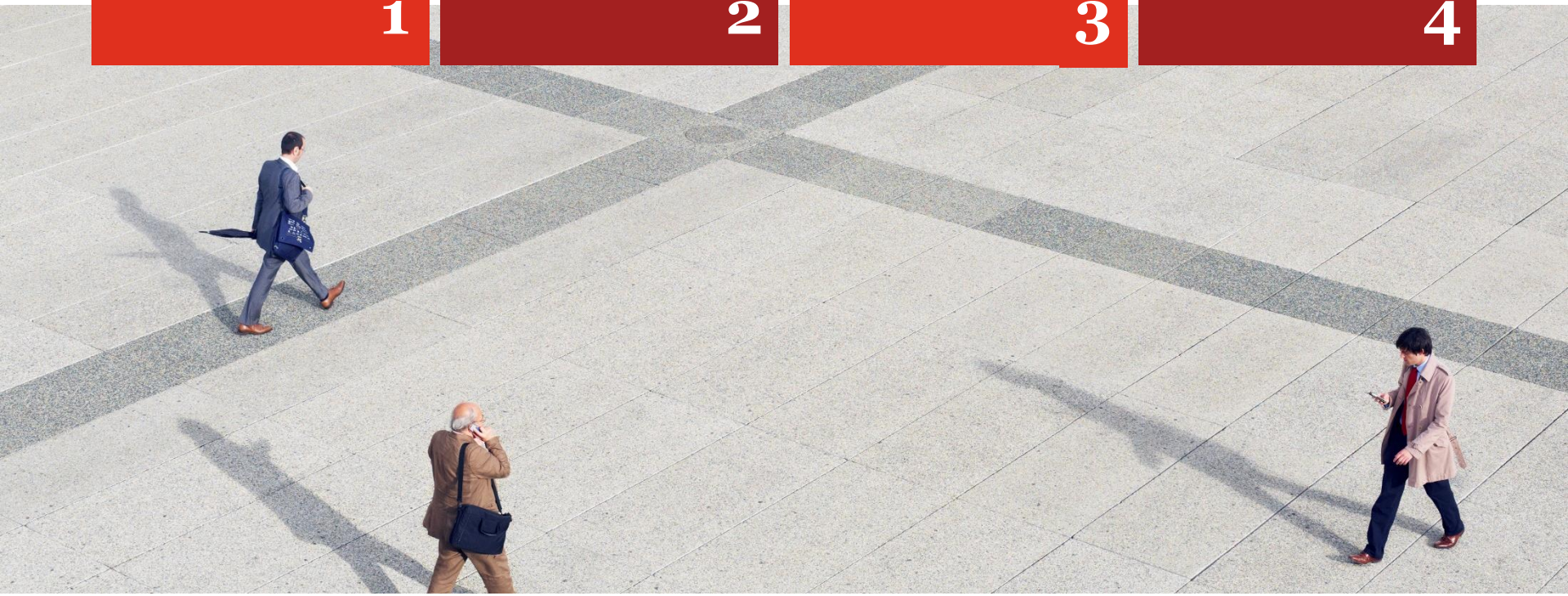
Recommendations for managing FX risk

Not just a Treasury issue, requires the wider business **1**

Consider all exposures, both Cash & Accounting **2**

Identify natural offsets first **3**

Be proactive, don't wait for unexpected loss **4**



Examples of work we have done

British Based Pharma Company

- Main revenue from royalties in USD and costs in EUR and GBP
- No consolidated view of its FX exposure (Forecast P&L/Balance sheet)
- Had identified an increasingly significant FX number in its consolidated P&L
- The client engaged us to help them understand and quantify their exposures and to recommend possible solutions to manage the risk

Global Hotels Group

- Recently expanded into new territories and hadn't revisited its Treasury policy for some time
- The client wanted us to undertake a compliance and best practice review of their policy and in particular their FX policy
- We created a good practice policy, adaptable to on board new markets (often EM with difficult regs). In addition, establishing a framework, to monitor the performance of the hedging program

Global Beverages Group

- Large volume of FX trades
- Manual processes and significant hard copy documents
- The client also had reconciliation issues in accounting
- We supported the client in automating the end-to-end FX execution process, introduced system based approvals and designed accounting journals with clear references to trades to allow reconciliation

Large Retail Group

- Significant FX gain and losses in a number of GL accounts
- Monthly volatility in earnings from FX
- Inability to trace FX gains losses back to hedging decisions
- We supported the clients in clearly mapping accounting of various FX gains ad losses, documentation of FX hedging processes and redesign of FX rates, accounting and allocation to reduce the volatility and trace accounting results to hedging decisions

What are the trends of the future…

Technology

Automated trading (using algorithms) against pre-defined policy set up in the dealing system

Policy changes

Netting, should we hedge account, payment factories. Holistic/ ERM.
Risk management at a micro level (SKU)

Regulations

Changes in regulations, possibly the end to OTC derivatives and requirements to make margin calls

Fintech

New counterparties offering foreign exchange derivatives

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