EUROMONEY

FX volatility tests corporate treasury resilience

Paul Golden May 30, 2023

Extreme FX volatility is proving a challenge for some finance directors who are struggling to minimize the impact on their bottom line.

Illustration: iStock

The sheer scale of currency fluctuation since the start of 2022 is striking. According to Kyriba's latest currency impact report, the 1,200 publicly traded North American and European companies surveyed for the report experienced cumulative currency impacts of almost $170 billion last year, of which more than $131 billion was negative.

Comparing these figures to the 2021 totals of $67 billion and $23 billion respectively only tells part of the story. During the past 12 months, sterling reached its lowest level against the dollar since 1985, and the yen was worth less than at any time since 1998.

Many finance professionals in large corporates had not even started their careers a quarter of a century ago and therefore have no first-hand knowledge of similar market conditions.

Abhishek Sachdev, Vedanta Hedging

One of the ways they have compensated is to retrench and hope for the best on the spot market, which is not ideal, as Abhishek Sachdev, chief executive of Vedanta Hedging, points out.

He adds that he has seen some chief financial officers (CFOs) go the other way and be more tempted to enter into unnecessarily complex structured products such as outperformance trades, which have the veneer of looking more attractive when there is such high volatility.

“Some FX brokers are taking this opportunity to offer longer-dated FX products to provide more attractive pricing, but this can be a double edged-sword for corporates,” he says.

Many corporates are realizing that they do not have the internal resources to properly manage their FX risk due to a lack of reliable exposure data, manual workflows that overwhelm small treasury teams and no insightful analytics that explain where the FX noise is coming from.

Talent search

Scott Bilter, principal at AtlasFX, suggests many have either compensated by trying to hire additional resources – leading to a shortage of treasury talent – or looked to external solutions for help.

Helen Kane, risk and exposure fellow at Hedge Trackers, a GTreasury company, agrees that competition for FX hedging talent has heated up during the past nine months and adds that CFOs without hedge programmes have been rushing to implement them, but frequently without the thoughtfulness and understanding required.

“It has not been uncommon for corporate hedge programmes to be developed by bankers for their corporate clients without a full understanding of the currency accounting environment,” she says. “[illegible] programmes rarely work like they were taught in MBA school – the CFO might assume that if they have EUR revenue they should be able to fix the USD value of that revenue, but it is rarely that easy because of accounting structures."

When FX volatility is low, organizations may employ little or no hedging, as they can still achieve a high probability of achieving the required outcome. However, as volatility increases, FX policy parameters may have to be revised accordingly.

Helen Kane, Hedge Trackers

"In the last few months, numerous treasurers have been required to focus their attention on revising FX risk-management policies and practices," says Dino Nicolaides, managing director head of treasury advisory UK and Ireland at Redbridge.

"A good treasurer can address this challenge by going back to first principles, which is where formal training and qualifications can prove very useful."

There are two potential financial implications of inefficient FX exposure management, says Amol Dhargalkar, managing partner Chatham Financial. "Firstly, financial results are subject to much greater volatility and could lead to missed estimates, and, secondly, hidden costs of inefficient FX exposure management and hedging can increase expenses for the organization," he says.

Competitive disadvantage

Inefficient FX exposure management lays bare an organization to greater variability in returns that may not be in line with the risk appetite of key stakeholders. It can also create a genuine competitive disadvantage (for example, in pricing being offered to end-user clients) as well as financial write-downs and hedge accounting losses in the financial statements.

The most visible impact is missing the guided earnings number due to FX losses, says AtlasFX's Bilter. "There was a wave of this in the second half of 2022 after relentless USD strengthening, so those who had significantly unhedged or underhedged foreign revenue exposure were giving a lot of 'constant currency' explanations on earnings calls to put a spin on their results."

According to Kane at Hedge Trackers, as finance professionals move between industries, they make the mistake of expecting currency to impact their financials the same way and therefore they tend to hedge the same way.

"The lack of understanding of currency in the financials continues, as Wall Street analysts are placated with vague currency headwinds and imprecise constant currency reporting," she continues. "CFOs will continue to focus where analysts focus, so the question of why hedge programmes haven't effectively protected margins rarely comes up."

Amol Dhargalkar, Chatham Financial

Chatham Financial's Dhargalkar notes that gathering exposures can be a challenge because larger organizations have to collect current and forecast exposure data across multiple systems and regions.

In many corporations, FX identification is a complex process due to various factors, including a scattered system landscape, transactions recorded in systems in the functional currency instead of the exposure currency, and embedded price indexes included in commercial contracts, explains Sander de Vries, treasury director at Zanders.

"To understand the FX exposure of the company, the management board/treasury should determine which financial metrics – for example, cash flows, covenant ratios – it would like to protect from FX movements," he says.

Forecast focus

Nicolaides at Redbridge notes that the most common way of capturing FX exposures is through cash-flow forecasting and the most frequent users of cash-flow forecasts are members of the treasury team who utilize these forecasts to take decisions in managing risks such as FX.

"A common issue is that because there is a disconnect between preparers and users, the former may fail to understand the importance of accurate forecasts for decision-making purposes and may not devote the required attention and time to providing accurate and credible forecasts," he warns.

Bilter says corporate enterprise resource planning (ERP) systems will have reports that are typically already summarized in USD terms without the transaction currency details required, and companies are therefore hedging both their income statement and balance-sheet exposures based on guesswork.

"For their longer-dated income statement exposures, the forecasting cadence led by FP&A [financial planning and analysis] will typically also be dollar centric, with perhaps a once-per-year FX rate assumption to use in that roll-up process that quickly becomes stale," he adds. "Corporates have a difficult time bridging the gap between this plan and what is typically a layered cash-flow hedging programme."

Currency accounting is not intuitive and even CFOs have to learn how currency flows through the financials, says Kane.

"An example here is a company that had a hedge programme inherited by a new treasurer," she concludes. "When asked to review the programme, I was startled to realize that, through a number of acquisitions, the company's exposure had gone from long EUR to short – yet the hedging had not changed over the decades it had been in place. As a result, it was increasing rather than decreasing the exposure to EUR."

Scott Bilter, AtlasFX

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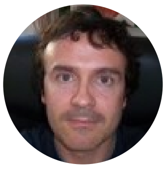

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Paul has written about finance since the early 2000s, with a particular emphasis on foreign exchange, treasury and wealth management. He is a regular contributor to several industry titles in addition to Euromoney.