Top 8 Mistakes in FX Risk Management

Managing FX risk is challenging, and often tops surveys of concerns among Treasurers. Many pitfalls await the inexperienced and unprepared. To help, here is a “Top 8” list of the most common mistakes multinationals make when managing FX risk.

1) Unclear Objectives and Policies

In order to design an effective FX hedging strategy, it is necessary to know exactly what the strategy is intended to accomplish. Is the goal to protect the balance sheet or the P&L? Should accounting results be prioritized over cash flow impacts? Closely related to this is the tendency for FX policy to be determined incrementally, in response to past losses generated by exposures that were not properly understood. An effective FX team will determine policies proactively, not reactively. Objectives should be closely aligned with the overall business strategy, and they should be clear, specific and measureable (see #3)

2) Lack of a Structured Approach

Too often, hedging activities are undisciplined and unplanned. Some examples incude poor forecasting processes, not leveraging income statement forecasts, poor liquidity management (i.e. handling liquidity needs with spot trades when they should be handled with FX swaps). Lack of a structured approach puts the program at risk when key personnel are absent or leave, and creates difficulties when communicating the hedging strategy to key stakeholders. A good way to test if a strategy makes sense is to stress-test it with different “what-if” scenarios. If you don't like what you see, then your strategy needs adjusting...

3) Lack of Performance Metrics and Benchmarks

The choice of metrics is critical, and should be closely linked to the objectives. Examples of good metrics include reduction in earnings volatility, reduction of earnings at risk, FAS 133/IAS39 ineffectiveness, and the like. Benchmarks are the standard to which performance to metric is judged; for example, FX earnings at risk < .01 EPS. Forecast error risk needs to be addressed by any fair metric. In the *absence* of good benchmarks, it is common for the P&L of the hedge itself to become the benchmark. This is uninformed and dangerous, and completely ignores the relationship between the hedge and the underlying exposure.

4) Taking a Market View

A strong hedging program should not be influenced by directional views or recent trends. Professional currency forecasters have proven time and again that they have no skill in forecasting FX movements. If professionals working full time can’t do it, how well does that bode for your organization? This attitude often leads to termination of hedges because they’re “losing money” - just before the underlying exposure begins to lose value and the hedges (now non-existent) would have had offsetting gains. Hope is not a strategy, and FX policies need to take emotion out of risk management.

5) Failure to use Non-Derivative Opportunities
Companies should first focus efforts on non-derivative opportunities. They include: Natural hedging opportunities, capital adjustment - invest additional capital or pay a dividend to balance exposure, currency risk-sharing clauses with customers and suppliers, and coordination of hedging policies to ensure risks are not created through inefficient intra-group hedging.

6) Use of Complex Derivatives
One of the most dangerous pitfalls found in FX risk management is the use of inappropriate hedging instruments. While trying to minimize hedging costs, companies may build a portfolio of derivatives with features such as “knock-outs” which lower the initial cost, but may lose protection when it is most needed. As a guideline, FX hedging should increase the certainty of cash flows, not decrease it.

7) Not minimizing derivative pricing
The FX market is large, opaque and not a place for the inexperienced or uninformed. Banks make the majority (58%) of their derivative profit from the FX market. When dealing, always know where the market is. Trade off “fixing rates” such as the WM-Reuters London 4pm fix. Even though trading on the OTC market, choose the third Wednesday (common expiry day for FX exchange markets such as the CME) for comparative pricing. If the size of the trades invites front-running (or skewness of two-way prices is a problem) explore anonymous trading solutions such as a prime broker + FXall or similar platform.

8) Having a poor balance sheet forecasting process
Companies can’t hedge a risk until they know just what is at risk, so accurate forecasting is at the heart of any hedging operation. But what should an organization forecast? That varies from company to company because the appropriate hedging strategy will, necessarily, depend on how and where the company is incurring FX risk. For example, third-party foreign-currency transactions may be the basis for cash flow hedging in a company with U.S. dollar (USD)-functional subsidiaries, while USD-based intercompany transactions may be the hedged item in a company with local-currency–functional subsidiaries. Many companies have mixed environments, in which subsidiaries operate in local currencies but exposures are consolidated regionally in shared service centers or in-house banks. It is important that the corporate treasury team have a solid understanding of where FX exposures are originating in the organization.

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