A Word from the Red Carpet on Managing Risk

By **Helen Sanders**, Editor

While treasury and Hollywood often seem to be worlds apart, it was Helen Mirren who said, "Fear sometimes stops you from doing stupid things. But it can also stop you from doing creative or exciting or experimental things", a comment that is as relevant to a treasurer's day job as walking the red carpet. As one of the world's greatest actors, you take risks on the script you pick, the director you work with and most importantly of all, your choice of red carpet footwear. Taking informed risks on the first two of these is how you move from rep theatre in a small market town to the West End, Broadway or Hollywood. Taking a risk on the third and hobbling through a première or breaking an ankle is avoidable and leads to all the wrong sort of headlines.

Changing attitudes to FX risk management

"While treasury and risk functions are at different stages of maturity, treasurers have also developed a different mindset in terms of how they assess and manage their specific risks: Firstly, the corporate view and management of risk is now moving towards global. Secondly, treasurers recognise the importance of a more dynamic risk management and execution policy that can be adapted to changing market conditions, availability of innovative solutions, and evolving business and regulatory requirements. Thirdly, they are taking a more integrated approach to different risks with more regularity than in the past."

Dipak Khot, Thought Leadership, Corporate Risk Solutions, UK & CEEMEA, HSBC

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So risk is neither unfamiliar nor always undesirable: however, in each instance, it needs to be treated appropriately: take, mitigate or manage. A company will always take the specific risks related to their business, whatever their industry, as this is where growth and competitive advantage can accrue. It will mitigate risks such as operational risk, where there is no upside. Most market risks, including FX, fall into a third category, where, like the risk of vertiginous heels, risks can create serial pain, but also serial gain, so they need to be managed correctly to limit downside risk without eliminating upside potential.

The scale of the challenge

Managing foreign exchange (FX) risk is core to treasury's responsibilities, but the scale of risk and therefore potential impact on earnings, continues to increase as corporations extend their international reach whilst buffeted by high levels of market volatility. Although the nature of FX risk remains universal, corporate skills and attitudes, together with the market and regulatory environment, have changed significantly over recent years. As Dipak Khot, Thought Leadership, Corporate Risk Solutions, UK & CEEMEA, HSBC describes,

"Historically, risk management looked quite different to the way it appears today. In the past, treasury management was largely confined within local boundaries, with each external or overseas unit responsible for managing its own market risk. Secondly, the treasury and risk policy was often static, and not reviewed regularly. This policy was largely focused on market risks that the treasurer understood best, such as FX, interest rate and commodity risk, and mostly these tended to be managed in isolation rather than under one umbrella. Even within FX, risks arising from different currencies were managed separately rather than as a basket risk. Amongst our clients, for instance, only a few, more sophisticated corporate treasuries managed a wider set of risks such as credit, inflation, correlation etc., and expertise in these areas was relatively limited in some organisations."

He continues,

"However, we are now in an environment where high levels of volatility are the norm rather than the exception. Furthermore, we have seen in the recent months that world geopolitical events have become more important in driving market volatility than the fundamental economic indicators that were used in the past. Over time, treasurers have learnt to accept 'black swan' events as something of a norm rather than an exception, and have therefore moved towards more flexible solutions to allow them to hedge risk appropriately. Similarly, tail risk hedging (i.e., hedging against events that have a low probability) is now an accepted reality among corporates, far more than in the past."

The regulatory environment has also changed. While in the recent past , treasury's activities have been heavily influenced by accounting requirements, such as obtaining hedge accounting treatment for derivatives, with IFRS9 coming into effect, treasurers are able to focus more on the risk requirements of their business, allowing for more economic rather than simply accounting hedging.

Holding the reins on volatility

Given that corporations of all sizes are extending their geographic footprint, and therefore the complexity of their FX risks is increasing, the issue of volatility becomes increasingly important. This applies not only in terms of the level of market volatility, but also the differences in currency cycles. An old treasury friend recently said to me that Europe used to be

Box 1. Q4, 2016 Currency Impact Report

Top 5 Most Volatile G20 Currencies

	Q1 2016	Q2 2016	Q3 2016	Q4 2016
1	CNY	IDR	GBP	KRW
2	ARS	EUR	RUB	EUR
3	BRL	KRW	ARS	TRY
4	TRY	CNY	BRL	IDR
5	MXN	GBP	IDR	AUD

Top 5 Most Volatile Currencies as Weighted by GDP %

	Q1 2016	Q2 2016	Q3 2016	Q4 2016
1	CNY	EUR	CNY	EUR
2	BRL	CNY	EUR	KRW
3	EUR	IDR	GBP	CNY
4	GBP	GBP	BRL	JPY
5	ARS	JPY	RUB	IDR

Source: FIREapps

a boring place to work, but with Brexit, unpredictable continental politics and significant volatility in the historically more 'settled' GBP – EUR and EUR – USD currency pairs, he was now enjoying it immensely! Box 1 shows a summary taken from FIREapps' Q4, 2016 *Currency Impact Report*. As this illustrates, currency cycles vary widely, often across very short periods of time, so treasurers need a strategy for managing all currencies in a systematic way that reflects this unpredictability and their fast-changing level of exposure.

However, to do this successfully presents two particular difficulties. The first is that many treasurers struggle to identify, let alone then manage their global exposures. The second is that few have the capacity to adopt proactive risk management strategies in all of the currencies to which they are exposed, and the materiality of risks in some smaller currencies may not justify adding further resources.

Identifying global exposures is typically more difficult for decentralised treasury organisations. Given the potential likelihood of financial loss, and the potential scale, many companies are now seeking to centralise at least some aspects of their treasury activities, such as FX. As Wim Grosemans, Head of International Payments, BNP Paribas Cash Management says,

"Large corporations (less mid-caps or SMEs at this stage) are becoming more focused on capturing FX exposures that are currently sitting in multiple locations and currencies, and centralising the management of this risk."

'Outsourcing' FX risk management through transactional solutions

While treasury and risk centralisation is in itself challenging, the difficulty then is how to establish a risk management approach across all currencies, regulated and non-regulated, core and non-core.

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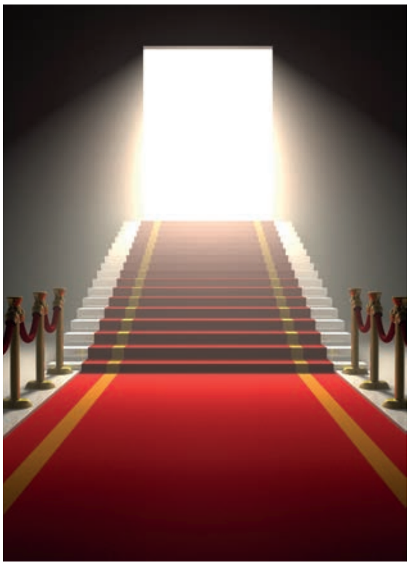

Steven Buonvino, Global Cross Currency Sales Lead, Treasury and Trade Solutions, Citi illustrates,

"Corporations typically have a concentration of major currencies where the majority of exposures and risk are created, with a long tail of non-core currencies, and treasurers and their banks are now taking a different approach to manage risks in core and non-core currencies. For example, many treasurers are managing their core currencies more actively, whilst looking for ways to reduce costs by managing non-core currencies in an operationally efficient way. This typically involves transactional solutions to streamline foreign currency intercompany or third party payments, as opposed to using financial market solutions."

This second point is particularly important here. Few treasurers have the resources, and in some cases the systems and expertise, to manage the full range of currency risks through the financial markets. Furthermore, the total exposure in some currencies may not justify the effort or cost required. However, given that these exposures are often unavoidable, as they represent salaries, supplier payments, local tax and customs payments etc., treasurers are looking for a more efficient way to manage them. For example, Wim Grosemans, BNP Paribas emphasises that these challenges are amplified in mid-cap companies,

"Mid cap corporations that may have significant import/ export businesses, but are less deeply embedded into multiple international locations, often have relatively high value cross-border (and cross-currency) flows. These companies are aiming to avoid having to maintain a complex cash and treasury management setup to fully manage these flows and the related exposures locally."

The benefit of a transactional approach to managing risks to non-core currencies extends beyond FX risk to cash and liquidity management. Steven Buonvino, Citi explains,

"Multinational corporations often face an issue where subsidiaries with autonomy over banking arrangements have opened numerous local bank accounts. Typically, these accounts are held in their local functional currency, with additional accounts in foreign currencies such as; USD, EUR, GBP and CHF. Today, treasurers are challenging this thinking and questioning whether these accounts are necessary and cost efficient. While managing flows through a separate account may appear to offer transparency, it also creates fragmentation and risk, and the same level of transparency can be created via other means. For example, the cost of FX can be quantified through pre-agreed spreads with the bank, whilst enhancing operational efficiency and control by automating the payment."

A transactional approach to managing non-core currency exposures is becoming increasingly common in both Europe and Asia. Jean-Marc Friess, Head of FX Payments, BNP Paribas discusses further,

"We are seeing a growing demand for regional and global solutions that centralise risk and streamline FX management. Many

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Box 2. Benefits of FX payment solutions

Operations

- Automated solution, reducing the resource requirement to manage foreign currency payment and collections
- Flexibility across a wide range of currencies, facilitating further international growth within the same solution

Cash & liquidity management

- Ability to reduce the number of foreign currency accounts, with implications for bank account management and costs, and liquidity management. It also becomes easier to centralise cash and treasury management.
- The need to fund and/ or exchange foreign currency payment and collection requirements is removed.

Risk management

- FX exposures are managed at a predictable cost

Audit and control

- Agreed margins and best execution

corporates are establishing shared service centres (SSC) or regional treasury centres, and implementing a single bank solution to simplify and standardise account structures, processes and controls for international payments and collections. For example, this may involve managing core currencies in-house, and effectively outsourcing the management of non-core currencies to their bank using an FX payment and collection solution for simplicity and cost purposes."

For example, some global banks offer international payment solutions that enable clients to make and receive cross-border payments in a wide range of currencies from a single operating account, typically in the company's base or functional currency. The foreign exchange transaction is typically done at an agreed margin, giving treasury visibility and auditability of rates. Other transactional solutions include the ability for treasurers to view and book rates in real-time for priority payments and intercompany transfers, while banks and non-bank providers also offer FX payment solutions to support international e-commerce. Jean-Marc Friess, BNP Paribas notes,

"We see client demands across five key areas:

- *Simplicity and convenience e.g., a reduction in the number of bank accounts; straight-through processing and automation; cost reduction*
- *Flexibility e.g., flexible rates/margins and coverage of their full range of currencies;*
- *Control e.g., the ability to monitor and track international payments*
- *Transparency e.g., agreed margins and best execution*
- *Single technology solution across all geographies with consistent pricing for payments and collections"*

Wim Grosemans, BNP Paribas continues,

"The value of connecting FX risk management with payments cannot be underestimated, particularly given the diversity and complexity of payment formats in each country and currency. Therefore, not only have we developed automated, streamlined international payment solutions, but we also publish a currency guide for the over 130 currencies in which we offer payment services globally.

"There are other reasons too for considering international payment solutions such as FX payment services. Many banks are consolidating their international networks, so corporate treasurers are finding that they have fewer potential banking partners in certain locations. Leveraging an FX payment service, which avoids the need to hold local accounts, whilst also automatically controlling potential exposures, is an alternative worth looking at."

Reuben Kane, EMEA Commercialisation FX+, BNP Paribas, notes the universality of these solutions across industries,

"A strong FX payment solution adds value across all industries as corporates seek to focus on their core business and avoid the cost and maintenance of highly complex cash and treasury management structures. Industries with a strong appetite for international expansion, such as pharmaceuticals and technology, seek solutions that can be quickly applied to projects in new markets or newly acquired entities. The shipping industry looks for solutions that guarantee timely settlement of payments to cover port costs, while insurance companies benefit from the efficient management of distributing overseas travel claims – often to exotic locations."

He also comments that cross-border payment solutions can be applicable to non-core payments in core currencies,

"Whilst international payment solutions are a great way of managing non-core currencies by reducing the number of accounts, optimising working capital and creating efficiencies, they can also apply to all payments that are non-core to the underlying business function. These operational payments cover salaries, tax collection / payments, insurance claims / premiums, dividends and interest payments, etc. Therefore, leveraging a central international payment platform can bring efficiencies to both non-core currency flows and non-core business flows.

Evaluating the benefit

As with any initiative, treasurers need to be confident the value proposition of FX payment solutions outweighs that of maintaining currency accounts and managing FX exposures in the financial markets. Steven Buonvino, Citi outlines,

Wim Grosemans, Head of International Payments, BNP Paribas Cash Management

Steven Buonvino, Global Cross Currency Sales Lead, Treasury and Trade Solutions, Citi

Reuben Kane, EMEA Commercialisation FX+, BNP Paribas

Jean-Marc Friess, Head of FX Payments, BNP Paribas

"At Citi, we help clients to understand the costs of maintaining their local bank accounts compared with implementing foreign currency payment and collection solutions. We use big data and apply filters to calculate the all-in cost of managing a bank account in that currency, typically $5 - $10k per account per year, and then compare this with the FX and cross-currency payment costs that would apply. We can then identify under-utilised accounts or those where the flows would be better managed through other means, such as a foreign currency payment and collection solution."

In many cases, however, by effectively transferring FX risk management for non-core currencies to become a transaction banking function, treasurers can simplify and automate this activity, allowing them to spend more time on managing their more significant FX exposures. Steven Buonvino, Citi discusses,

"By separating out core and non-core currencies, treasurers can focus on their most substantial risks and develop a more sophisticated, targeted hedging strategy that is closely linked to cash flow forecasts and funding requirements, including identifying natural hedges and netting exposures using liquidity management techniques. We have built FX risk management capabilities into our Treasury Advisory Group, recognising the inherent links between cash & liquidity management and FX, and we are encouraging clients to take a similar approach."

It is not only the way that treasurers are managing their non-core currency risks that is changing, as recent TMI articles authored by HSBC have illustrated (e.g., "Avoiding the Edge of the FX Risk Cliff" in edition 250, or at www.treasury-management.com). Treasurers are also taking a more strategic and specific approach to hedging core currency risks, including adopting a flexible hedging strategy over a longer duration and with a degree of optionality in some cases. Furthermore, they are taking a broader view of risk across risk types, but also in the context of other business metrics as Dipak Khot, HSBC highlights,

"At HSBC, we help clients to take a more holistic view of risk. We use a number of analytical models to enable clients to see their market risk in context, including the impact of market changes on key performance indicators, such as EBITDA, EPS, leverage ratio etc."

To do this effectively, treasurers need both systems and solutions to manage a potentially more sophisticated approach, but also the ability to articulate the value of new risk management strategies to internal and external stakeholders. Steven Buonvino, Citi comments,

"One of the difficulties that treasurers often experience when trying to explain potential risk management strategies to the board is presenting alternative solutions in a meaningful way. By harnessing Citi's models to show 'before and after' views, with detailed analytics and visual tools, it becomes easier to illustrate the story and engage senior management in understanding, evaluating and managing risks more effectively."

Dipak Khot, HSBC also emphasises the growing importance of risk management relative to peers and competitors, and the support that banks can offer in this respect,

"Within our client base, treasurers are also keen to benchmark their policies and processes against their peers to measure their approach against industry norms and best practices. While some of the data required to do this can be gleaned from publicly available information, at HSBC, we provide peer analysis based on both public as well as private sources, on a no-name, generic basis. We also inform clients of regulatory and accounting changes, such as IFRS9, and the implications."

Risk is inevitable and indeed often desirable, creating the opportunity for success as well as the potential for loss or failure. However, for most non-financial corporations, managing FX risk is typically a distraction, diverting resources from the core business. In an environment of heightened volatility, geopolitical and ideological shifts, and 'black swan' events becoming routine rather than exceptional, treasurers need to ramp up, but also prioritise their risk management activities. Using transactional solutions alongside financial market instruments can be a valuable way of simplifying risk management for non-core currencies, enabling treasurers to focus on core risks and contribute to business success. ■