

CFO Insights

How to uncover hidden FX risks

With the US dollar's continued strength against other major currencies, organizations are facing pressure to address related risks, such as foreign exchange (FX) exposure identification and visibility into those exposures. Without strong exposure identification capabilities, companies may have limited transparency into earnings volatility caused by FX movements or be left with inaccurate data that could impact risk management decisions.

The impacts are being felt across finance, particularly in treasury. In Deloitte LLP's [2016 Global Foreign Exchange \(FX\) survey](#), more than half (56%) of respondents report that lack of visibility and reliability of FX forecasts is the biggest challenge in managing FX risk.¹ The lack of visibility reflects the complexity of the topic, with 31% of corporations relying on three or more sources to identify exposures.² (See Figure 1.)

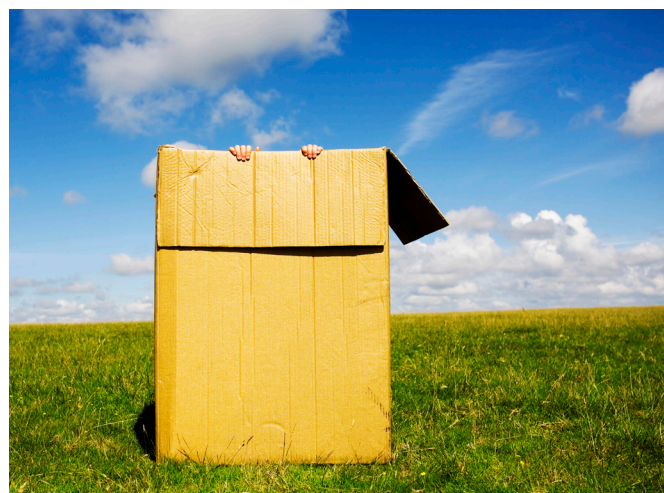
Addressing such challenges may require more focus on improving the level of confidence CFOs and treasurers have in forecasting mechanisms so they can more effectively identify risks along the supply chain that are not transparent. Sources of hidden FX exposures range from internal functions, such as treasury, trading, and technology, to external forces, such as currency volatility or government-imposed cash restrictions. For example, mishedging or unintended speculation is an internal exposure that may not be transparent, stemming from an organization's treasury operation placing hedges without the knowledge of existing offsetting exposures. Transfer pricing exposures, a potential source of a nontransparent external risk, can come about when an organization forecasts exposures residing in a subsidiary that is in a currency other than the functional currency of the subsidiary.

FX exposures often hide in plain sight on a company's balance sheet and within various intercompany transactions, which can complicate exposure

identification. Identifying FX risk requires organizations to drill down into the various on-balance-sheet exposures, as well as forecast cash flows to pull out granular data about transactions that take place at the company and subsidiary level. And in this issue of *CFO Insights*, we will outline common missteps in identifying FX exposure and discuss why companies need a solid understanding of their various forecasts and drivers of those forecasts so that they can identify where exposures may hide.

Alternative approaches emerge

Some organizations address transparent and nontransparent exposures by looking for alternative approaches to FX risk management, rather than using only pure derivative hedging. One approach is to set up a central hedge desk to net exposures. This type of desk aggregates FX exposures as part of the treasury function to take advantage of natural offsets before going to the market and hedging externally. The approach usually allows organizations to reduce total hedging costs, although to capture the benefits, it requires the company to configure the organization's systems for hedge accounting.



Another emerging trend is for organizations to standardize their FX and treasury processes for certain decentralized systems, such as those used in emerging markets. The goal is to improve transparency and allow for other hedging techniques when using more restricted and emerging currencies.

To address FX exposures, organizations should also consider connecting operations with the treasury function so there is a seamless integration between business activities and risk management activities that may be directed by treasury. An effective FX risk management program establishes an appropriate balance between protecting the company against market risks and satisfying the administrative requirements of hedge accounting.

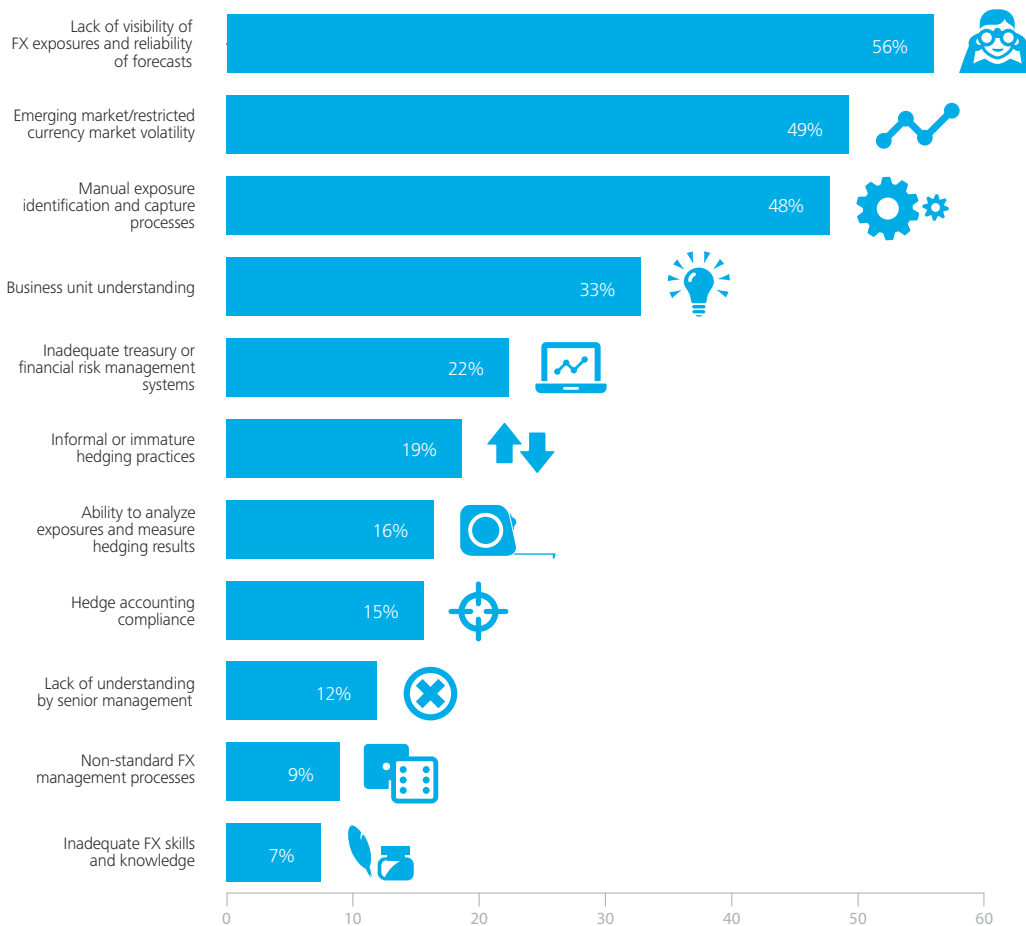
Common exposure missteps

There are several common missteps in identifying FX exposure that, if not addressed properly, can lead to missed or incorrectly identified FX exposures; which in turn can handicap a company's ability to manage its FX exposure by creating siloed and slow decision-making. Consider, for example:

- Multiple systems and handoffs.** Disparate treasury systems can lead to more time spent on manual reconciliations and a limited global view and timeliness of risk reporting. For companies with multiple ERP systems or that have visibility into their FX risks only through ERP or planning systems, many challenges have been in reliably capturing FX exposure within the treasury processes so that they can be addressed.

Figure 1. Challenges in managing FX risk

Volatility and lack of visibility rate high



Source: "Continued evolution: The 2016 Global foreign exchange survey," Deloitte LLP, March 2016.

- **Inability to identify natural offsets.** This may prompt the company to hedge its gross positions, leading to higher hedge costs and potentially leaving the company unaware of its true exposure.
- **Big data and modeling analytics.** Substandard systems or processes can lead to several challenges, including inadequate capacity to manage and respond to increased data flow, analytical systems that respond slowly or inaccurately to operational changes, and market events and FX analysis that are not effectively integrated into decision-making channels.
- **Highly manual processes.** An inefficient resource model can allow less time for analytics and potentially result in an adverse impact on FX operations and risk management. Additionally, manual processes can leave more room for error and hinder information flow across the enterprise. As a result, a disproportionate amount of time can be spent keeping systems afloat instead of strategically managing risks.
- **Inconsistent FX accounting.** Many FX exposures can be hedged naturally through non-derivative solutions by operationally managing FX gaps in the value chain and coordinating activities across enterprises. Yet, companies often lack the bandwidth to identify these opportunities or to produce accurate, complete, and timely data, as well as robust analytics to quickly assess FX exposures and identify hotspots. In addition, tying up resources to research reconciliation items can make hedging ineffective.
- **Policy and board alignment.** Many boards are often unfamiliar with derivatives and the complexity of FX risks. Further, metrics and benchmarks that are developed from misaligned incentives and measurements can hinder an organization's comprehensive FX risk management program.
- **Enterprise integration.** A lack of standard processes throughout the enterprise often hampers an organization's ability to manage FX risk. For example, when multicurrency transaction processing is decentralized, especially in growing global organizations, the FX system setup and the application of FX accounting rules may differ greatly across business units, creating challenges when a company seeks to optimize FX operational efficiency.

What to ask your treasurer

FX concerns and the strength of the US dollar have been high on the list of most worrisome risks in the *CFO Signals™* survey for several quarters. Moreover, many CFOs believe the US dollar will only get stronger. In the Q4 2015 *CFO Signals* report, 57% of CFOs expect the dollar to appreciate against the renminbi over the next year (see sidebar, "Renminbi risks: What CFOs can do"), and the proportion is about the same for appreciation against the euro.³ (See Figure 2.)

In this environment, CFOs should be working closely with their treasurers to understand the core risk management challenges around FX exposure and visibility. Some of the questions that can guide the discussion include:

Do we have the talent and the technology necessary to root out hidden FX risks? To have an effective FX risk management program, companies really need strong resources with deep experience related to FX exposure and derivative accounting as well as strong market knowledge and corporate technology infrastructure. According to Deloitte's 2016 *Global Foreign Exchange survey*, however, more than 60% of respondents rely on manual forecasting processes.

What processes and procedures do we have in place to respond to unexpected currency changes? Case in point: the dropping of the exchange-rate peg on the Swiss franc in January 2015, which resulted in a one-day appreciation of the franc against the euro of almost 20%. Additionally, these types of events often expose an organization's weaknesses around FX management. Having processes that can quickly identify answers to questions around their organization's exposures and ultimate impacts of the P&L and the bottom line is key.



Finally, how are we measuring the effectiveness of our overall FX management policy? An FX management policy can serve several important functions in addition to a critical control function around FX processes and multicurrency transactions. Moreover, an effective policy can help assess treasury performance, provide a framework for analysis, and involve treasury in broader corporate decision-making that could impact FX exposure.

The ability of companies to manage currency risk effectively will continue to be tested. This could be particularly true given new hedge accounting rules that are expected to be released by the Financial Accounting Standards Board as well as changes to the global tax rules under the OECD’s Base Erosion and Profit Shifting (BEPS) initiative. CFOs need to be comfortable that currency-related value erosion is avoided, and where necessary, challenge their treasury teams to address some of the identified hurdles.

Endnotes

¹ “Continued evolution: The 2016 Global Foreign Exchange survey,” Deloitte LLP, March 2016.

² “Continued evolution: The 2016 Global Foreign Exchange survey,” Deloitte LLP, March 2016.

³ *North American CFO Signals*, Q1 2016, US CFO Program, Deloitte LLP.

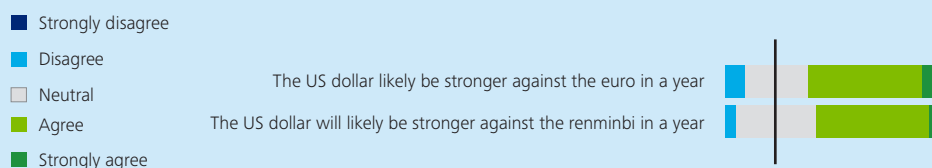
Renminbi risks: What CFOs can do

Given the changing environment concerning the Chinese renminbi (RMB), now may be a good time to perform a thorough review of how currency is managed at your company (see “Eyeing China—and its currency—with caution,” *CFO Insights*, October 2015). Specifically:

- Companies with substantial renminbi holdings might think through how they can offset the risk of significant currency-rate swings with investment mechanisms or lending mechanisms and related hedging strategies. For example, in some cases, trading regulations allow companies to take a short position in RMB against a long position in other currencies outside China. Other steps, such as currency hedging with instruments like currency forwards, have become more expensive, so CFOs have to balance the value of those strategies against the rising cost.
- Where RMB can be converted to other currencies, it may be prudent to reduce exposure. Companies might also revisit how they can hedge by looking at how they conduct their business. For example, CFOs can look at how they can align more of their costs to be domestic costs, in what currencies their cross-border transactions are contracted, and how they can do financing within the marketplace in which they are operating.
- In terms of contracts and cross-border trading, some MNCs are more protected against currency changes than others. For example, some elements of a contract might be denominated in RMB and some in USD. Sometimes a transaction might be settled on China’s mainland or settled offshore with a trading company that has the rights to take it into the mainland and do the transaction. At present, Chinese bankers have noted that the appetite for exchange requests from RMB into USD is at a multi-year high. That provides additional leverage for those who have US dollars to spend in transaction settlements.
- CFOs may want to review the terms and conditions of contracts and cross-border agreements so that they can be prepared for any potential exposure to shifts in the RMB. The history of gradual exchange-rate shifts in the range of 2% to 6% were more easily managed. But the recent rate of change can have significant bottom-line impact given the large size of the businesses many MNCs have built in China. A useful first step may be to model the financial impact of shifts of this size or larger in a much more compressed time frame.

Figure 2. Expecting appreciation

How CFOs think the dollar will perform against the renminbi and the euro



Source: Q4 2015 *North American CFO Signals*, CFO Program, Deloitte LLP

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