



Foreign Exchange Risk Management

An Effective and Scalable Framework for Harnessing Currency Volatility

The Rise of Volatility

Never before have global companies been so exposed to currency market volatility and the risks associated with it. As supply chains stretch around the globe, more companies are venturing farther into foreign markets, buying and selling goods in places long considered out of reach for all but the largest multinationals. These international ventures often generate spectacular opportunities for business growth and financial prosperity, but they can also expose companies to significant and potentially damaging foreign exchange risk.

High currency market volatility is a relatively new phenomenon. Throughout the twentieth century, fiat money gradually became the dominant global medium of exchange, enabling governments to print currency without effective constraints, making it difficult to assess fundamental values.

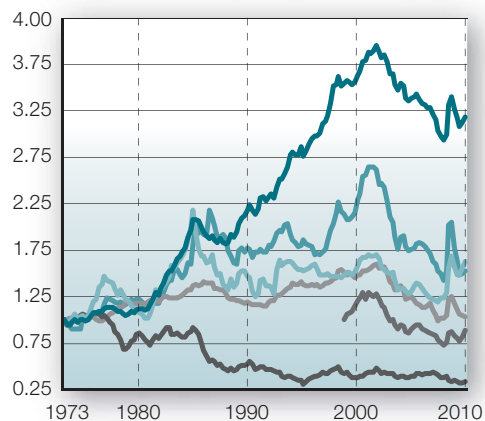
After the breakdown of the fixed exchange rate system in the early 1970s, most of the world's largest economies switched to floating currency rates freely determined by market forces. During the same period, trading volumes in foreign exchange markets expanded massively, to the point that annual turnover now vastly exceeds the value of world trade. According to figures recently published by the Bank of International Settlements, average daily transaction flows now exceed \$4 trillion US dollars.

In short, a great experiment is currently underway, and exchange rates are moving dramatically as a result. No one knows where this process will end – meaning that, for the time being, high volatility is the only certainty. In this context, effective currency management is absolutely crucial for the modern enterprise.

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Relative Exchange Rate Movement Since 1973

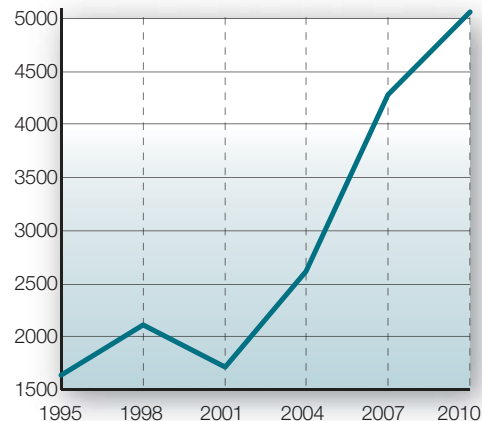
Major Currencies, Rebased to 1973 Values



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

Average Daily Foreign Exchange Market Turnover

Billions of US Dollars



Source: Bank of International Settlements, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2010

Currency Risk Management as Competitive Advantage

In an environment where currency fluctuations bear little discernible relationship to business fundamentals, profits can be wiped out in the blink of an eye and business models can be destroyed. The landscape is littered with the remains of companies that failed to manage foreign exchange risk appropriately.

While most companies acknowledge the risks involved in doing business internationally, the positive impact that currency risk management can have on competitiveness is less often recognized. The ability to effectively work across borders while avoiding currency-related losses can expand a company's reach and increase profits substantially. A robust trading framework can provide a solid foundation for business success while positively differentiating a company from its competitors.

Primary Objectives

In order to achieve true effectiveness, a currency trading framework should be designed with three goals in mind:

Cash Flow Efficiency: Unpredictable and highly volatile cash flows can wreak havoc on resource allocation, dramatically lowering organizational efficiency. Increasing the predictive accuracy and accounting simplicity associated with the cycle of cash through the business can lower costs and substantially improve strategic planning efforts.

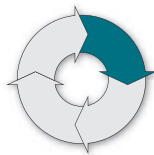
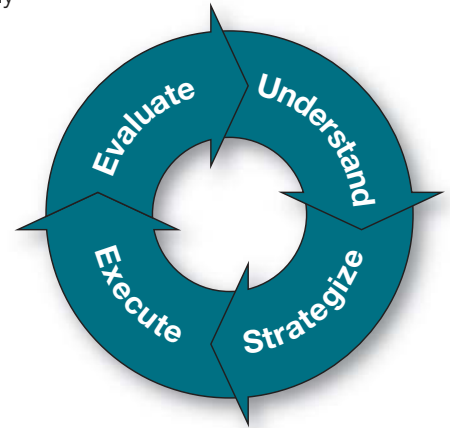
Risk Mitigation: Vulnerability to swings in exchange rates can compromise profits and undermine a company's ability to survive and succeed in new markets. Protecting the bottom line is absolutely crucial in ensuring that companies remain stable and sustainable in the long term.

Opportunistic Market Entry: Exchange rate volatility represents both risk and opportunity. Few businesses are prepared to completely ignore the opportunities that can be captured when currencies move in a favorable direction, and often leave themselves exposed to risk as a result. In order to survive changes in objectives and leadership, a currency policy should recognize this and create a framework for executing trades at favorable levels, while keeping the organization protected against material risks.

With the global economy in upheaval, the only constant is change.

Four Crucial Components of a Risk Management Strategy

With the global economy in upheaval, the only constant is change. Against this backdrop, building an effective risk management framework begins with envisioning a complete, integrated process. A feedback loop must be created between business objectives and the tools and strategies used to achieve them, so that the organization continually adapts in response to evolving markets and circumstances. This cycle can be broken down into four essential components:



1. Understand

Managing risk is impossible without having a clear picture of where exposures exist and the processes currently being used to manage them, if any.

Exposures: Broadly, there are three types of external currency risk that can materially influence business performance:

Transaction exposure is the simplest and most transparent – it is the gain or loss that can be generated when the exchange rate applied to cash flows changes. When costs or revenues are affected by currency fluctuations, the resulting unpredictability can damage many areas of the business.

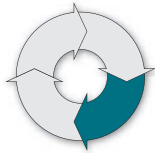
Translation exposures are more complex and occur when the value of a foreign asset or liability fluctuates due to exchange rate changes, resulting in a requirement to adjust balance sheet values. Translation vulnerabilities can create volatility on both the income and balance sheets.

Structural exposures are those that may influence the very viability of a business model. If input costs rise in China over the years due to an appreciating exchange rate, does the operational structure collapse? If European sales become untenable, will the business survive?

Needless to say, each of these forms of risk can have substantial effects on earnings and sustainability. Traditionally, transaction exposures were the most commonly hedged, but the materiality of translation and economic vulnerabilities has increased in recent years as businesses have expanded internationally. The need for sophisticated monitoring and management techniques has grown exponentially.

Controls: After developing a picture of where exposures lie, it is important to look at the processes and strategies that are currently in place. Clarifying existing procedures for measuring and managing risk can help to identify areas of potential improvement. Mapping out the financial controls that are already in place is essential in determining where weaknesses may be present.

Objectives: If you don't know where you're going, you're likely to wind up somewhere else. Interviewing internal and external stakeholders is often a good method for building an understanding of the risk tolerances and goals that should drive ongoing exposure management. Lenders, investors and senior leadership often have differing perspectives, and these must be considered in order to avoid missteps. Of course, defining these objectives can be a highly subjective endeavor – performing a sensitivity analysis on earnings and quantifying these tolerances in terms of probabilities and percentages can be vital when building a robust policy framework.



2. Strategize

The past two years have seen extraordinary growth in the number of businesses that maintain a formalized risk management policy. Why have written policies assumed such importance? Because more often than not, when all is said and done, more is said than done.

By ensuring that personnel are clearly accountable, processes are unambiguously defined, and strategic goals are well understood, a written policy helps to ensure that theory is translated into practice. Formal policies vary widely in length and complexity, and the best are designed to scale up as the business itself evolves. While this process may sound time-consuming, a strong written document can be created relatively quickly and easily – particularly with the assistance of a foreign exchange specialist.

Ultimately, a risk policy simply needs to address four questions:

Why?

It is the thought that counts. When risk management motivations are forgotten, problems occur.

Defining the objectives of a currency risk management program can be tremendously beneficial for internal personnel as well as external stakeholders. The articulation of these goals in a written policy can be paired with ongoing education to ensure that all foreign exchange activities are aligned with primary business objectives and risk tolerances.

Above all, positions must not be placed in order to speculate. Speculation involves taking on an additional, unnecessary exposure that did not exist previously in an attempt to profit from a swing in the market. In contrast, hedging involves strategically reducing existing exposures so that the firm is no longer as vulnerable to unfavorable market movements.

When?

The more time that elapses between when an exposure is identified and when an offsetting hedge is placed, the greater the financial risk. Allowing subjectivity into this process is one of the greatest sources of risk for the typical company. Accordingly, many policies specify the event that triggers analysis and establish the measurement process used to define and prioritize the exposure. Clear deadlines should be communicated, defining when exposures must be reported internally and when offsetting positions must be placed. Most policy frameworks also set out an exception process to be used when an issue occurs.

Who?

Without accountability, risk management theory never becomes practice. Strong policies clearly define functions and levels of responsibility within the organization while segregating duties so that appropriate financial controls can be maintained. These roles and responsibilities should be assigned on a functional rather than individual basis so that procedures survive the inevitable personnel changes which so frequently derail otherwise sound policies.

Vitality, many policies include personnel not normally considered financial decision-makers. Buyers, sales teams, and executives often make decisions that carry foreign exchange implications. Research has shown that these decisions are a primary source of uncertainty, frustrating cash flow planning efforts and often leading to substantial losses. Ensuring that these personnel are accountable for communicating actual and expected foreign exchange exposures on a timely basis can sharply reduce the number and severity of negative surprises.

What?

Effectively managing currency risk requires using hedging tools in a disciplined and pragmatic manner. The strongest policies clearly name the set of financial tools that may be used by risk managers, and describe the criteria used to judge their applicability in particular situations.

Tools

In general, currency risk can be managed in two ways: internally, or via external financial hedges.

Offsetting exposures internally is unquestionably the most cost-efficient and effective method for lowering risk and should always be considered before resorting to external tools. Netting an incoming cash flow against an outgoing one can sharply reduce the amount of currency exposed to exchange rate fluctuations without requiring entering into a financial instrument. Changing functional accounting currencies to better reflect cash flows is an excellent way to reduce the impact of foreign exchange on earnings.

Moving operations into a country where revenues are earned is often called “natural” hedging. Natural hedging can be an effective method for managing structural exposures, particularly when these operations support long-term strategic goals.

In reality however, internal hedging methods are often highly impractical, or impossible. Offsetting cash flows often exposes companies to timing issues, meaning that foreign exchange risk has been swapped for alternative (and potentially more harmful) forms of uncertainty. Moving business units into other countries can substantially amplify other types of risk, and can be quite costly, particularly in the event that growth strategies change.

In contrast, external financial hedges are designed to efficiently and precisely target currency risk without increasing other exposures, meaning that they are often the most cost-effective and useful tools available. These typically take the form of a financial contract with a currency provider, and contain provisions for the settlement of funds in the future according to an agreed-upon formula.

Broadly, two types of instrument are available to the corporate currency risk manager:

The first and simplest is the **spot trade**. Waiting until a transaction must be settled before agreeing on an exchange rate implies that the company is fully exposed in the event that the exchange rate moves in a favorable direction. The corollary is that unfavorable movements also directly impact the value of the cash flow, meaning that few companies choose to manage risk in this manner.

Forward (or swap)-based instruments simply fix an exchange rate today, for delivery in the future. The cost of this type of contract is derived from the difference in interest rates between the two currencies being traded, and does not reflect market predictions of exchange rate movements. Because of this, forwards are some of the most cost-efficient and flexible financial tools in existence, allowing companies to easily and effectively reduce their exposure to market movements, and they have come to dominate corporate currency hedging programs over the past two decades.

Resource Center: <http://business.westernunion.com/resource-center>

Criteria

A wide range of factors should be taken into consideration when choosing the most appropriate financial tool for the job:

Hedge Effectiveness: The most important factor in selecting a risk management tool is whether it truly mitigates the targeted risk. Not only must the instrument match the currency and timing of the underlying business requirement, but it should also offer a clearly defined worst-case protection level against currency movement. Most financial hedges can be illustrated using a simple “payout diagram” that outlines the various scenarios that may unfold between execution and settlement. Understanding the potential impact of these events is absolutely vital in managing risk effectively.

Certainty: Certain hedging instruments require a commitment to exchanging funds at some point in the future, and should only be placed against exposures that carry a high probability of realization.

Timing Flexibility: In the business world, cash flows are rarely entirely predictable. Does the instrument provide the ability to settle earlier than expected, or efficiently deliver late? Forward-based tools are priced according to interest rate differentials, making them more flexible than is often realized. Deciding whether to hedge should not be influenced by timing uncertainty, but deciding which instrument to use should be.

No strategy can be better than its tactical execution.

Participation: A strong hedging program may prove to be a short-term competitive disadvantage if exchange rates are moving favorably. Accordingly, most businesses prefer to retain some exposure in the event that markets trend in the right direction. Ideally, downside protection is balanced with upside participation.

Accounting Treatment: Often, hedging instruments actually streamline accounting procedures and reduce reporting complexity, but there are instances where this is not the case. Factoring in the accounting implications of an instrument can help to optimize strategies and reduce the possibility of complications down the road.

Credit Requirements: Due to the possibility of negative market movements, many hedging instruments carry the potential to affect corporate credit arrangements or cash positions over their lifetimes. Developing a firm understanding of these possible scenarios is vital, and can be a deciding factor in determining which tool is most appropriate.

Complexity: When all other factors have been considered, choosing the least complicated instrument has clear advantages. A comprehensive understanding of the mechanics of the product can help to understand how it will perform over its lifetime, and can be invaluable when financial decision-makers have to articulate the benefits of a particular strategy at the senior leadership level and beyond.

When managing currency risk, one size does not fit all. The strongest trading strategies are driven by the specific requirements associated with continually shifting exposures and economic environments. History has shown that deploying a balanced array of instruments and tactics helps to achieve efficiency, while improving risk management performance when market conditions change dramatically.

To take a page out of medical advertisements, many of these tools should only be used with the assistance of an informed and experienced expert. Nothing substitutes for the experience gained through observing the performance of these tools through a number of market events and trading cycles. This is where a dedicated currency specialist can add significant value.



3. Execute

No strategy can be better than its tactical execution.

As many equity investors can attest, picking the right stock is only part of the battle – purchasing it at the right price is just as important. Much the same applies in the foreign exchange markets: once the most effective hedging instrument has been chosen for a particular exposure, applying the right trading tactics can mean the difference between success and failure.

Day-to-day market movement can present many opportunities for corporate hedgers to enter positions at favorable levels, but large negative moves can wipe out earnings instantly. As a result, many of the most experienced corporate risk managers trade tactically by employing pairs of standing market orders to capture opportunities while protecting themselves in the event that markets shift in an unfortunate direction.

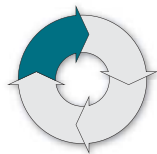
A strong currency risk management strategy can help to provide the foundation for success.

Market orders can be placed to automatically trigger a trade when the exchange rate hits a pre-specified level. When the trigger is placed on the favorable side of the market, the order is called a “take profit”; when it is placed on the less favorable side, it is called a “stop loss”. Pairing both types of order in a disciplined manner can help to optimize trade execution levels, while ensuring that the bottom line is protected against large negative moves.

A variant of this tactic is called a “trailing stop loss”. A trailing stop loss order sets a protection level at a specified percentage away from the prevailing spot price, and moves with favorable movement in the currency. This creates a “worst-case rate” for hedging and accounting purposes while allowing for upside participation – particularly in those circumstances when the market moves sharply in one direction.

Maintaining situational awareness can be crucial in applying these tactics well. Currency markets are always susceptible to large shocks when the geopolitical environment shifts or significant economic changes occur. Being aware of this larger context can be extremely useful – these developments can affect foreign exchange operations, but can also have an enormous impact on resource allocation decisions across the business.

Looking at charts to visually quantify recent trading patterns can be instrumental in understanding the risks and opportunities available, and can be particularly helpful when determining where to place market orders. Speaking to trading specialists may be highly worthwhile, both in determining where market consensus is heading and in understanding where this consensus is vulnerable to adjustment. When adjustments occur, currency volatility follows, and volatility creates opportunity.



4. Adapt

As Charles Darwin is often quoted as saying, “It is not the strongest of the species that survives, nor the most intelligent, but rather the one most adaptable to change”. Continual refinement and adaptation is an absolutely crucial component of the strongest trading programs.

Identifying shortfalls and building on successes is vital. Internalizing effective components while discarding and replacing the strategies that are not meeting business goals generally requires that risk managers benchmark hedging performance against internal objectives rather than against the currency markets. Smoothing out earnings volatility and ensuring business sustainability are of paramount importance, while attempting to generate profits from foreign exchange movements is a sure path to failure.

The refinement process can be formalized by requiring that regular reviews be conducted in line with financial reporting periods. Producing brief “performance profile” documents at these junctures can help to guide policy adjustments and communicate important information to internal and external stakeholders. Packaging these with the risk management policy itself will create a living document that evolves as the organization does, ensuring that the framework remains relevant and effective as the business evolves over time.

Summary: Surviving and Thriving in Turbulent Times

As the global economy has grown ever more interconnected, the foreign exchange markets have become increasingly vulnerable to sudden and dramatic shifts. The impact of these adjustments has also grown as companies have increased their international exposures, to the point that exchange rate movements now materially affect earnings for the majority of the world's international businesses.

In this highly uncertain and rapidly changing economic environment, a solid currency risk management framework can drastically reduce the possibility of surprising losses, make cash flows more predictable, and provide a competitive advantage against other firms that leave themselves exposed to currency volatility.

It is important to remember that this framework is not simply a collection of financial instruments that can be used to address specific exposures. It is not a set of mathematical models that can be used to see into the future and predict all outcomes.

Instead, the world's most successful companies have built these robust risk management practices directly into their corporate cultures, taking a holistic, disciplined approach to managing exposures. This focus on an integrated and adaptive process, rather than on the use of complex trading

tactics or advanced quantitative modeling has proven to be the most sustainable and profitable strategy for managing risk over the long term.

Ultimately, a strong currency risk management strategy can help to provide the foundation for success in markets around the world – helping the best businesses to survive and thrive on a global scale.

Of course, the ideas presented for consideration in this White Paper are merely a starting point. Many businesses simply do not have the internal resources available to build, implement and monitor a currency risk management program. These resources are not always easily developed or maintained, particularly over the long term: managing foreign exchange risk effectively often requires highly specific knowledge of business operations, the market, and the tools available.

A dedicated foreign exchange specialist can add significant value to this process by providing the information, the tools, and the expertise required to help you make the right decisions.

To learn more about the specific tools and strategies that can be used to manage risk and harness currency volatility, please visit: <http://business.westernunion.com/resource-centre>

To contact a currency risk management specialist, please e-mail: solutions@business.westernunion.com.



About the Author

Karl Schamotta, Senior Market Strategist for Western Union® Business Solutions, has designed and implemented risk management and trading strategies for hundreds of companies, ranging from small businesses to large corporations. As a member of the Business Solutions analytical team, Karl also provides market analysis and strategic guidance on a daily basis for thousands of international businesses. Karl is a regular contributor to a number of international treasury and finance magazines, and his market analyses and forecasts have been widely quoted by such publications as the Washington Times and the Wall Street Journal.

Karl is a member of the Professional Risk Manager's International Association (PRMIA) and the Global Association of Risk Professionals (GARP), and is President of the Association of Financial Professionals – Calgary.



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Western Union Business Solutions
Tel: 201.263.6500 | Fax: 1.877.255.0669
demandgenerationus@business.westernunion.com
business.westernunion.com

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Global Offices

United States

Western Union Business Solutions
Custom House (USA) Ltd.
Tel: 1.866.344.4583
Fax: 1.877.255.0669
business.westernunion.com

Canada

Western Union Business Solutions
Custom House ULC
517 Fort St.
Victoria, BC V8W 1E7
Canada
Tel: 1.250.220.1015
Fax: 1.250.412.0775
business.westernunion.ca

Australia

Western Union Business Solutions
Custom House Currency Exchange
(Australia) Pty. Limited
Level 13, 130 Pitt Street,
Sydney, NSW 2000
Tel: 61.2.8001.2100
Toll Free: 1.800.887.773
Fax: 61.2.8001.2122
business.westernunion.com.au
Australian Financial Services
Licence No: 238290
ABN: 95 086 278 659

United Kingdom

Western Union Business Solutions
Custom House Financial (UK) Limited
Company Number 04380026
Registered Office Address:
2nd Floor, 12 Appold Street
London, EC2A 2AW
Registered in England
Tel: 0845.882.4790
Fax: 0800.389.9432
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