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Currency Risk Management

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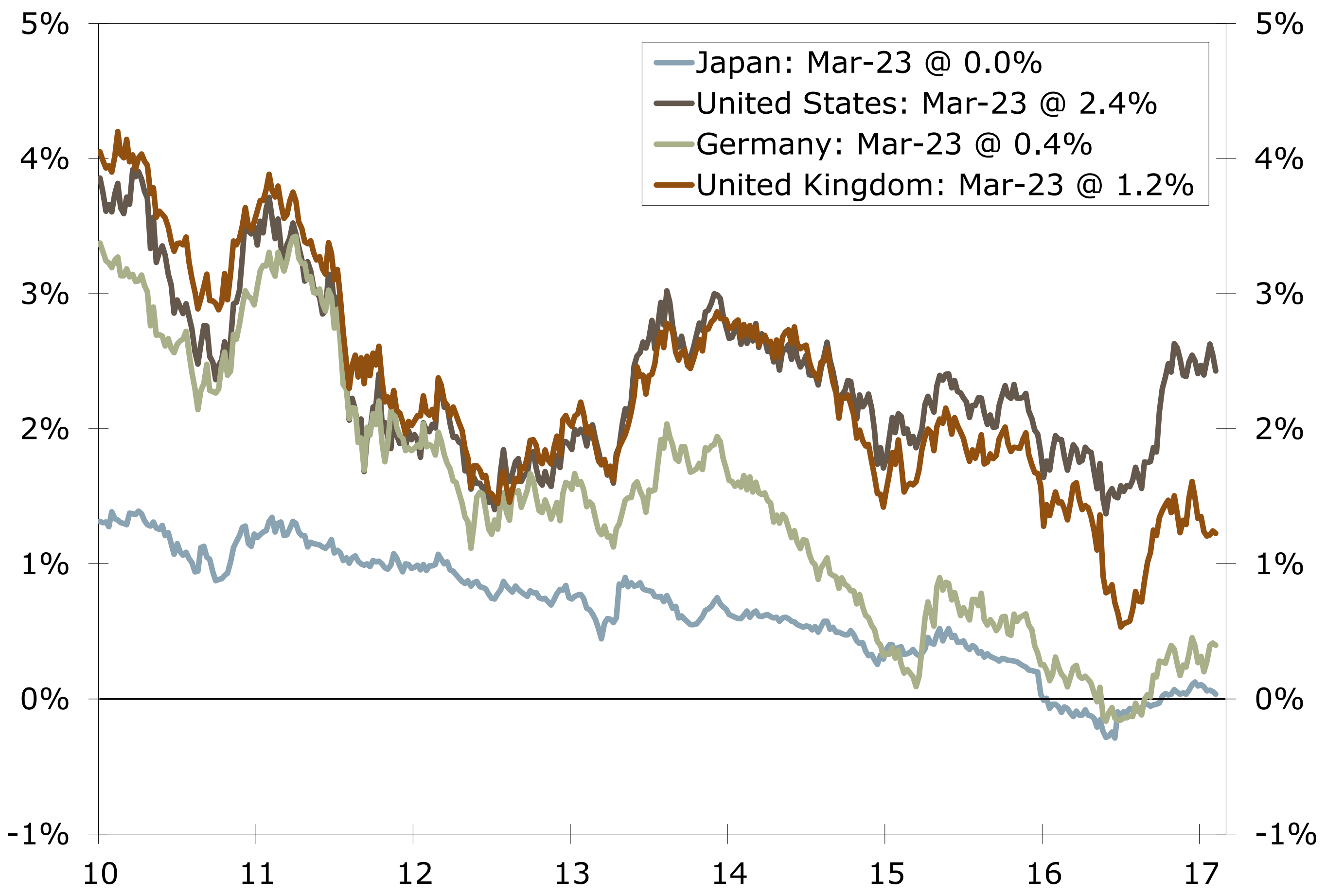
2017 Outlook

- **Trump**
  - Potential impact of deregulation, trade and tax policy changes.
- **BREXIT**
  - Article 50 has been invoked.
  - Expect 2 years of tough negotiations between the UK and EU.
- **French and German elections in 2017**
  - Populist candidates who propose leaving the EU are gaining momentum.
- **Monetary policy divergence**
  - Fed is expected to hike multiple times in 2017 while ECB, PBoC, BoJ, RBA and BoE are all dovish (with some Central Banks employing negative rates).
- **Corporate Tax Overhaul (Repatriation Holiday & BAT)**
  - Approximately 30% ($300Bn) of foreign cash held overseas was repatriated in 2005.
  - The USD strengthened by 10% throughout 2005.
  - It is estimated that US multinationals currently hold at least $2.5T in overseas cash; if 30% is repatriated, there would be more than $800Bn.
  - Politicians are citing an economic theory that the dollar would strengthen 20 – 25% if the border adjustment tax (BAT) is implemented.
- **The overall backdrop will continue to be USD supportive**

Government bond yields have declined across the globe but have jumped since the election



Source: Federal Reserve Board, IHS Global Insight and Wells Fargo Securities

- **Payments (Spot Contacts)**
  - A contract to exchange a given amount of currency for another at the current exchange rate with delivery usually two business days after the transaction date.
  - The principal reason customers enter into spot contracts is to execute a current foreign currency payable or convert a foreign currency receivable into U.S. dollars.
  - “Trade Date” refers to the date on which the transaction is initiated and the exchange rate is set. “Value Date” refers to the date on which the exchange of currency will be completed or settled.

- **Hedging (Forward Contracts)**
  - A contract to exchange a given amount of one currency for another at some future date (i.e., the Value Date is more than 2 business days from the Trade Date) at a specified rate.
  - A common reason for entering into forward contracts is to hedge a future foreign currency payable or receivable. This "locks in" the U.S. dollar amount of the payable or receivable and provides a hedge against adverse moves in the currency markets.

Manufacturing Company Exporting to Canada

- A manufacturing company began exporting to Canada when the rate was 1.2500
- The company took their standard USD sales price and multiplied by 1.2500 to come up with Canadian dollar (CAD) pricing
  - 1mm USD x 1.2500 = 1.25mm CAD
- Within 9 months, the exchange rate was 1.3800 and the company received 10% less dollars than they anticipated
  - 1.25mm CAD / 1.3800 = 905,797 USD
- The Canadian dollar weakened significantly during the year and this exporter did not have the ability to change their price, nor did they have a currency hedge in place
- Unfortunately, this company lost money on some of their sales to Canada because their profit margin was less than 10%
- Now, this company hedges their CAD sales when the contract is signed, and they have educated their sales force about the risks associated with pricing in CAD

The establishment of benchmarks to guide the risk management process

Step One

Define Overall Corporate Philosophy and Objectives

Step Two

Identify Exposures

Step Three

Quantify Exposure Risks

Step Four

Define Risk Management Policies and Procedures

Step Five

Identify Strategies to Manage Risks

Step Six

Execute Strategies

Step Seven

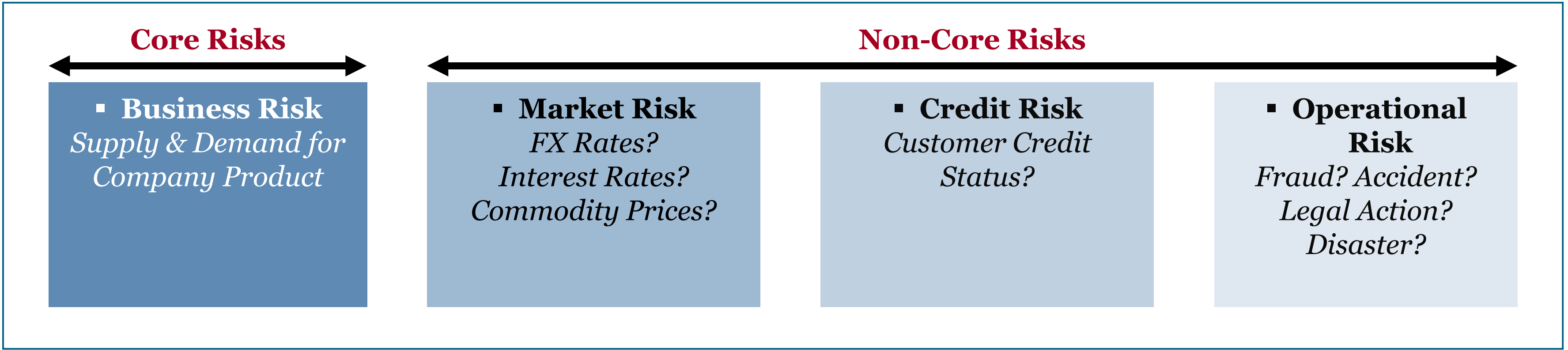
Monitor Exposures and Hedges

Step Eight

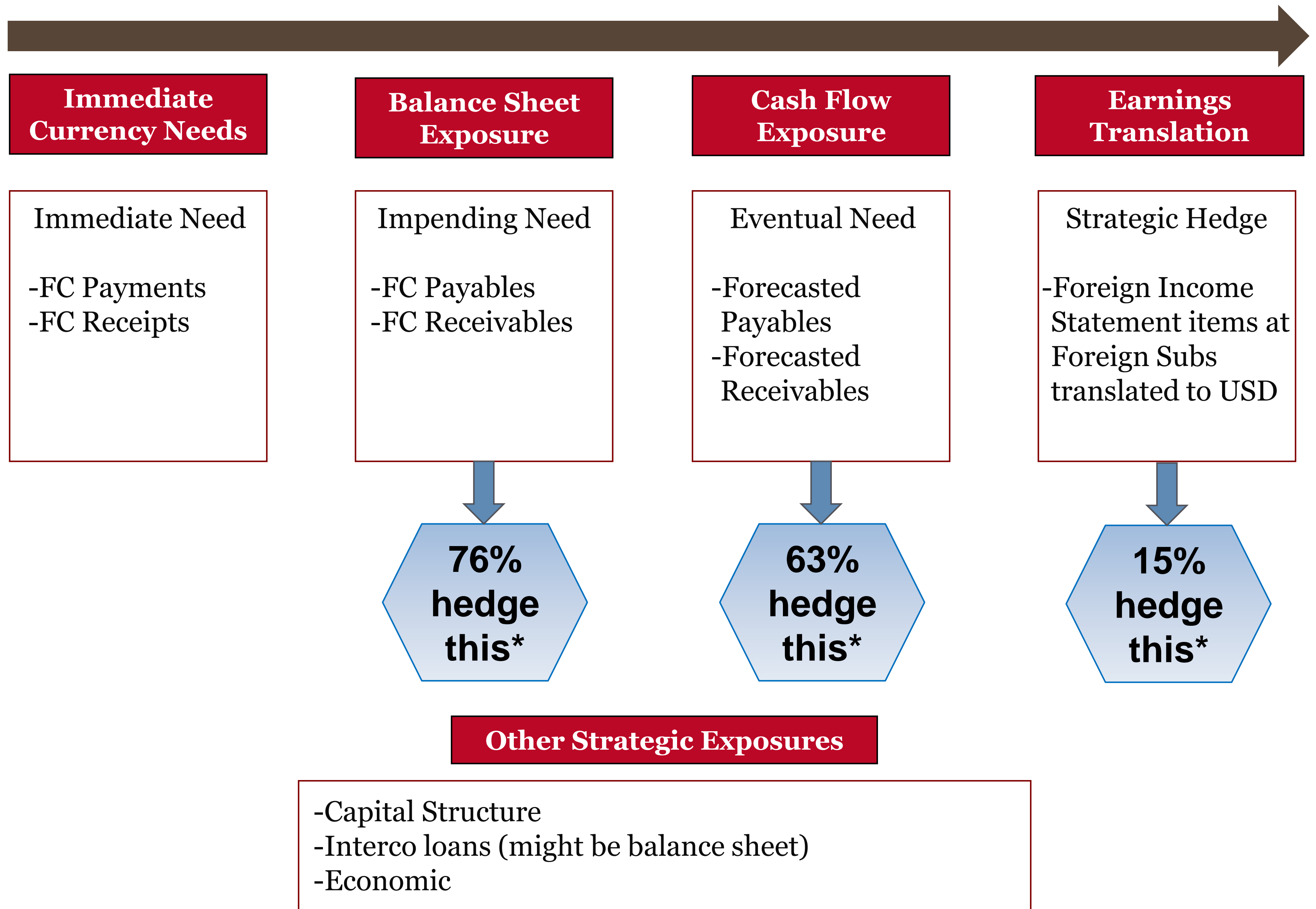
Review and Measure Performance

Risk Management Objectives

- The overall objectives of risk management activity include, but are not limited to, the following:
  - Reduce or **eliminate volatility** (to earnings, interest expense, cash flow, investment values)
  - Maximize and **improve predictability** of revenue/expenses
  - Allow a company to focus on its core business
  - Provide a source of competitive advantage (or reduce the disadvantages from local competition)



Identifying Types of FX Exposure



*Source: 2016 Wells Fargo Foreign Exchange Risk Management Survey

Balance Sheet Exposure

Scenario –

- USD Functional company has a 10MM Euro receivable related to recent sales
- Balance Sheet Asset = 10MM * 1.10 (spot FX rate) = $11 MM

By month end, the Euro falls to 1.05…

- Balance Sheet Asset = 10MM * 1.05 = $10.5MM
- Impact to earnings is $500K loss
- $500K credit to the asset and $500K debit to earnings

Each month collections will reduce the asset and new sales will increase the asset

Cash Flow Exposure

Scenario –

- USD Functional company has a 100MM CAD in annual sales
- Expected USD Revenue = 100MM / 1.25 (spot FX rate) = $80MM

What if the CAD is at 1.50 at the time of the sales?

- Revenue = 100MM /1.50 = $66.7MM
- Recognized Revenue is $13.3MM lower
- This does not show as a loss, but ultimately has the same negative impact

Ultimately a weaker currency can mean a lower USD value of sales, lower margins, and lower profitability

Earnings Translation

Scenario –

- GBP Functional subsidiary has 30MM GBP in annual sales and 10MM GBP in annual expenses yielding 20MM GBP in annual profit
- Expected impact to consolidated USD profit = 20MM * 1.50 (spot FX rate) = $30MM

What if the GBP averages 1.40 over the year?

- Revenue = 30MM * 1.40 = $42MM
- Expenses = 10MM * 1.40 = $14MM
- Translated Earnings = $28MM
- This represents a $2MM adverse impact to consolidated earnings

Translation is unique

- It is not a direct cash flow and the foreign earnings may never actually be converted
- The impact is calculated at the average rate for the year
- US GAAP does not allow for hedge designation

Best Practices

Establish a formal hedging policy

- Purpose/Objectives of hedging
- Types of Exposures to hedge
- Products / Tenors to use
- Risk Identification
- Oversight / Controls / Reporting
- Maintain some flexibility

Set Expectations

- Budget Rates based on achievable hedge rates
- Create an understanding that hedges are not supposed to make money
- Confirm that the goal is to reduce volatility

Accounting treatment

- Is hedge accounting possible/desirable?
- If applicable, create hedge document prior to trading
- Validate strategies with internal and external auditors
- Establish procedures for valuing / reporting

When trying to determine which structure to execute, the company should consider the underlying exposure and its corporate philosophy toward managing risk.

Corporate Philosophy

"Our goal is to know exactly the USD value of our foreign currency transactions. We are less concerned about sacrificing upside potential if we can lock-in the value today."

Forward Contract

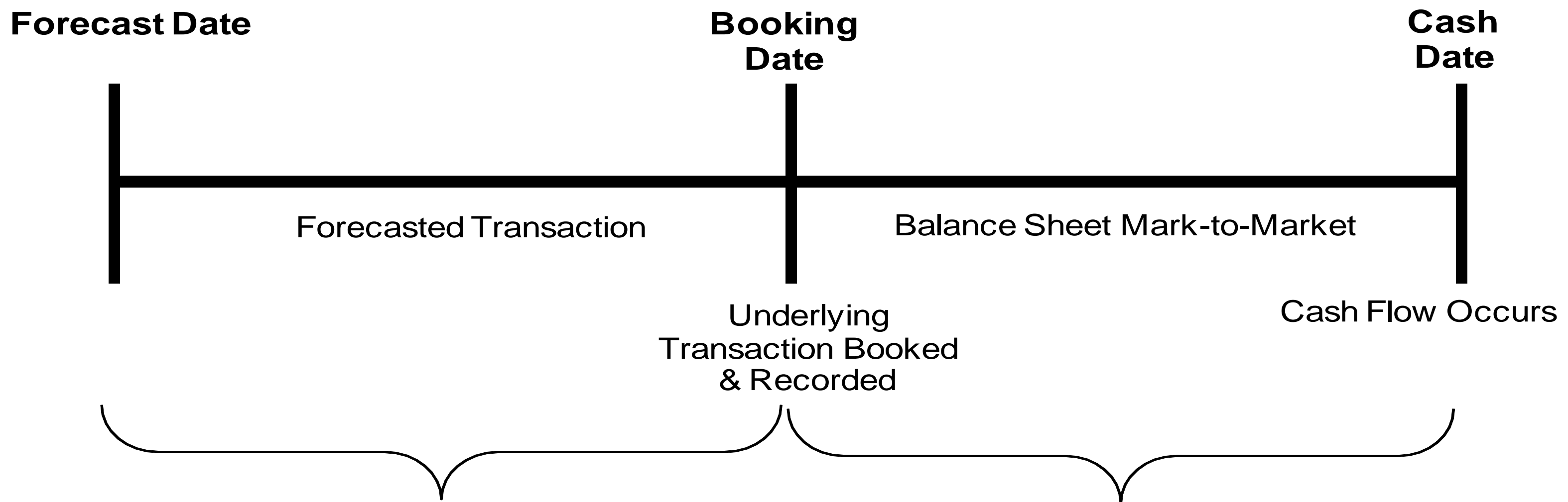
"There is some uncertainty regarding the timing of our exposure. We want the right to lock-in a set rate, but do not want to be obligated at close to use that rate. We wish to retain upside potential and we understand that will entail some cost."

Purchased Option

"Our job is to protect against large negative surprises. We can tolerate some variance due to FX movements. We would like to retain some upside potential, but are unwilling to pay an upfront premium."

Collar
Participating Forward
Forward Extra

Accounting: Risk Management Overview



Time Horizon

3 Months – 3 Years

Hedge Instruments

Forward Contracts, Options, Option Combinations

Time Horizon

Monthly Rolling Balance Sheet

Hedge Instrument

Forward Contracts

What would the accounting treatment look like?

- Booked foreign currency asset or liability (underlying exposure) must be accounted for as specified in ASC 830 (FAS 52), re-measured spot to spot, period to period, through P&L

- ASC 815 (FAS 133) based on ASC 830's basic principles ***permits*** the fair value of a recognized foreign currency asset or liability to be hedged as a fair value hedge, or the change in value of its associated cash flows to be hedged as a cash flow hedge
  - This approach is known as hedge accounting

- Hedge accounting is purely **discretionary** and always an election

- Most companies record the mark to market changes in fair value of derivatives hedging this exposure directly to OCI

What would the accounting treatment look like?

- Companies can elect Cash Flow Hedge Accounting under ASC 815 (FAS 133) when hedging their forecasted revenues and expenses
- If hedge accounting is granted, the change in value of the effective portion of the derivative goes to OCI (Other Comprehensive Income), an equity account on the balance sheet
- Hedge accounting is not a requirement, only an election
- If hedge accounting is **not** elected, or the hedge does not qualify as a highly effective derivative, the changes in value go to directly to earnings, not OCI
- Proper documentation is the key to success when electing hedge accounting under ASC 815 (FAS 133)

Important Information for FX Transactions

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