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Visualizing and managing currency risk for SMEs



As uncertainty persists in the global economy, FX risk management increases in complexity for many small and mid-size enterprises as most of their cashflows are subject to variable and unpredictable exchange rates.

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Introduction

Developing a robust FX risk management practice is a multi-faceted undertaking, involving a range of analyses, scenario modelling outcomes, and “decision gates.” Taking it step by step can make it much less daunting.

In this paper, we offer a ‘best practices’ approach to help you understand the process, and outline the steps you may take to help you as you analyze exposures, create a hedging policy, implement and manage your hedging strategy—tailored to your business and risk appetite. These insights are informational only and not tailored to any specific business or risk profile.

I. Take It Step by Step

The first step is to analyze FX exposures and measure the effects of the movement of rates on the company’s liquidity. Your liquidity is tied to cashflows, which may help you identify transactional risk that could occur from a specific exposure.

Collecting and monitoring cashflows from distributed windows or different platforms is a time-consuming, painstaking process. Once you’ve mastered this, you can more confidently execute an informed hedge program to mitigate your exposure.

Analyse your exposure: Five steps

Analysis of the risk profile for each currency in your cashflow forecast helps you define your hedge strategy—one that matches your business profile.

Here are five essential steps to creating and implementing an effective foreign exchange hedging policy.

I. Take It Step by Step

1. Structure your analysis.

You can segment your analysis by entity, business unit, or division, or even on the group level. Whether you are managing FX risk using a spreadsheet such as Excel, or another tool, ensuring you always have all the data available will help you to make the most thorough exposure analysis for your group or entities.

2. Balance opportunities and costs.

Few companies perform a structured risk analysis to identify optimization opportunities to achieve a proper balance of minimising losses and potentially gaining upside (wins) from market fluctuations, whilst keeping the cost of hedging in check.

3. Set your FX Risk Policy.

Having an FX Risk policy in place can help you to set your medium-term and long-term targets. For a more considered response to FX volatility in cashflow forecasts, hedged positions and business profile, a holistic FX policy can help define thresholds that you can benchmark while managing FX exposure. It is typically wise for an FX risk management policy to allow for enough time for the effects of the commercial response to become evident. This depends on one's business cycle: some businesses plan monthly; others quarterly; still others annually.

4. Start with a Currency Map.

Where are you going, and how do you plan to get there? Creating your foreign exchange risk management policy may seem overwhelming: in practical terms, where do you start? Put simply, if there is any degree of complexity involved, a 'Currency Map' can help you visualize market fluctuations alongside your cashflows. Your base currency may not be the transactional currency that is part of your cashflow forecast, and mapping the underlying exposure in your base currency can become tedious. Evaluate options and look for a cashflow risk management tool that can accommodate the elements of your unique FX strategy.

5. Consult an expert.

It can be helpful to talk to risk analytics experts who have developed tools to help businesses perform exposure analysis and reporting as well as hedging, or leverage a self-serve risk management platform to help visualize cashflows. Bear in mind that your hedging tactics may need to adapt to changes in your business and in the markets. How confident are you of your inflows and outflows, and how much flexibility do you need? Capturing exposures and recognizing potential sources of risk is a good foundation for developing and implementing a policy that helps you achieve your goals.

Read on to explore best practices for setting your goals, developing your policy, and monitoring performance. Understanding the process can help increase your confidence in your risk management decisions no matter where your business takes you.

II. Reactive vs Proactive: What works for your business?

As you work toward benchmarking your organization's FX exposure against your set policy, it's crucial to understand the starting point: Is your organization's FX management proactive or reactive?

We'll explore the major differences between the two, and provide some key considerations that can help with structuring FX exposure analysis.

Reactive FX Management: The Defensive Approach

Reactive FX risk management is a more conservative strategy. Organizations opting for Reactive FX risk management set a hedging policy (e.g., protecting planned gross margins) and adhere to it through a specific business cycle, regardless of market conditions.

This approach reduces the need for constant monitoring and decision-making, requiring fewer resources and resulting in simpler decision-making and less involved plan management.

Key aspects of reactive FX management:

- Fixing a budget rate as a target for the entire business cycle
- Limited monitoring of day-to-day changes in market conditions and more focus on cashflow exposures
- Reduced time spent and reduced drag on resources

This approach can lower the potential for profit or outperformance, but it also can reduce the risk of significant losses; in other words, this relatively conservative approach is typically associated with less downside potential and less upside potential.

II. Reactive vs Proactive: What works for your business?

Proactive FX Risk Management: The Offensive Approach

Organizations that embrace **proactive** FX risk management monitor the FX market on an ongoing basis, and make strategic decisions to hedge their currency exposure.

Proactive FX Risk management typically requires a deep and broad understanding of the market and superior tracking tools, used by some professionals, managing FX risk.

Key aspects of proactive FX management:

- Frequent monitoring and analysis of current market conditions to try to stay ahead of forecast for potential risks.
- Implementing FX hedging strategies tailored to the nature of each exposure, and keeping objectives in mind while evaluating potential challenges.
- Assessing and calibrating hedging strategies as market conditions change.
- Creating a more detailed plan, and utilizing a combination of financial instruments, such as forwards, structured options, and/or swaps.
- Implementing tactics aligned to market entry at the right levels, intervals and amounts, relative to one's FX exposure.

Whether a reactive or proactive approach is more suitable to your business, it's prudent to keep an eye on your cashflow schedule for each forecasted exposure. Over the span of the business cycle, each transaction may carry multiple elements of FX exposure which can eventually impact your bottom line.

III. Risk Reduction Strategies

The FX strategies and ongoing decisions made by finance managers can have a significant impact on the profitability of their business operations.

Visualizing your cashflow and balance-sheet risks can help with better understanding which FX hedging strategy might be a tactical fit for a specific financial period in the overall cashflow cycle. Here we focus on specific hedging tools: namely Forwards, Vanilla Options and FX Structured Options, which can help deliver some desired outcomes. We will also talk about how layering FX hedges, and varying certain aspects of the hedge, such as hedge durations and deemed-optimal hedge levels, can be part of overall currency risk management planning.

Balancing the big-picture view with attention to detail: The forest and the trees

A comprehensive FX hedging strategy may, for some businesses, include combining hedging tools to help minimize currency risk. A strategy based on clear objectives and careful planning, coupled with the flexibility to recognize and capitalise on opportunities, can help some businesses achieve their goals.

By employing a range of hedges, companies can use these to help protect themselves from adverse currency fluctuations and these can also help them achieve their financial objectives. Broadly speaking, below are key categories of FX hedging tools available.

— **Forward Contract Hedging:**

Forwards involve entering into a contract with a financial institution or a broker to buy or sell a specific currency at a predetermined rate on a future date. These contracts are traded on a direct two-party basis 'over-the-counter' (that is, off-exchange), and are highly customizable in terms of amounts booked, expiry dates, and flexibility of drawing down on them.

Forwards can be booked 'Open-', 'Window-', or 'Fixed-dated' to match the unique cashflow requirements of the hedger. In some circumstances, a financial institution may not allow fully open forwards. This could expose the hedger to interest-rate risks associated with the currencies involved if pre-delivered outside the window.

— **Currency Option Hedge:**

We will take a high-level view of two main structures, Vanilla Options and FX Structured Options.

III. Risk Reduction Strategies

— Plain Vanilla Option:

The Vanilla is a “premium” option structure. By paying a premium upfront, a company can purchase a currency option which gives them the right, but not the obligation, to buy or sell a specific amount of a currency at a predetermined rate within a specified time frame. It gives the hedger protection when they need it, but the hedger can also let the option expire if the spot rate is more advantageous at expiry. Typically, like insurance premiums, the option premium is non-refundable.

— FX Structured Option:

In certain market conditions and business situations, an FX Structured Option, which does not require a premium paid upfront (a key trade-off being much less ability to choose to simply let it expire, relative to a Vanilla Option), is sometimes used for certain hedging needs in corporate hedging programs. Most structures seek to give some protection against unfavorable market movements while also allowing for some limited upside. With regard to flexibility, FX Structured Options fall somewhere between a Forward Contract and a Vanilla Option.

- The **Forward Contract** is the least flexible in FX rate and amounts dealt. No premium is paid, but there is no participation if spot rates become more favourable than the Forward rate.
- The **Plain Vanilla Option** offers the most flexibility in terms of FX rate achievable and amounts dealt. Paying the premium provides the holder 100% participation in favourable market movements.
- **FX Structured Options** can be used toward some specific FX objectives, and are highly customisable to individual business needs.

With each and every one of these strategies and hedging products there are risks and trade-offs. A detailed discussion with an FX expert can help a business decide whether to use some/all/none of these tools, and how these tools can be tailored to each business’ unique FX exposures and objectives.

Assessing the nature of cashflows and consulting with an FX specialist to help a business build the right level of flexibility can help reduce this concern for that business.

III. Risk Reduction Strategies

What's next?

Once you understand the key hedging tools that are at your disposal, you can collect vital FX details.

These macro-level details may include factors like:

- Annual FX requirements (all the currency exposure)
- Budget rate used for sales, pricing, and/or business planning
- Aligning hedges to the time horizons of business planning, such as monthly or quarterly and for how long
- Products to be used for hedging
- Allowable leverage levels within the hedging approach

IV. Setting Risk Management Goals:

Determining risk appetite and target risk levels

Once you've assessed your foreign exchange exposure, the next step is setting risk management goals: How much risk is your company willing to take on, and what are your target risk levels?

Achieving consensus within a business' leadership team, on risk appetite, and on the strategy designed to achieve business goals, tends to be foundational for a successful implementation.

It's crucial for a business' stakeholders to reach a consensus on their business goals, margin requirements, and risk appetite to develop their hedging strategy.

Gaining consensus

It might help to start with the outcomes of your prior program. Did you achieve the intended results? Has your business—or your business objective—changed? How far ahead can you feasibly plan?

What is your company's hedging policy (treasury policy) and risk appetite?

Are you looking for protection against adverse market movements? Certainty on pricing, no matter how the market moves? Participation in favourable market movements? How much flexibility do you need?

Once this is agreed, you can model your strategy and potential outcomes. Creating different scenarios for your stakeholders can help make the case for whether to implement and, if implementing, how to implement.

Regular performance evaluations can help keep you on track as you work to achieve your goals.

IV. Setting Risk Management Goals:

Determining risk appetite and target risk levels

Hedging examples to achieve different objectives

Tactics can be adapted to market conditions, and to the predictability of a given business' exposures. A business expanding a product line or developing new supplier relationships may need more flexibility in their hedging program than a business with long-term requirements. A one-off FX requirement is tactically different from a fixed monthly obligation over months or years.

Below we describe two hedging structures that can be adapted to specific business needs, and how to execute, monitor, and test for effectiveness.

— **Rolling hedge**

A rolling hedge program offers flexibility when market conditions are changeable, or requirements are variable. As the expiry date of your existing hedge instrument approaches (be it an option structure or a forward contract), you enter into a new contract with similar terms, or renew the existing contract with a later maturity date. You might implement this kind of hedge if you are able to predict your needs only a few months ahead, or if you are able to change pricing in response to changes in the market.

As an example, you might hedge at one rate for months one through three, and revisit your needs and renew or renegotiate terms when the initial hedging instrument nears its expiry date. This structure allows you to take advantage of favourable movement and lock in some profits by changing the strike price, or protect against adverse movements by pushing out the expiry date.

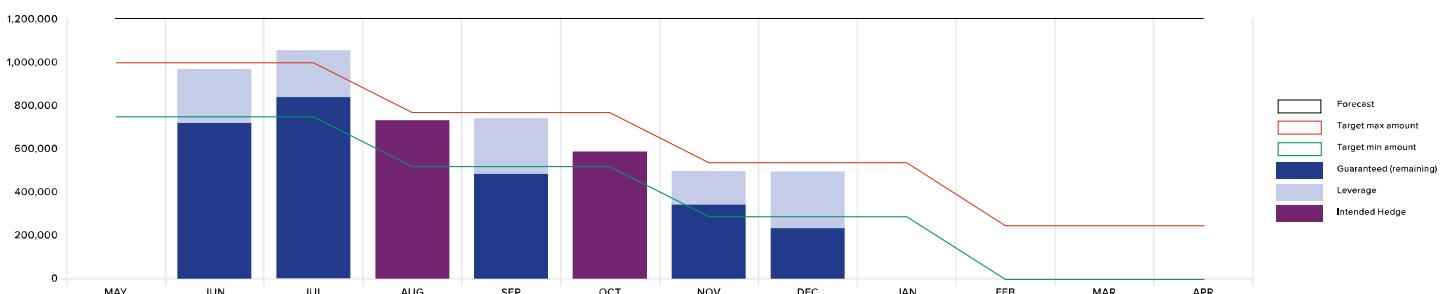
IV. Setting Risk Management Goals:

Determining risk appetite and target risk levels

— Layered hedge or Ladder hedge

If your business has more predictable requirements, a layered hedge could allow you to vary the duration and hedging instruments you use. You could set up a hedge for the first quarter of your year (months one through three), a second hedge for months two through five, a third for months three through six. This can help you to achieve a blended exchange rate and smooth out the effect of fluctuations from market volatility.

The layered hedging approach might incorporate tools such as forward hedges and/or currency option hedges, among others, tools than can help protect you from adverse currency fluctuations, and which tools can also help you achieve your financial objectives.



The example above is for illustration only. Amounts, percentages, product mix, and tenors are completely customisable based on clients' hedging policies and preferences.

DISCLAIMER: These brief examples do not disclose all of the risks and other significant aspects of trading in such products. In light of the risks, you should undertake such transactions only if you understand the nature of the contracts (and contractual relationships) into which you are entering, and the extent of your exposure to risk. Trading hedges/derivative-contracts is **not** suitable for many members of the public. You should carefully consider whether trading is appropriate for you in light of your experience, objectives, financial resources, and other relevant circumstances.

V. Mapping Cashflows and FX Needs to Better Visualize Risk and Exposure

We've described the value of consensus within a business on risk management goals, the strategy and objectives aimed at achieving those goals, and on implementing the agreed strategy.

Here we outline how a business can use an array of tools, including sensitivity analysis (examining how levels of uncertainty might affect outcomes), scenario planning (to test different hypotheses), and visualization can help identify potential risks and opportunities so businesses can better plan and implement their risk management strategies.

We'll also address how members of a team can contribute their own expertise to the strategy and execution of a plan.

In developing your hedging strategy, it tends to be prudent to clearly define your business objectives, your risk tolerance, and the level of flexibility your business needs. These elements are often part of a broader business strategy and thus are relatively stable.

Executing strategy typically requires access to a wealth of information, from cashflows and contracts to supply chains and timelines.

Some questions you might consider in this context:

- What does your hedging policy allow? Are you looking for certainty, or are you comfortable with less certainty so that you can potentially take advantage of upside, should a market move in your favour?
- How far in advance can you usefully forecast your currency needs and cashflows? Are you comfortable with a portion of your requirements remaining unhedged? How much and for how long?
- What about general market conditions? In more volatile markets (or with more volatile currency pairs, such as exotic currencies), you may need either more or less flexibility.
- How much flexibility do you need? Some businesses have long-term commitments (and thus more future cashflow visibility), longer-dated contracts, or pricing that can't be easily changed. Others may have more flexibility in their delivery and payment schedules, or can easily change their pricing: they may be comfortable with more flexibility and uncertainty.



V. Mapping Cashflows and FX Needs to Better Visualize Risk and Exposure

Communication and consensus are keys to success

Each member of your team has a different role and different expertise. Questions you might consider:

- What information and data do we need to understand our projected cashflows, obligations, and risk factors? What do we know, what can we project, and what DON'T we know?
- Who contributes to developing the strategy?
- Who has the authority to make the final decision as to whether the business approves the strategy, and to direct the team to implement the strategy?
- Who monitors results and measures outcomes, and how often will we report on outcomes?
- How do teams communicate? Many treasury teams manage their analyses and create their scenario modelling on spreadsheets. That can sometimes make it more challenging to make changes on the fly and quickly gain consensus across disciplines, especially across locations and with dispersed teams.

Mapping and visualizing exposure

Visualizing the path to achieving your objectives is an important next step. Different tactics are either more or less responsive to different conditions, and so testing different scenarios can help you make a more informed decision about your hedging.

V. Mapping Cashflows and FX Needs to Better Visualize Risk and Exposure

Choosing the right tools

Earlier in this paper, we outlined different hedging tools and the roles they can play in a plan. You might be more comfortable with forward contracts, which offer rate certainty but not upside participation. You might be considering more complex FX structured products, such as structured option contracts, which offer some protection and some upside but less certainty than a forward contract.

We also presented the concept of blending tools and tactics, including layered hedges and rolling hedges, which can offer more flexibility in terms of timelines and amounts hedged.

Please bear in mind, though, that while these hedging products can be useful tools, each and every one of them has trade-offs too. For example, they can add complexity to the planning process. A careful cost /benefit-analysis of each product's pros and cons is an important first step before implementing these tools.

Timelines: What's right for your business?

Some businesses may use lower hedge ratios over longer time horizons. This can help them to protect a portion of their FX exposure, and adapt or update their tactics to try to adapt to market conditions as they gain more visibility of their needs.

Scenario planning and modeling outcomes ('if this, then that' scenarios) can add visibility and can help you make more prudent decisions. You might need to adapt your tactics to changing market conditions, but the business objectives and big picture strategy tend to be stable anchors.

Again, your plan will be aligned to your own policies and risk appetite.

Bear in mind...There is no one-size-fits-all, and usually no obviously right answer or obviously wrong answer when considering an FX hedging plan and weighing the trade-offs of pros and cons faced at each fork in the road. Clearly define your business objectives, your tolerances for risk, the level of certainty you need, and how the tools at your disposal (each with its own pros and cons) can help you achieve your goals.

VI. Monitor, Review, and Report

We've taken you through a framework for managing FX risk, from assessing exposures and defining your risk appetite through to developing and implementing a hedging policy.

Here we come to the 'reckoning': how did the implemented strategy perform?

Performance can be influenced by many factors: some you can plan for, but others will likely be outside your control. Your business may have expanded, or you may have aligned with new suppliers due to adding products. You may have dealt with shortages and/or pricing changes. A geopolitical issue or natural disaster may have affected expected currency valuations in the currency pairs you deal in, or necessitated your trading in unfamiliar markets. High interest rates and inflation may also have had some impact on your profitability or supply networks.

Your evaluation could be as basic as asking yourself this following set of questions:

- Have we achieved our goals? And if not, why not?
- Has our business changed? Has the market? What could we have done differently?
- What tactics might we need to adjust for the next few months? For the next year?

Regular reporting to a business' internal stakeholders and leadership is an important part of this process. A reporting schedule for overall business performance is usually outlined in the business framework.

A data-driven performance report on hedging positions and outcomes can provide actionable insights on what is working, and what isn't, in your strategy. It can help you visualise where and what adjustments may help you keep your strategy on track, and gain consensus on the changes.

Businesses engaging in any FX hedging may find that they need access to near real-time reporting. Markets move fast, and so too does company liquidity, which presents both risks and opportunities.

This paper was designed to introduce Corpay's Risk Visualizer tool, which helps treasury professionals capture cashflows, model risk under different FX market conditions, and supports scenario planning.

Integrated within Corpay Cross-Border's online platform, Risk Visualizer provides an array of analytical and visualization tools that can help businesses capture and map their currency exposures and cashflow expectations. With the tool, they can more confidently and proactively develop and implement their hedging strategy and monitor its performance. The Risk Visualizer tool also includes a Position Summary report that businesses can easily download on their reporting schedule.

To learn more, and for a demonstration of the tool, please contact your account manager or connect with our Treasury Management Group at TMS@corpay.com.

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