
**Setting up an FX Risk Management Program**

Managing FX risk brings many advantages to a company - higher valuation, lower earnings volatility and lower cost of capital. Therefore, by hedging, the Controller/Finance group adds great value to the company. However, implementing an effective program that is easy- to-operate and cost effective requires expertise and good choices. Let's take a look at the base requirements for an effective and *practical* hedging program from the perspective of a corporation and its finance staff:

- It should work with the current and future financial and accounting systems.
- It should minimize the staff time required to establish and operate ongoing.
- It should be well documented, repeatable and provide an audit record trail.
- It should provide for maximum functional currency[1,2] liquidity and minimize volatility
- It should report (and explain) any mismatches between the underlying exposures and the hedges. Mismatches can stem from forecast deviations, forward points, and incorrect and/or catch up remeasurement[3] entries.
- It should minimize the cost of trading and keep the cost of hedging as low as possible.

That's quite a list. Let's take a look at each one in more detail.

The first three requirements ensure the staff is not overburdened, and as staff changes, the hedging program is not disrupted. Also, the hedging program should not force the staff to change the way they work in any substantive way. As companies grow, they often move to an ERP (enterprise resource mgmt) system such as Oracle or SAP to manage the increased complexity. Obtaining data to be used in a hedging program should not be an undue burden on staff, so the ability to work with both excel-based and ERP-based internal systems is important. The CRM system is equally at home with either.

The next requirement is often overlooked, that of providing maximum FC (functional currency) liquidity without excessive volatility. As a company details its cash requirements for the coming month, it is tempting to simply convert LC cash receipts to FC as they arrive, or as needed. Because a spot transaction will create a P/L with respect to the accounting rate for the current month, this can create unnecessary volatility. The CRM system avoids this problem, yet is able to provide FC liquidity as needed - and without the need to perfectly forecast LC cash deliveries.

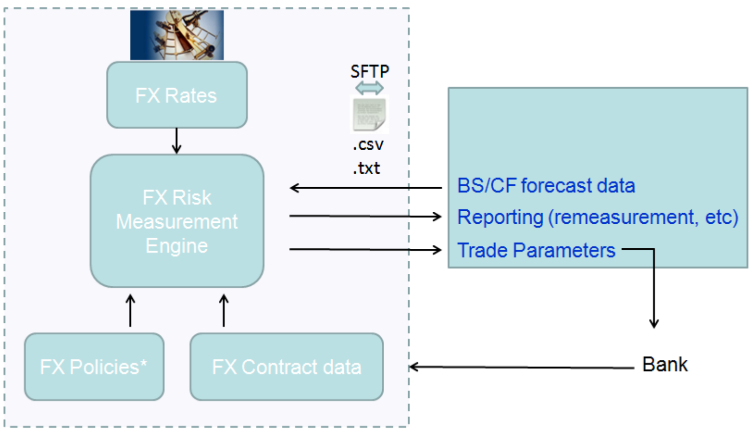
As the staff closes the books on a month or quarter, they will need to understand and be able to explain to senior management any mismatch between the underlying exposures and the hedges. There are numerous sources for such deviations. Balance sheet forecast deviations, slippage (the difference between intended and actual spot rates of transactions), forward points - all will have some impact. A professional hedging program will be able to document and explain not only all remeasurement and

[1] Functional Currency (FC) is the currency in which an entity primarily generates and expends cash. The Reporting Currency is the currency in which an entity prepares its financial statements.
[2] Local Currency (LC) is any currency, which is neither the Functional, nor the Reporting Currency.
[3] Remeasurement is the process by which LC assets and liabilities are revalued into the Functional Currency.

mark-to-market values, but all deviations. The CRM system provides this information so that the financial staff can understand and report to senior management (and auditors).

Hedging entails some cost – be it forward points, margin requirements, etc. A good hedging program will include the optimal setting of the accounting rate (the rate used to remeasure LC balance sheet items into FC), and maximize the transparency of bank derivative pricing. The CRM process entails what is called a "netting" day, one of only two trading days each month. We have selected the third Wednesday for this "netting" day. The third Wednesday is the day that FX *futures* contracts expire in the exchange futures markets. Futures, while not suitable for hedging, *do* provide transparent pricing of FX due to their being exchange traded. Bank OTC (over the counter) prices must converge to futures pricing on this day each month, prohibiting banks from setting pricing far from the true market value. CRM uses additional techniques to maximize transparency and minimize the price that our clients pay.

The actual CRM hedge process is more complex than can be explained in a simple two-page overview, however, the diagram below illustrates the flow of data between CRM, the Client and the bank.




In conclusion, the finance group can add tremendous value to the company by implementing a robust, effective FX hedging program. Working with CRM, the impact to staff on implementation and operations will be minimal, and FX liquidity will be maximized, and trading costs minimized. Contact us today to learn more about how our hedging program can work for you.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Paul Stafford received the Bachelor of Science in engineering from UC Berkeley, and a Master's in engineering from Stanford University.

He worked as an engineer for NASA for 6 years. He then spent 19 years with Hewlett-Packard Company in R&D and marketing before beginning his career in FX derivatives and hedging. He holds patents in optics and microwave signal processing, and has authored numerous technical papers.

Paul turned his engineering and analytic skills to FX derivatives 4 years ago, and has since published numerous articles, was interviewed by Inc. Magazine in 2012, and was the keynote speaker on FX issues at ASC in 2012. He is a FINRA-designated Investment Adviser and Registered Representative.


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Stefan graduated from the Wharton School of Business at the University of Pennsylvania and was subsequently awarded the Chartered Financial Analyst designation by the CFA Institute, and recently the Certificate in Investment Performance Measurement (CIPM) designation.

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