Foreign Exchange

2016 Risk Management Practices Survey

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2016

FX Risk Management Practices Survey

Wells Fargo Foreign Exchange has been surveying companies large and small, public and private, for eight years to gather information about the type of foreign exchange risk these companies face and how they manage it. The findings in this report provide valuable insights for our clients and prospects in developing benchmarks and strategies around foreign exchange (FX) risk. These findings also help Wells Fargo shape its product and service offerings so we can most effectively help our clients meet their financial needs and succeed financially.

We truly appreciate the contributions of the participants who provided the responses necessary to yield comprehensive and meaningful survey results. We hope you find the survey's contents informative and useful in measuring or establishing your own company's policies around FX risk management.

Executive summary

Since our 2014 survey, significant volatility in the FX markets has put more pressure than usual on corporate hedge programs, with companies often highlighting the effects of FX in their quarterly earnings releases. The 2016 FX Risk Management Practices Survey results show how companies responded to this market environment. The results also reflect many of the reoccurring challenges faced by corporations attempting to manage FX risks consistent with a best-practices approach, as well as leading practices in FX risk management.

Greater concern regarding FX risks

In response to the significant market volatility during the past two years, 55% of our respondents indicated that FX had become a greater concern for them. In response, they took the following actions:

- 47% indicated that they had increased the amount of their exposures hedged
- 29% indicated that they had developed or revised their FX risk management policies
- 18% extended their hedge horizons
- 13% changed the mix of hedging instruments used

Corporations continue to be challenged by FX risk management

The results of our survey also highlight the recurring challenges corporate hedgers face in attempting to manage FX risks consistent with a best-practices approach:

- A significant number of companies (36%) indicated that they had no formal policy to address FX risks
- Only 17% of corporate respondents indicated that they measured potential FX risk. With so few companies quantifying and reporting risks to senior management, this points to a lack of oversight and control
- Of the companies that do not hedge forecasted transactions, significant reasons for not hedging include forecast inaccuracy (33%) and a general lack of expertise and resources to manage a cash flow hedge program (23%)
- 53% of all companies stated that their biggest obstacle to establishing FX risk management best practices was deciding when to hedge and choosing the right strategy; this result, more than any other, is indicative of the corporations' unpreparedness in regard to their FX risk management programs

55%

More than half (55%) of respondents report that foreign exchange became a greater concern for them in the past 12 months.

Leading practices in FX risk management

We asked our customers basic questions regarding their hedge programs. The following results offer insights into which exposures companies hedge, how they hedge them, and why.

Exposures hedged

When asked about the exposures they hedge, our respondents indicated:

- Three out of four companies (76%) hedge foreign currency balance sheet positions
- Six in 10 companies (63%) hedge forecasted transactions
- 10% hedge their net investment risk
- 15% hedge earnings translation risk

Leading practices in FX risk management

Hedge accounting

For hedges of forecasted transactions, hedge accounting is employed frequently by public firms (82%), compared to just 37% of private firms. Companies with revenues exceeding $500 million are more likely to elect hedge accounting than smaller companies.

Hedging instruments used

- The use of forward contracts is nearly universal among those who hedge
- 97% use forward contracts for balance sheet hedges, and 92% use them for forecasted transaction hedges
- Purchasing options is less prevalent, with only 9% of companies purchasing options for balance sheet hedges and 13% purchasing them for forecasted transactions

Budget rates

- Almost all public companies (91%) set budget rates as part of their formal planning process, compared to just 67% of private companies
- 49% of respondents indicated that they set budget rates based on current market rates (spot or forwards) or a blend of actual hedge rates
- 42% indicated that they set budget rates based on consensus forecasts

Hedging strategy

- Two-thirds of respondents (67%) say they manage risk systematically compared to active or dynamic hedge programs
- Most companies (85%) manage risk on a centralized basis
- 40% cite a maximum hedge horizon for forecasted exposures of 12 months, but 42% hedge to longer maturities
- For hedging forecasted transactions, companies describe their objectives either as reducing risk to both cash flows and earnings (35%), limiting risks to cash flows and margins at the entity-level (32%), or reducing earnings risks (31%)

Hedge objectives

The top three hedge objectives identified by our respondents are, in order:

1. Smoothing the effect of changes in FX rates over time
2. Protecting budgeted results
3. Helping senior management forecast the company's financial performance

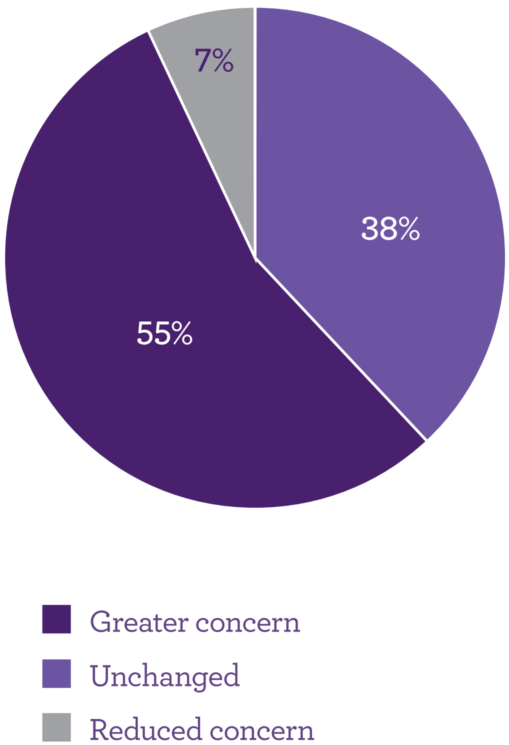
82%

Most companies that hedge forecasted transactions will hedge these exposures for 12 months or longer.

FX risk management challenges

Heightened currency volatility has intensified concerns about FX risk management

Attitude toward FX risk management



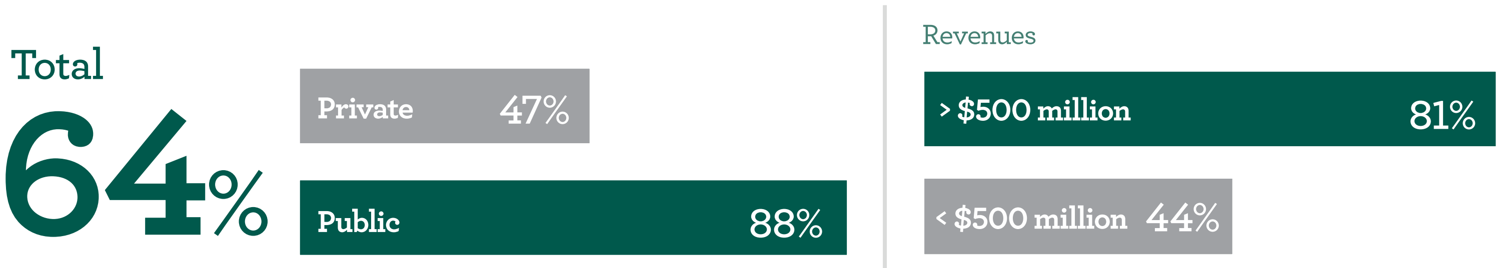
Changes made to risk management approach

- **47%** Increased the amount of exposure that is hedged
- **29%** Developed/revised FX policy
- **26%** Improved/enhanced systems
- **18%** Extended the average maturity of hedges
- **13%** Altered the mix of hedging instruments used
- **7%** Decreased the amount of exposure that is hedged
- **3%** Shortened the average maturity of hedges
- **16%** Other
- **6%** None

Effective risk management is hindered by the absence of formal FX policies . . .

Respondents that have a formal written policy:

- While 64% of survey participants have a formal written FX policy, roughly one in three do not
- Large firms and public firms are more likely to have written policies



…and by a lack of regular and comprehensive risk quantification

Respondents that use a quantitative or statistical methodology to measure risk

Total

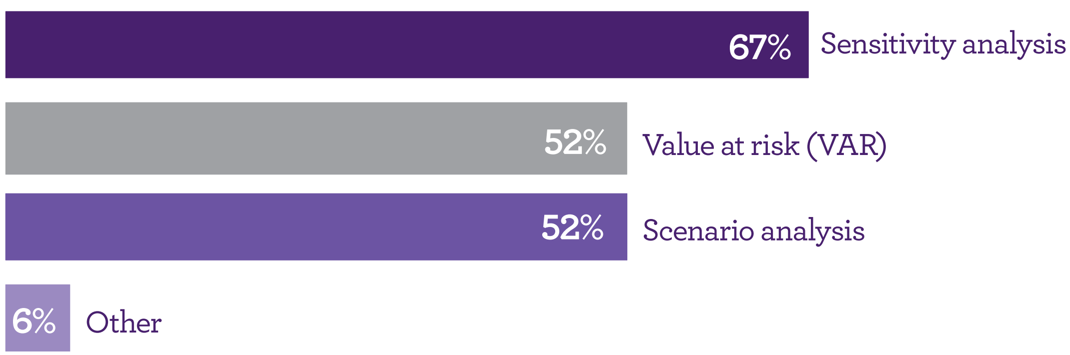
17%

24% vs. 8%

Companies with revenues of $500 million or more are more likely to employ quantitative and statistical methodologies than companies with revenues of less than $500 million.

- Only 17% of survey respondents regularly quantify their exposure to FX risk

Methods used to quantify FX risks



62% vs. 18%

Of the firms that employ quantitative methods, companies with revenues of $500 million or more use the Value at Risk methodology more often than companies with revenues of less than $500 million

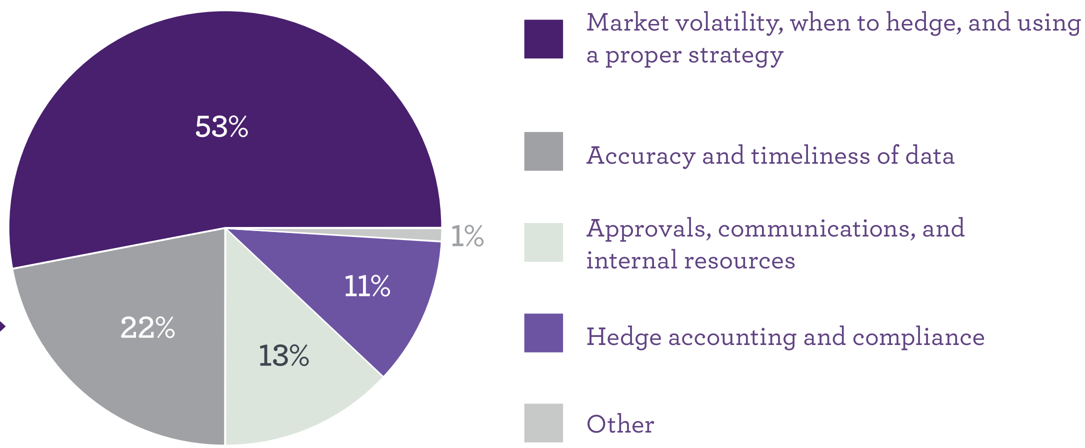
- Most of the survey participants that quantify risk use several techniques, with sensitivity analysis the most common

* Caution: low base size

In this environment, determining when and how to hedge FX exposures remains a significant risk management challenge

Greatest FX risk management challenge

Half of the survey respondents cited market volatility, when to hedge, and identifying the proper strategy as their greatest challenge.



Public/>$500 million

Public companies (33%) are more likely than private companies to cite accuracy and timeliness of data as the greatest risk management challenge, as are large companies with revenues of $500 million or more (28%).

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Leading practices in FX risk management

Balance sheet positions remain the most commonly hedged exposure

Three-fourths of companies with trade-related assets or liabilities on their balance sheet hedge foreign currency positions, as do two-thirds of those with finance-related assets or liabilities on their balance sheet.

76% vs. 71%

Roughly three in four hedge nonfunctional currency booked assets or liabilities, compared to 71% in 2014.

Companies that hedge non-functional currency booked assets or liabilities

Total

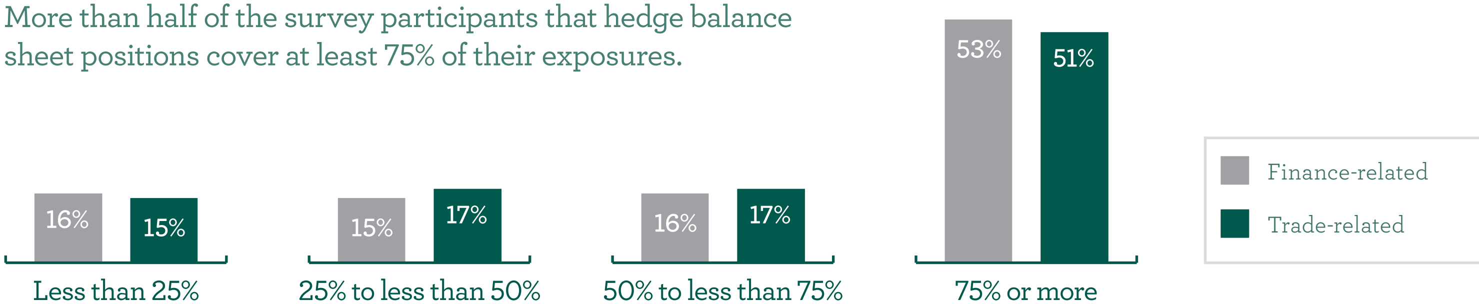
76%

Type of non-functional assets or liabilities on balance sheet

Of the respondents hedging balance sheet positions, half hedge between 75% and 100% of their exposures; hedge horizons are typically 3 months or less

Percentage of balance sheet positions hedged

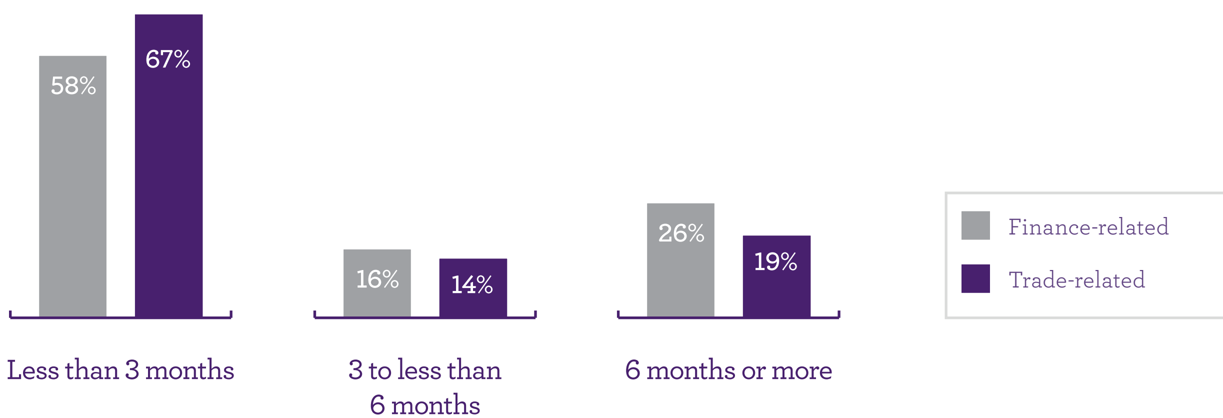
More than half of the survey participants that hedge balance sheet positions cover at least 75% of their exposures.



Maturities of balance sheet hedges

Balance sheet hedges predominantly have horizons of three months or less.

Hedge horizon



The use of forward contracts for hedging balance sheet positions remains nearly universal

Forward contracts are used for both finance- and trade-related positions

Balance sheet position hedge instruments

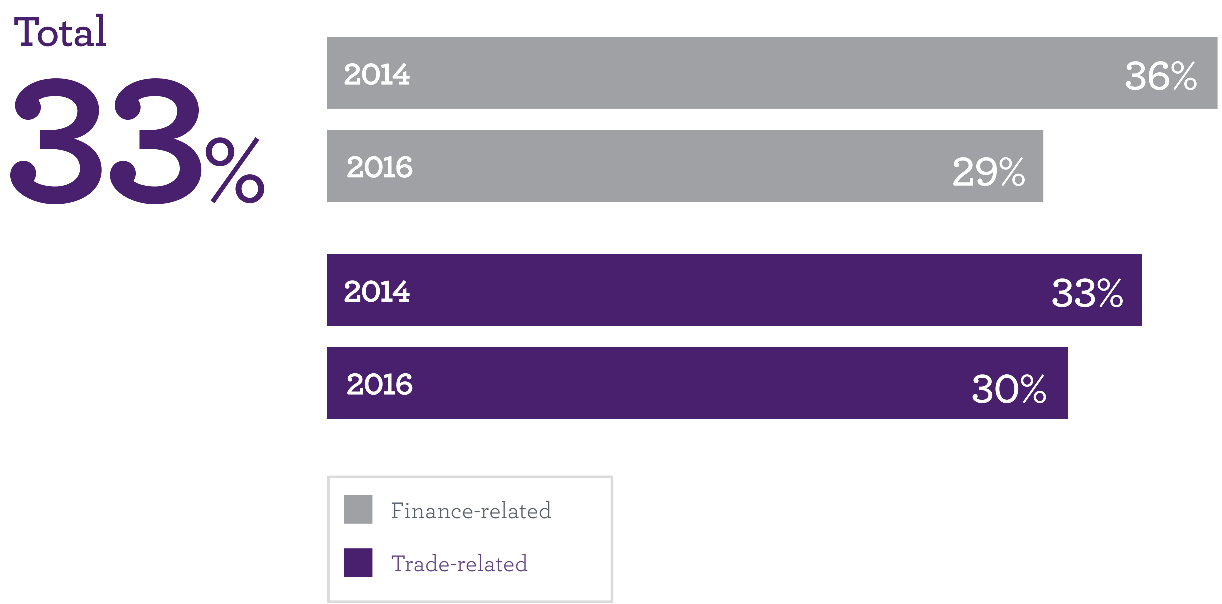
2014		2016
98%	Forward contracts	97%
11%	Purchased options	9%
9%	Option collars	7%
7%	Cross-currency swaps	9%
5%	Participating forwards	4%
1%	Forward extras	2%
3%	Other	4%

Finance-related		Trade-related
90%	Forward contracts	96%
5%	Purchased options	9%
6%	Option collars	6%
10%	Cross-currency swaps	7%
3%	Participating forwards	4%
3%	Forward extras	1%
4%	Other	4%

Survey participants tend not to apply special hedge accounting to hedges of balance sheet positions

Hedge election for hedges of balance sheet positions

- Only one in three firms that hedge balance sheet positions elect hedge accounting



The reasons for not hedging balance sheet items include small and/or uncertain exposures and limited resources

Factors influencing the decision not to hedge balance sheet positions

Finance-related

37%	Risk of exposures is small
34%	Intercompany loans are classified as long term in nature
32%	Timing of repayment of loans is uncertain and we wish to avoid cash settlements on rolled hedge contracts
12%	Hedge costs are too high
7%	We designate FX-denominated liabilities as a hedge of our foreign net investment
2%	We are constrained by credit
12%	Other

Trade-related

49%	Risk of exposures is small
27%	Constrained resources to manage the positions effectively
24%	Settlement of accounts payable/receivable is uncertain and we wish to avoid cash settlements on balance sheet hedges
16%	Hedge costs are too high
13%	Lack of the ability to track and understand the size of the risks
18%	Other

- Small exposure size is most often cited as a reason for not hedging
- Exposure uncertainty and resource constraints are also important factors

Nearly two in three survey participant firms hedge forecasted transactions

Companies that hedge forecasted foreign currency revenues and/or expenses

Total

63%

63% vs. 59%*

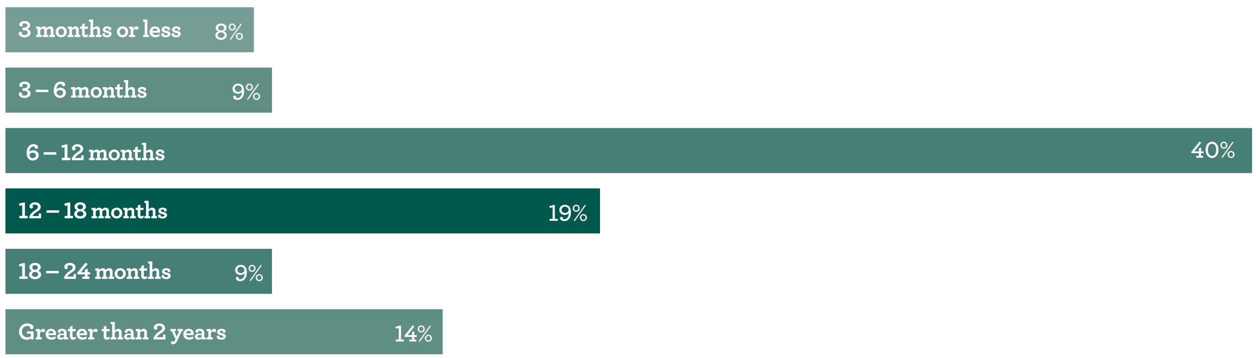
The percentage of participants hedging forecasted transactions (63%) exceeds the finding in our 2014 survey (59%), and both private and public firms appear to have increased the hedging of forecasted transactions (59% and 60%, respectively, in 2014).*

* Because of changes in the wording of survey questions, these comparisons likely represent conservative estimates of the increased hedging of forecasted transactions.

Of the respondents that hedge forecasted transactions, a maximum hedge horizon of 12 months is the most popular (40%), but another 42% hedge to longer horizons

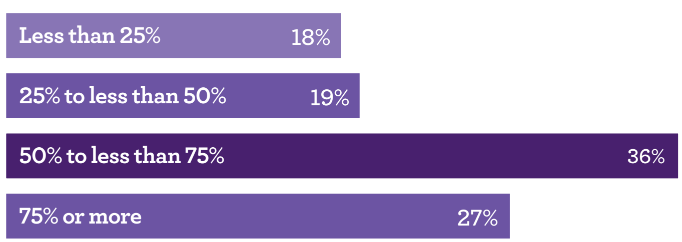
Maximum maturities for hedges of forecasted transactions

More than 40% hedge to a maximum maturity exceeding one year, and another 40% hedge to a maximum maturity falling between six and 12 months.



% of forecasted transactions hedged

The categories in the figure below represent average coverage ratios across hedges of all maturities. Companies typically hedge declining percentages of exposures at longer hedge horizons.



The use of forward contracts is nearly universal for hedges of forecasted transactions

- Nearly all companies that hedge forecasted transactions use forward contracts
- Non-forward hedge solutions are more common for forecasted transactions than for balance sheet positions

Forecasted transaction hedge instruments

- **92%** Forward contracts
- **13%** Option collars
- **13%** Purchased options
- **9%** Participating forwards
- **9%** Cross-currency swaps
- **3%** Forward extras
- **1%** Other

35%

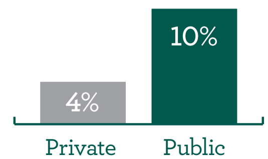
About one-third use other hedging solutions to hedge forecasted foreign currency transactions.

Provide a budget for option hedges

- Few companies provide a budget for hedging with options

Total

6%



Revenues

> $500 million	6%
< $500 million	6%

Firms that hedge forecasted transactions tend to have multiple objectives

Purpose for hedging forecasted transactions

35% Protect both cash flows and earnings

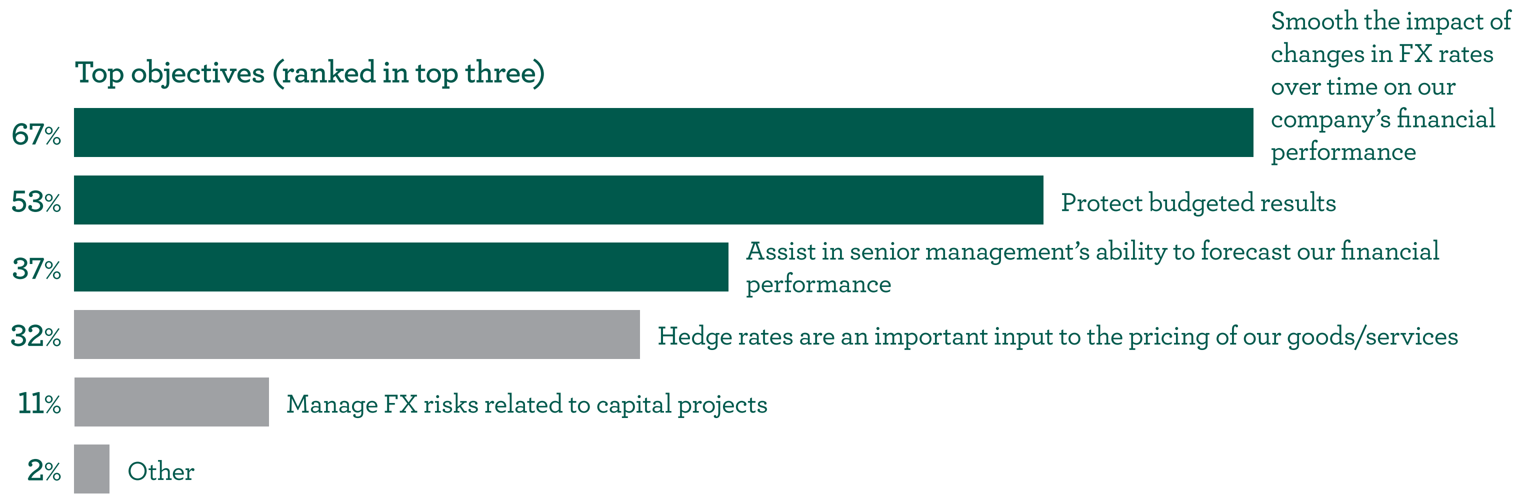
32% Protect cash flows and margins at the entity level

31% Protect earnings at the consolidated level by hedging transactional cash flows

3% Other

Objectives for hedging forecasted transactions

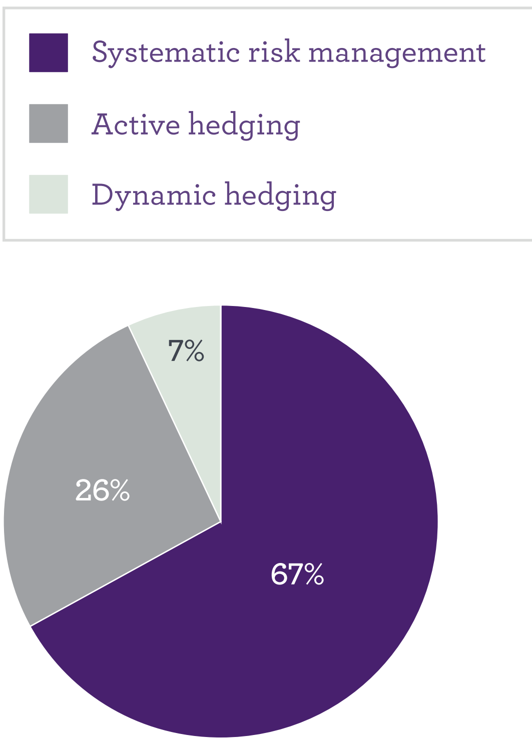
Two-thirds of companies ranked smoothing the impact of FX rates on their company's financial performance as one of their top three risk management objectives.



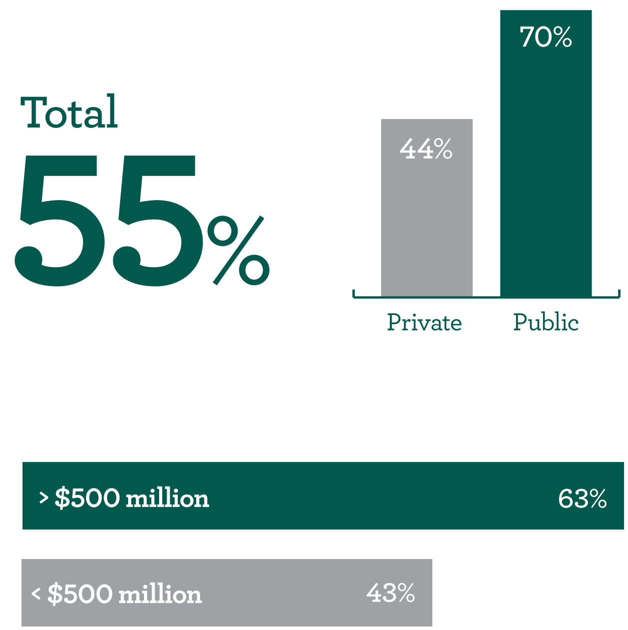
When hedging forecasted transactions, survey participants tend to take a systematic approach and often layer their hedges

More than half the survey participants that hedge forecasted transactions layer their hedges.

Approach to hedging forecasted transactions



Use of layered hedge programs



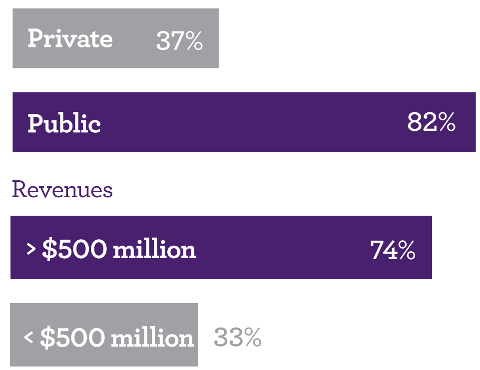
In contrast to the accounting for hedges of balance sheet positions, hedges of forecasted transactions tend to be designated for special hedge accounting

Elect special accounting for hedges of forecasted transactions

- More than half elect hedge accounting
- Public and large companies are more likely to do so

Total

57%



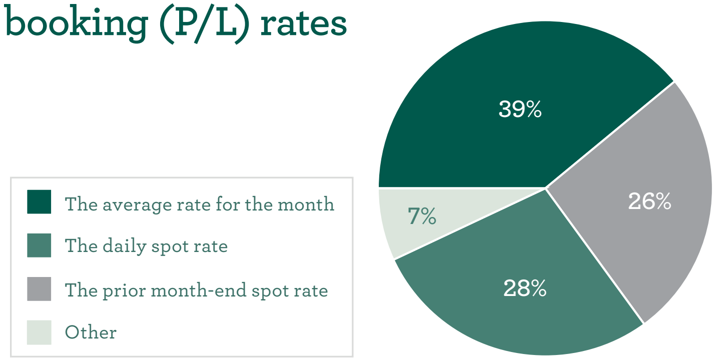
Assistance with hedge accounting

Nearly one in three companies utilize assistance from their banking partner.

25%	Accounting/ audit firm	13%	Internal software
35%	Banking partner	3%	Other
30%	Third-party vendor software	17%	None

Accounting convention for booking (P/L) rates

The average monthly rate is the most common accounting convention for foreign currency denominated transactions.



33% vs. 21%

Public companies use the prior month-end spot rate more often than private companies.

The reasons for not hedging forecasted transactions include small exposures, forecast uncertainty, and limited resources

Factors influencing the decision not to hedge forecasted revenues and expenses

42%	Exposures are small
33%	We are unable to accurately forecast our exposures
23%	We lack the expertise and resources to hedge our forecasted exposures effectively
17%	Hedge accounting is difficult
12%	Our senior management does not believe in hedging
6%	We do not fully understand our risks
15%	Other

Hedging foreign net income and equity net investment translation exposures is less common than hedging balance sheet positions and forecasted transactions

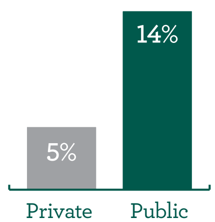
Hedging equity net investment in foreign subsidiaries

A minority of companies hedge, or in the past have hedged, their equity net investments in local currency functional subsidiaries.

Currently hedging equity net investment in foreign subsidiaries

Total

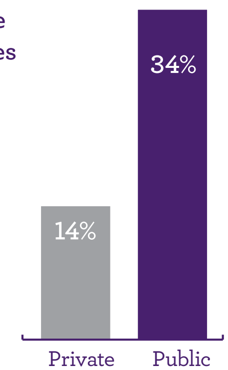
10%



Currently hedging or in the past hedged the equity net investment in foreign subsidiaries

Total

24%



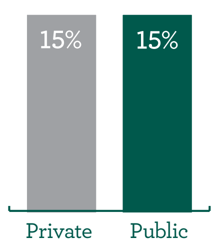
Hedging translated value of foreign currency net income

One in seven companies report hedging the translated value of foreign currency net income.

Currently hedging translated value of foreign currency net income

Total

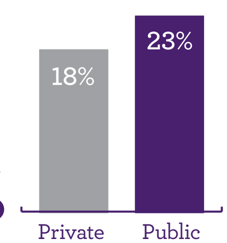
15%



Currently hedging or in the past hedged the translated value of foreign currency net income

Total

21%



Additional FX risk management practices

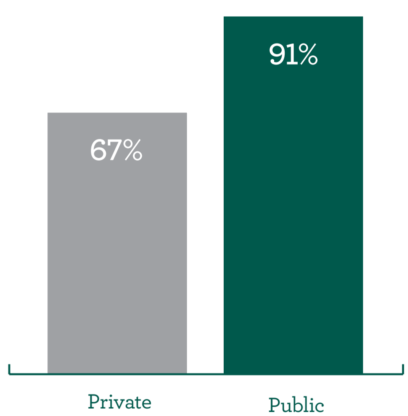
Most firms set FX budget rates, and the approaches used vary

Set FX budget rates

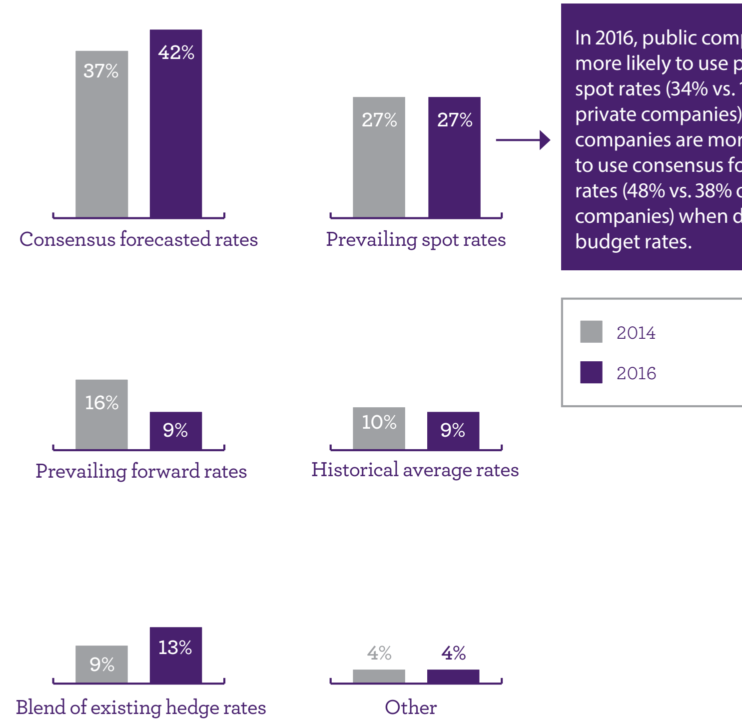
- Three-fourths of the survey participants set budget rates, typically on an annual basis; public firms are more likely to set budget rates than private firms
- Firms use various methods to establish budget rates, but the most common single approach involves the use of consensus forecasts
- Because forecasts may not represent actionable market rates, their use may interfere with effective risk management

Total

77%



Source of budget rate*



In 2016, public companies are more likely to use prevailing spot rates (34% vs. 17% of private companies) and private companies are more likely to use consensus forecasted rates (48% vs. 38% of public companies) when determining budget rates.

* Only includes responses if the company has non-functional assets or liabilities on their balance sheet or if the company has subsidiaries in foreign jurisdictions.

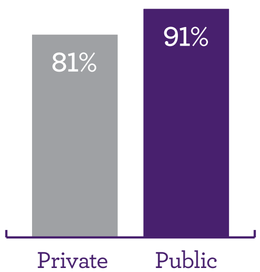
Most companies manage FX risk on a centralized basis, and require a minimum credit rating for FX counterparties

Rely on centralized risk management

- Companies of all descriptions manage risk on a centralized basis

Total

85%



91% vs. 81%

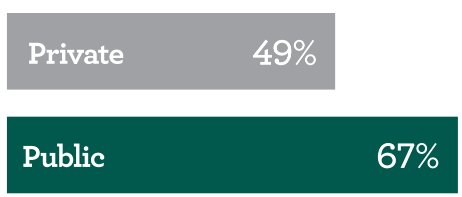
In 2016, public companies are more likely to manage FX risk on a centralized basis (91% vs. 81% for private companies), as are companies with revenues of $500 million or more (89% vs. 80% for companies with revenues of less than $500 million).

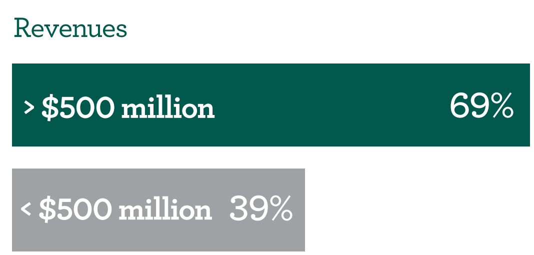
Require a minimum credit rating for counterparties

Minimum credit ratings for counterparties are more likely required by public companies and by those with revenues of over $500 million.

Total

60%





Appendix

Survey participant information

Survey participants

Parent company location

87% U.S.

13% Non-U.S.

Company annual revenue

19% Less than $100 million

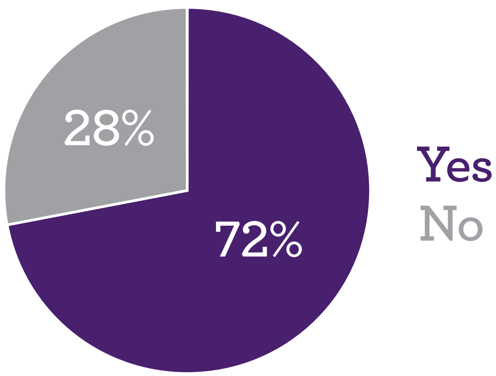
26% $100 million to < $500 million

13% $500 million to < $1 billion

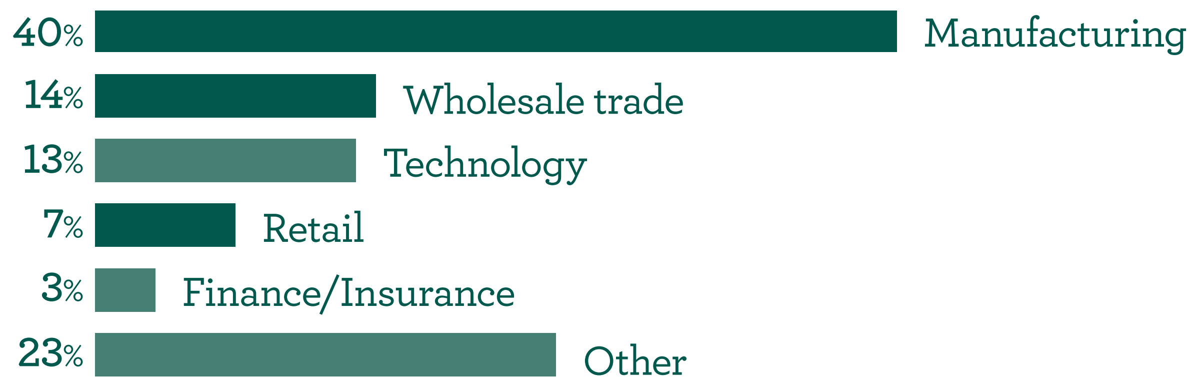
29% $1 billion to < $5 billion

13% Greater than $5 billion

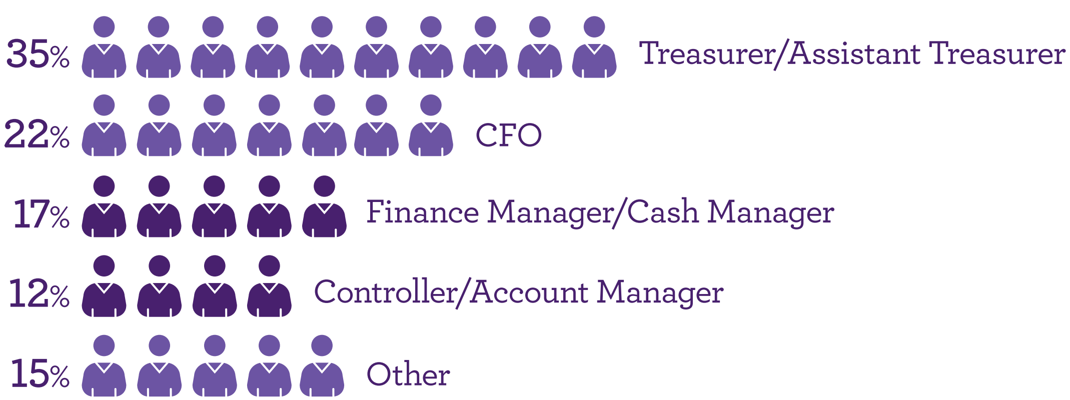
Have foreign subsidiaries?



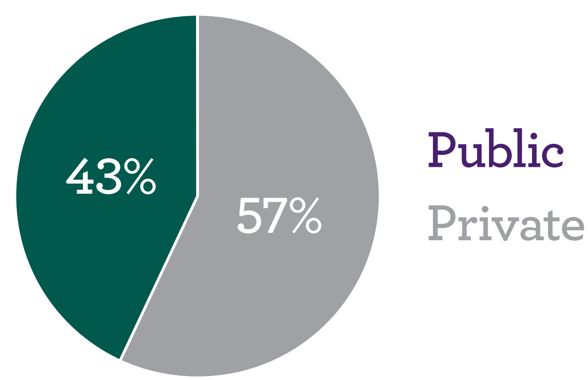
Industry



Title within company

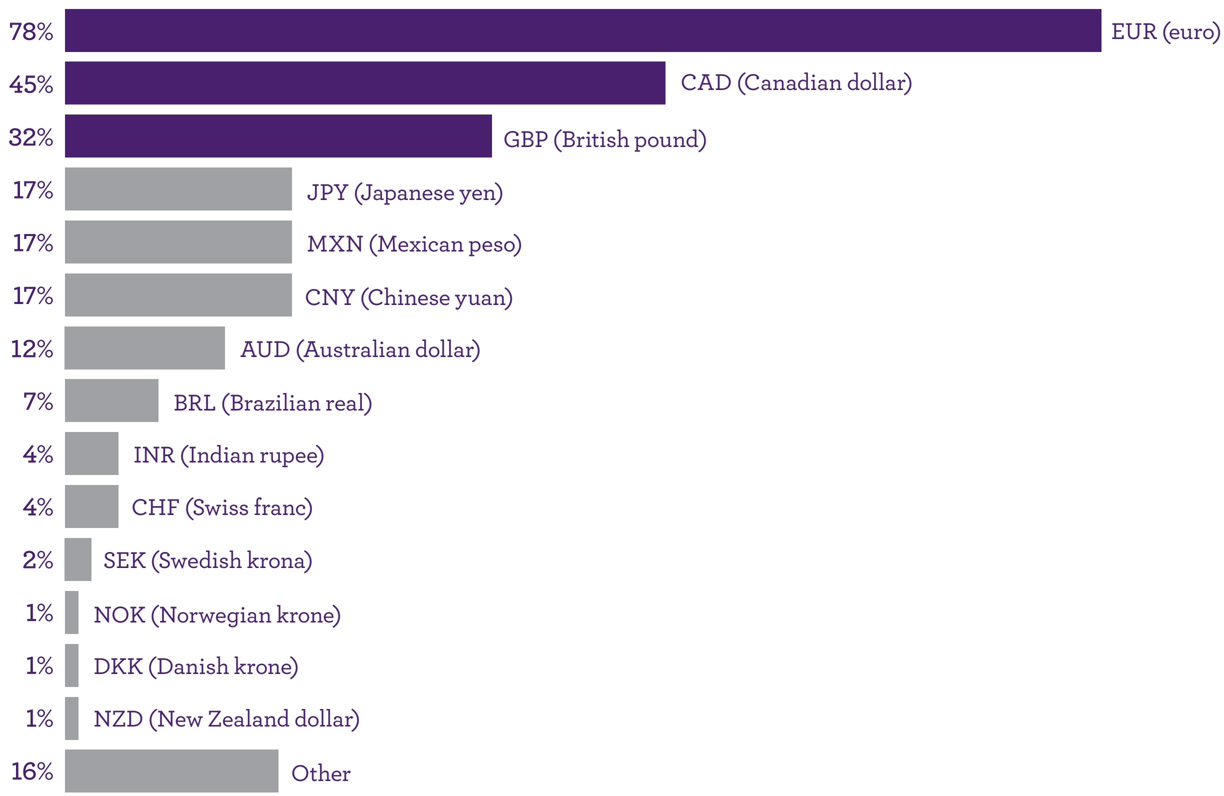


Public vs. private company



Currencies traded

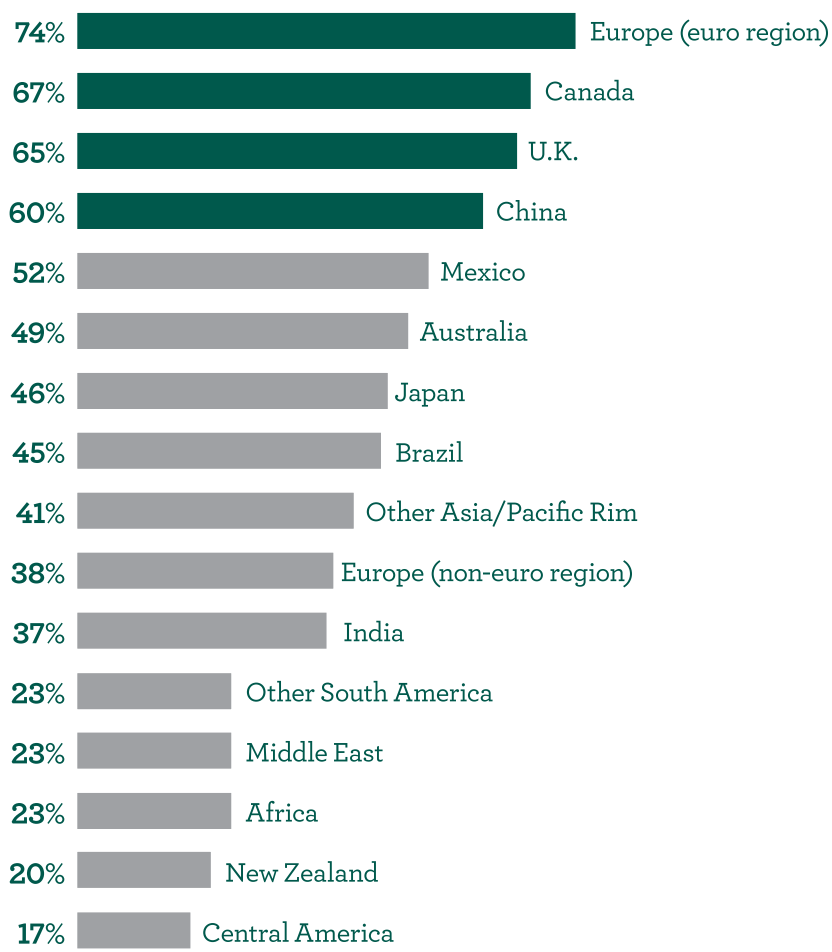
Top currencies traded (ranked in top three)



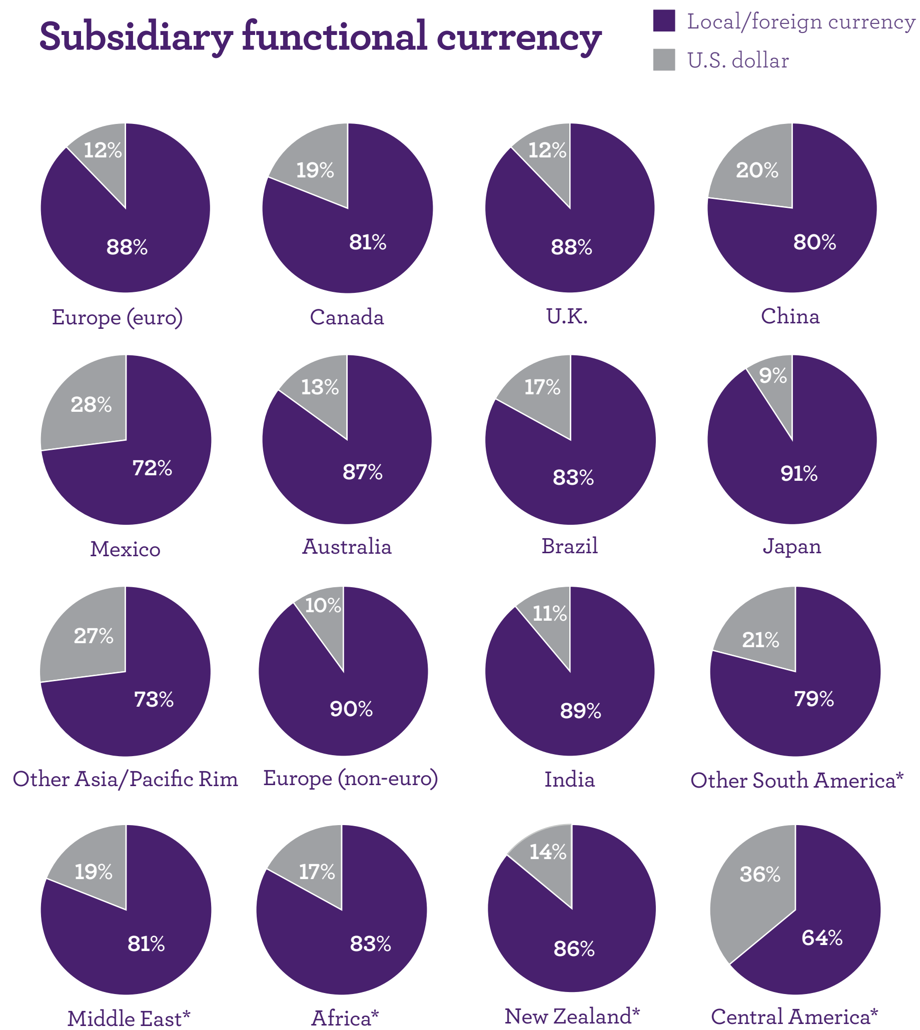
Foreign subsidiaries

Foreign subsidiaries most commonly operate in the euro region of Europe, Canada, the UK, and China.

Regions where foreign subsidiaries operate



Subsidiary functional currency



*Caution: small base size

Summary and conclusion

The U.S. dollar has risen by approximately 25% in the two years since the Wells Fargo Risk Management Survey was last conducted. The 2016 survey solidifies the view that this move in the dollar has created a heightened concern around currency moves for many companies, and indicates that these companies have responded by hedging a greater portion of FX exposure. This year's survey provided many observations about how companies are measuring and addressing FX risk, as well as what they perceive as some of the biggest challenges to managing FX risk. The survey also sheds some light on how perceptions and actions around FX have changed during the course of this very volatile period in the currency markets.

We hope the results and analysis presented in this report help you and your organization in your pursuit of optimal risk management strategies. We welcome any feedback or questions you may have related to this survey.

Contact us

For additional information about our risk management solutions, contact your local Wells Fargo Foreign Exchange Specialist:

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Houston	1-800-357-3249
Los Angeles	1-800-932-5239
Minneapolis	1-800-299-5810
New York	1-866-650-8217
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Seattle	1-800-985-8427

Together we'll go far

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