Managing Liquidity During Turbulent Times:
Strategies for Managing FX Risk

Corporate and institutional treasurers around the globe are facing unprecedented volatility and unpredictability, both in their own business and the wider markets. In this environment, what new perspectives or approaches should treasurers be taking to manage their exposures?

Trading volumes have significantly reduced, putting pressure on cash flows, and supply chains are slowing down – as many industries are facing demand volatility. We are seeing an urgent flight to quality, with significantly increased dollar deposit levels, while demand for USD credit lines, in US dollars, is significantly increasing. FX markets are seeing volatility and reduced liquidity making devaluation risk, for non-functional currencies, a real challenge.

Recently, Citi cash management experts came together on a podcast to discuss how treasury teams are grappling with this unpredictability in the markets and actions to consider – and here are some of the main takeaways.
How are treasurers responding in an evolving situation?

Visibility and control over cash around the globe has never been more important. Treasurers are carefully forecasting cash flow over the next 3-6 months, to ensure that the business can survive – should inflows reduce or even stop. Companies are rightly preserving and shoring up every bit of liquidity they can. Treasurers are drawing down on external facilities and reviewing their intercompany funding processes, plus centralizing and holding cash at a group level as far as possible. Few are looking at radical new approaches – but are engaging familiar, proven techniques, such as target or zero balancing mechanisms, both domestically and cross-border. By doing so, they are in a better position to mobilize liquidity – while leveraging automation at a time when resources and remote working is hampering operations.

In Asia Pacific, where organizations have had longer to deal with COVID-19 implications, treasurers have been harnessing data from shared service centers, payment and collection factories to build out deeper working capital analytics processes, such as:

• **Performing detailed portfolio analysis** to unlock cash with dealers and distributors to fund cash flows and reduce short term assets;

• **Reviewing credit default swap spreads** of these dealers and distributors to mitigate credit default risks; and

• **Assessing currency risk daily**, particularly when invoicing in multiple currencies.

Addressing FX challenges

While maintaining access to cash, multinational corporations are also focusing on their FX exposures – as devaluation risk threatens inflows, the cost of funding foreign exchange outflows increases, and the value and credit risk of FX holdings held in more vulnerable countries and banks comes into question.

The FX markets were already starting to show signs at the start of the year, following years of extremely low volatility. Since then, liquidity in the spot and forward markets has dried up to the extent – or to an even greater extent – than we saw during the global financial crisis. Both G10 and emerging market currencies have been affected, as well as the USD, due to severe dislocation in the USD funding markets, while MXN and BRL have fallen to record lows.

What is the minimum outflow, what could be the likely inflow, is there a gap – and how will it get funded?
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Identifying FX risks

Before determining what action treasury should take to manage FX risk, the first step is to get a handle on the extent of risk and where it arises:

• **Establish foreign currency requirements.** Cash flow forecasting is essential to determine the amount of cash a company needs to hold, both at group level and in each foreign currency. While forecasting is a regular activity for treasurers, it is particularly important at present — given the risks of currency devaluation, local bank counterparty risk, snap capital and currency controls, etc. While each business is different, the decision should be driven by short-term cash flow forecasting, risk tolerance, and prioritizing important payments.

• **Stress test cash flow forecasts.** In the current environment, the potential for forecasting error — both in identifying and quantifying risk — is higher than usual given the unpredictability of demand and disruption in supply chains. Stress testing to assess the impact of potential spikes or troughs is an important way to identify liquidity pinch points and potential FX risks.

• **Look beyond the business to identify risks.** FX risk management at times of stress takes on a different dimension than during more benign conditions. While treasurers typically look at FX risk in terms of revenue and balance sheet exposure, FX risk implications extend much further. Many MNCs sell globally in their group functional currency, e.g. USD. Where these companies sell to customers that operate in local currency, but pay USD, the customer takes on the associated FX risk. However, this FX risk becomes the MNC’s credit risk in their accounts receivable. Likewise, many supply chains are USD-denominated. When an MNC’s non-US suppliers buy materials and manufacturing components in USD, they take on FX risk; however, this risk then becomes the MNC’s supplier risk.

Hedging FX risks

Most corporates hedge in the FX forward markets, but as market liquidity has dried up, and volatility increases, treasurers may need to review their approach:

• **Communicate early.** Typically, MNCs review their hedge position and adjust this at month end. For those with very large balance sheet hedges, given market conditions, it is important to communicate early with FX providers to discuss best execution strategies to manage poor liquidity and reduce cost.

• **Look at credit limits.** The spike in volatility is creating some large negative swings in the mark-to-market valuations of firms’ existing derivative hedges. This greater negative valuation of these hedges reduces the capacity of FX providers to execute new hedges, and credit lines become fully utilized. Treasurers should assess the extent to which hedging credit lines have been impacted by the rise in volatility to make sure they can execute new hedges when required. Where credit lines are utilized, treasury may need to use less credit-intensive hedging alternatives such as FX options.

• **Avoid under-hedging.** Unpredictability in forecasts makes hedging more difficult. The natural tendency at times of uncertainty is to hedge less, but this could lead to higher FX risk. One approach is to hedge based on averages, and incrementally increase hedge ratios as visibility increases.

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Checklist: Optimize Your Firm’s FX Exposure

☑ Review cross-border flows, and identify opportunities to improve efficiency, particularly those with large volumes/value, given that there is an FX component

☑ Implement automated multi-currency sweeping to eliminate manual conversions and free up treasury to focus on more pressing concerns

☑ Automate FX payments below a certain size at pre-agreed spreads

☑ Above this level, leverage an FX dealing platform wherever possible

☑ Advise your bank of large, high priority payments in advance, to discuss optimal execution

To learn more, listen to the Strategies for Managing FX Risks podcast here.