

RISK ADVISORY

Foreign Exchange budget rates: A key milestone in treasury and FP&A maturity

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Key takeaways



FX budget rates represent an important milestone in treasury and FP&A maturity, helping companies move from reacting to currency movements to managing them strategically.



No single methodology is universally superior. The choice of FX budget rate should align with a company's broader business strategy and support business objectives through greater planning certainty.



By establishing an objective exchange-rate baseline for budgets and forecasts, companies can make informed decisions about global expansion, including market entry, subsidiary funding, supply chain footprint, contract pricing, and M&A or other capital deployment opportunities.

As companies expand internationally, foreign exchange risk evolves from a background market variable into a meaningful driver of financial performance. Early-stage organizations often rely on ad hoc FX assumptions when forecasting global revenue and expenses. In fact, many still think and plan in USD terms, even though cash flows may be practically denominated in foreign currencies. As global operations grow, this passive approach can introduce volatility, obscure underlying business performance, and make it harder to hold the institution accountable to financial targets.

Leading budget rates methodologies

The FX budget rate is the exchange rate used to convert non-USD expenses, revenues, investments, and other financial contracts denominated in a foreign currency into USD. Drawing on our risk discovery engagements with corporate clients across the life cycle, we find that the following budget rate approaches are used most frequently.

- **Prevailing spot rate:** Absent of a defined view or feeling about foreign exchange, this tends to be the default alternative in many situations as it reflects where the market is trading at the time budgets are finalized. The spot rate is generally considered an unbiased budget rate choice¹.
- **Prevailing forward rate:** Like the spot rate, the forward rate represents where the market is trading, and more importantly, points to the rate that is attainable and achievable today by locking into FX forward hedges. Forward rates are especially appropriate in situations where cash flows are projected for longer horizons, or involve markets where interest rates differ materially versus those in the US, as forward rates incorporate the relative cost of funds across borders.
- **Prior year or period average rate:** An important key performance indicator (KPI) for many institutions is period-over-period growth. Using the last period's average exchange rate as the budget rate for the current period establishes a relevant, although not always easily achievable, anchor for performance.
- **Padded FX rate:** Without hedging, there is about a 50-50 chance of delivering on the budget rate if the spot or forward rate is selected. Often, firms will opt for an off-market budget rate which is less advantageous than the prevailing spot or forward rate, but by construction, easier to achieve in a probabilistic sense. This 'padding' may represent the upfront premium for

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an option that may be purchased to ensure the budget rate is met, or it may be determined by the maximum amount of downside tolerance for FX losses a firm is willing to bear.

- Consensus forecast: Many banks, financial institutions, and economic organizations publish forecasts for key macro variables including exchange rates. The 'consensus' FX forecast rate is the median forecast of all contributors for a particular currency pair. Some global institutions find comfort in using the consensus forecasts as the corporate budget rates as a common perception is that they are produced by 'experts'. That said, there is no evidence to support that forecast accuracy for the consensus is better than any other one source, such as the current spot rate².

No single FX budget rate methodology is universally superior. The choice should align with a company's broader business strategy and support business objectives through greater planning certainty.

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Implementation considerations

FX budget rates should become an integral part of the FP&A process. They should be selected concurrently as budgets are finalized and be updated at the same cadence. At the high-growth stage in the life cycle, this generally happens once a year or with the next fundraising date in mind. Later-stage companies may have medium-term plans which extend beyond a single fiscal year. Any flexibility to adjust budget rates after they are set should receive the same attention as a change to the underlying cash flow forecasts. Adjusting an FX budget rate is more than just an accounting entry, it constitutes a change to core business projections and associated performance metrics.

Furthermore, the objective around the budget rate must be explicitly defined. Is the objective to achieve or outperform the budget rate? Furthermore, as there is no guarantee of achieving the FX budget rate without a hedging plan in place, it is equally important to establish the amount of underperformance to the budget rate that is deemed acceptable. Bringing clarity paves the way for the development of risk management policy.

If the objective is to meet or stay close to budget rates, companies will hedge with forwards and opt for higher hedge ratios. Layered forward hedge strategies which deploy USD cost averaging techniques are designed to minimize variances to budget rates, whilst retaining flexibility to benefit from favorable FX rate moves. If, however, the treasury function is incentivized to outperform budget rates, this is where option-based hedging strategies are especially appropriate.

Next, if the budget rate choice is an off-market rate, is the budget rate achievable? If the rate is underwater, locking into forwards monetizes that FX loss, but remaining unhedged may exacerbate the loss. In this case, purchased options are ideally suited to offer protection, but also the opportunity to benefit from market recovery. If the FX budget rate is in the money, however, zero-cost option combinations such as collars and participating forwards can be used to monetize the gain and retain the flexibility for further upside potential.

Lastly, the FX budget rate choice should include input from key stakeholders such as management, treasury and the overseas business units, with accountability shared across the organization.

Concluding comments

Implementing an appropriate FX budget rate and hedging strategy into your company's FP&A process can help mitigate FX currency risk, provide more accurate reporting, and establish benchmarks against which to measure performance.

Beyond the strategic elements, we find that global companies can extract tactical value-add from using budget rates when negotiating overseas sales contracts or one-off projects, determining sales organization KPIs, optimizing subsidiary funding and supply chain footprints, and deploying capital overseas.

You want to give careful consideration to your company's stage, risk tolerance, and business objectives and strategy when deploying a budget rates strategy. We view this as a key milestone in treasury and FP&A maturity, reflecting a deliberate decision to separate operating performance from currency fluctuations and bring greater consistency, transparency, and strategic discipline to the planning process.

If you'd like to review your FX risk profile and talk through possible solutions, please reach out to your FX contact or FXRiskAdvisory@firstcitizens.com.

¹According to the Efficient Market Hypothesis, all available information is reflected in the current price, so tomorrow's price is just as likely to go up as it is down. ²See discussion in this First Citizens Bank/SVB white paper: <https://www.svb.com/foreign-exchange-advisory/fx-risk-advisory-for-corporates/the-50-fx-hedge-ratio-a-practical-starting-point/>

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