BIRCHSTONE

How are black swan events impacting business decisions?

Birchstone Markets benchmarking data reveals unique industry insight into influences on finance leaders' decisions and how to future proof risk strategy.

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Introduction

As the incidence of black swan events is on the rise, are economic 'shocks' still coming as a surprise? While the ramifications of each are unique and unpredictable, ultimately the outcomes are all too familiar, and the impact on business just as unprecedented.

What do we mean by a 'black swan event'? In this context, it refers to an extremely rare and unexpected event that has severe and widespread impact on financial markets, businesses or the economy as a whole. Characterised by their unpredictability and significant deviations from standard financial models and expectations, the irony is that they have become all too common.

Except, now, they are a little more probable, more documented and more measurable, and we need to build this expectation into our risk strategy.

What hasn't changed is that these events are difficult, if not impossible to forsee using conventional forecasting methods or historical data analysis.

> **"The Black Swan: The Impact of the Highly Improbable."**

Introduction continued...

They can often occur without warning and catch most market participants off guard.

What has changed is the way that Financial Directors (FDs) can adapt their risk strategy based on a higher likelihood of these events, even if we don't know what they might look like.

> **What hasn't changed is that these events are difficult, if not impossible to foresee...**

It is now essential for FDs to double down on preparation for these unpredictable events, to protect and influence treasury decisions across the board.

Historic examples include the 2008 financial crisis, the dot-com bubble burst in the early 2000s, and the 1987 stock market crash. More recently, we'll focus on the impact of the escalating Ukraine conflict on energy price hikes, the 2022 mini budget, and the supply chain squeezes continuing to hang over most organisations following the Covid-19 pandemic. These events had profound consequences that were difficult to manage and not fully anticipated by most financial experts.

Despite this downbeat opener, there are silver linings to the ominous storm clouds that we have painted. One is the potential held by the combination of people and technology to shape FX risk strategy. Combining industry expertise with peer sentiment, market data, economic patterns and prevailing external influences provides a more accurate market barometer.

Using insight allows us to hedge more effectively and build a robust FX risk plan. It also constructs a better understanding of the business potential and the risk involved.

This report looks at changes in peer sentiment across FX and risk management, the reasons behind those changes, and what that means for future strategy.

> **Without the right risk strategy in place, the impact can be profound...**

Data Background

The insights in this report are derived from surveying over 100 Finance Leaders in the UK in 2022 and 2023. We assess attitudes, behaviours and priorities across these leadership profiles on a continuous basis.

> **The data, built around risk profile, confidence, attitude, and economic outlook, is sourced from a survey developed by experts in financial psychometrics.**

Data Breakdown

Job titles:

CFO, Finance Director, Financial Controller

Industries:

Agriculture, Consumer Goods, Financial Services, Food and Drink, Healthcare, Industrial, Leisure and Hospitality, Power and Utilities, Retail, Support Services, Technology, Media and Telco, Transport.

Company ownership:

PE owned, Listed, Private.

Inflationary pressures and margin squeezes have driven a renewed focus on FX as a main treasury challenge.

Protecting profit margins is paramount, and with inflation rising and interest rates increasing, margins are being squeezed more than ever before. Fluctuations in exchange rates can impact the costs of goods or services, eroding profit margins. An FX strategy can help to safeguard profit margins by managing and reducing currency-related risks.

The Covid-19 pandemic drew even more emphasis on the importance of robust FX strategies. Supply chain disruptions, inventory hangovers and global economic uncertainty had a cascading effect on FX transactions. With significant currency fluctuations, CFOs and FDs had to swiftly reassess and adjust currency exposure.

For example, as we know, geopolitical conflict has a profound effect on foreign exchange markets, with uncertainty leading to heightened volatility and abrupt currency movements. That means that FDs need to be acutely aware of the potential impact for rapid fluctuations in exchange rates during crises.

15%

GROWTH

A stronger focus

FX has become an even stronger focus as a key treasury challenge, seeing a **15% growth** in the last 12 months.

121%

INCREASE

Costly decisions

That's reflected in a **121% increase** Year on Year of FDs who would be very stressed by a costly FX decision.

Business outlook is shaped by boardroom confidence and governance accountability...

Compared to others, how do you rate your willingness to take financial risk?

17%

VERY LOW RISK TAKER

FDs are more risk averse

In these uncertain times, the proportion of FDs who are less willing to take financial risks has grown by 516%, (from 3% in 2022 to 17% in 2023).

How happy are you with your FX strategy?

44%

UNSATISFIED

Between 2022 – 2023

Satisfaction in FX has dropped, with 44% of FDs either unhappy with their FX strategy, or do not have one.

What is your view on the valuation of the Pound in the next 6 months?

30%

POUND WILL DEPRECIATE

In 2023

Over 30% of FDs believe that the pound will depreciate. This is very similar to 2022. This reflects an uncertainty of direction, and that nobody really knows what lies ahead, possibly due to black swan events.

Business outlook is shaped by boardroom confidence and governance accountability...

Regarding your FX management, what, if anything, do you spend the most time thinking about?

35%

GOVERNANCE

Growth in focus on Governance

Governance has risen up the agenda as a key objective for **35% of FDs**, compared to **25%** last year.

What is your business outlook for the next 6 months?

28%

CONCERNED

FDs are concerned

With little change from 2022, this is a large proportion of people who continue to lack a positive view on their business performance.

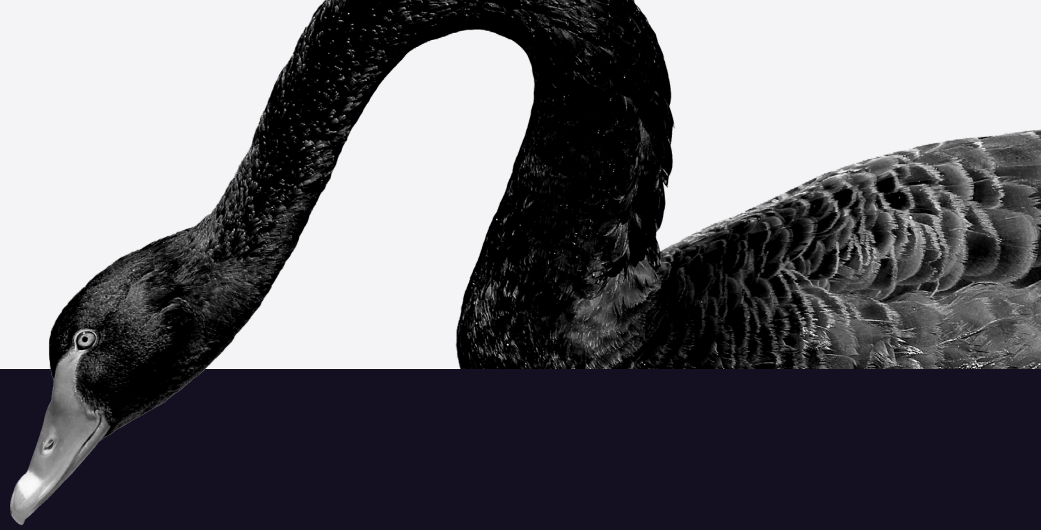
Would you feel confident to explain your FX risk management approach to your stakeholders?

24%

NOT CONFIDENT

Are not confident

In 2023, **24%** of respondents said 'definitely not'. This is a **242%** increase from 2022 where people felt more confident. As the market becomes more uncertain, FDs feel less conviction behind their knowledge and lose confidence.



Importance of a data-driven FX strategy

We work in an environment where currency swings can have profound impacts on financial performance. Being informed and data-led is the bedrock of effective risk management, cost-efficiency and strategic decision making.

> **...A data-driven FX strategy is about more than prudence. It's a strategic imperative...**

It's a vital tool for safeguarding financial stability and capitalising on opportunities in the global marketplace.

Drawing on good quality data allows FDs to make informed decisions on a significant scale.

FX strategy can drive risk mitigation, performance management, strategic planning and competitive advantage.

Any organisation engaging in international business or with exposure to foreign currency risks should be considering an FX strategy.

An effective FX strategy will align with the company's financial goals and risk tolerance while providing a framework for managing currency exposure.

Exchange rates are volatile, and unexpected currency movements can impact the profitability and financial stability of a company.

What is the data telling us?

It’s all about governance

Governance is now a key treasury objective, rising up the agenda by 35% from 2022 - 2023.

The fact that governance is in the spotlight is a direct reaction to those caught short by black swan events. The 2022 Kwasi Kwarteng mini budget had a significant impact on the UK and the global economy. Sterling plummeted to record lows, crashing down to $1.09 for the first time since 1985. A sell-off ensued as frightened investors feared a surge in government borrowing to cover huge tax cuts.

This crash issued a punishing verdict on Kwasi’s ‘dash for growth’, and was deemed a reckless fiscal event. The cost of UK borrowing rose by the most in a single day for over ten years. The investor propensity to fund the UK’s external deficit dissipated with a significant interest rate hike from the Bank of England to regain credibility and stablise the market.

This confidence crisis and currency crash sent shockwaves through the FX market. It highlighted the importance of good governance and having the right structures in place both in general practice and in readiness for black swan events.

Those caught short are now unwilling to leave themselves exposed in the same way again, with Warren Buffet famously saying that ‘it’s only when the tide goes out that you know who is swimming naked’.

Depending on the industry, and geographic scope of operations, some organisations may also be subject to specific regulatory requirements relevant to FX management.

In general, many organisations are held accountable during extreme events and are required to absorb any onward customer impact.

We need to be braver with FX strategy and build credibility in the boardroom.

Between 2022 and 2023, satisfaction in FX strategy is reported to have dropped 42%, showing a lack of confidence and increased concern about FX decisions.

Whereas, 2022 saw reasonable regress of confidence in sound hedging decisions, this comfort level has dropped by almost a third, at 33%.

Building a robust FX strategy can reduce volatility in financial statements, improving the ability for directors to assess a company's underlying financial performance and making evaluation more straightforward for stakeholders, including investors and lenders.

It's also important to be able to manage transaction exposure.

Historically low interest rates meant macroeconomic decisions from the Bank of England, the ECB or the Fed had less impact on currency changes, however, with higher interest rates come bigger currency swings and more focus on the need for long term planning.

FX strategy and risk management can help to manage this exposure by using hedging techniques like forward contracts, options or swaps, and play a much more significant role in the current economic climate. They're also potentially less well understood, putting pressure on performance and fractures in the boardroom.

> **It becomes a vicious circle, with more board level pressure...**

As adverse market conditions squeeze margins and impact on reporting and performance, the cost of operations can sky rocket.

These exchange rates impact the way that we buy and sell internationally, with sharp currency drops eroding purchasing power.

As imports become more expensive, this uptick in costs takes its toll on production expenses and reduces profit margins. That, coupled with supply chain crises, can cause inventory problems for organisations, and in the retail industry, stock-related hangovers, too.

Although not in our period of analysis, the after-effects of Brexit are still being felt, with uncertainties around trade agreements and access to the European Union market. We're in a new and moving regulatory landscape now, where currency trading strategies need to adapt to changing market dynamics.

Conclusion

Birchstone Markets peer data has highlighted a reduced confidence in FX strategy, while the impact of FX decisions is on the rise. The bedrock is good governance to reduce exposure and regulatory issues, mitigate risk and better manage future shocks.

Confidence in FX and transparency of risk exposure can help maximise profits, optimise working capital and ensure financial compliance and stabiliity.

> **...FX is the thread that weaves through an entire organisation's financial operation...**

Good governance in terms of crisis preparedness is crucial for developing contingency plans so that when unexpected shocks such as economic downturns or geopolitical crises occur, these plans come into their own. Governance has an even more important role to play in building long-term resilience, and the focus now should not just be on managing immediate risks. It's a foundational element in an FD's efforts to manage FX exposure, make sound treasury decisions, implement risk management strategies, and reduce the reverberations from significant shocks.

In today's complex and dynamic business environment, a culture of risk awareness, accountability and transparency is essential for financial stability.

At Birchstone Markets, we talk about the ability to 'control the controllables'. FX risk and financial management are inextricably linked to the global economic and geopolitical landscape. Black swan events like Brexit, Covid-19, the Ukraine war and fiscal policy shocks consistently have profound effects on FX transactions, trading and confidence.

FDs need to prepare and develop resilient risk management strategies, stay informed, and diversify their currency exposure. In doing so, they can guide organisations towards stability and success in an increasingly turbulent financial environment.

The only certainty we have going forward, is that these black swan events will continue to emerge and test us. This might seem like a bleak outlook, as these are major challenges faced by FDs and CFOs across industry. We know that the FD profession is no stranger to pressure, but there is no doubt that future-proofing treasury decisions now needs to take a new dimension.

Control the controllables.

In that challenge lies opportunity. There has never been a more important time to make sure that you are working every element of your business as hard as you can, and that includes FX.

James Arnold

CEO & Founder

"Over the last few years, we have seen increasing incidences of tumultuous black swan events, sending reverberations around the global financial system and society as a whole. Even as this level of disruption becomes expected, we never quite know what we're in for. That means that risk strategy is more important than it's ever been, and these periods of intermittent calm are even more dangerous than the events themselves if wasted or not put to good use.

However natural it may be to take solace in the quieter periods, this is the time to take action.

> **Taking advantage of this time and being opportunistic will help you to lay the right foundations to protect against future shocks and build a more robust, competitive approach."**

Jonathan Pryor

Managing Director

"FX often lives in the shadows for corporates, and it's only when you think about these external shocks that you really feel the pain and understand the magnitude of macroeconomic influence on your everyday operations. But, we need to professionalise and educate on this area so that every FD is on top of their FX strategy.

> **It's less about the market-driven event, and more about, as a business, how efficient are you being?**

How professional are you being? Don't wait for something to happen to act - instead, take FX out of the shadows and tackle it head-on. Today's tough environment means that we all need to gain efficiencies and eek out every pound that you can."

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