



Association for
Financial Professionals®



2010 AFP
Financial Risk Survey
Report of Survey Results

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April 2010



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Association for Financial Professionals
4520 East-West Highway, Suite 750
Bethesda, MD 20814
Phone 301.907.2862
Fax 301.907.2864
www.AFPonline.org

2010 AFP Financial Risk Survey

Introduction

Since the economic crisis began in August 2008, financial risk management has become paramount to the success and survivability of organizations across the United States and the rest of the world. The ability to identify, assess, quantify and mitigate financial risks has separated the survivors from the also-rans.

In response to the crisis, regulators and legislators in many countries are examining the role that derivatives played in the crisis—especially over-the-counter (OTC) derivatives—and are considering new regulations to mitigate their risks. Some of the proposed regulations could adversely impact many techniques that companies use to mitigate the risks.

In light of these developments, the Association for Financial Professionals (AFP) conducted its first “Financial Risk Survey” in November 2009 to ascertain: (1) the types of financial risk that organizations faced over the previous twelve months, (2) the instruments that organizations used and are using to mitigate those risks, and (3) why organizations use those instruments. Results of that survey are reflected in this inaugural *2010 AFP Financial Risk Survey* report.

This report shows that interest rate risk and credit risk are the most common financial risks that organizations face. However, for some organizations, market risk, liquidity risk, energy risk, and commodity risk are actually more significant threats than the more common risks from interest rates or credit. Whereas interest rate and credit risk can adversely affect earnings and cash flows—often significantly—even short-term market or liquidity risk can still call into question the financial viability of an organization.

Organizations hedge their financial risks primarily to reduce variability in cash flows and/or earnings and to achieve the lowest cost. The key determinants of which tools organizations use to hedge financial risks are the cost of the transaction and the degree to which an organization’s senior management is familiar or comfortable with the specific hedging instrument.

Both the questionnaire and the final report, along with its contents and conclusions, are the sole responsibility of AFP

Key Results

- Eighty-two percent of organizations report having an exposure to Interest Rate risk.
 - Of those organizations that report such exposure, 31 percent considered it a significant risk.
 - Approximately 45 percent of organizations hedge this exposure each to reduce variability in cash flow and earnings as well as to achieve the lowest cost.
 - Seventy-two percent of organizations use Over-the-Counter (OTC) swaps.
 - Seventy-nine percent of organizations report the cost of the transaction is a factor in determining which hedging instrument they utilize.

- Seventy-two percent of organizations report having an exposure to Credit risk.
 - Of those organizations with this exposure, 38 percent consider it a significant risk.
 - At least 45 percent of organizations hedge this exposure each to reduce variability in cash flow and earnings.
 - Forty-nine percent of organizations use credit insurance.
 - Seventy-two percent of organizations report the cost of the transaction is a factor in determining which hedging instrument they utilize.

- Sixty-four percent of organizations report having an exposure to Liquidity risk.
 - Of those with this exposure, 53 percent of organizations consider it a significant risk.
 - Fifty-seven percent of organizations hedge this exposure to reduce variability in cash flow.

- Fifty-two percent of organizations report having an exposure to Market risk.
 - Of those with this exposure, 64 percent of organizations consider it a significant risk.
 - Sixty-one percent of organizations hedge this exposure to reduce variability in cash flow.

- Fifty-one percent of organizations report having an exposure to Foreign Exchange (FX) risk.
 - Of those with this exposure, 40 percent of organizations consider it a significant risk.
 - Seventy-two percent of organizations hedge this exposure to reduce variability in earnings.
 - Eighty percent of organizations use Over-the-Counter (OTC) forwards.
 - Seventy-two percent of organizations report the cost of the transaction is a factor in determining which hedging instrument they utilize.

Summary Results

The financial risks to which a majority of respondent organizations are exposed include interest rate (82 percent), credit (72 percent), liquidity (64 percent), market (52 percent) and foreign exchange (51 percent). A smaller but still significant percentage of organizations report risk exposure to a series of commodities; including, energy (39 percent), non-agricultural (20 percent) and agricultural (13 percent).

Organization's Exposure to Financial Risks (Percent Distribution)

Interest rate (the risk to earnings or capital due to the movement of interest rates)	82%
Credit (the exposure of a business to losses due to the failure of a counter party to a transaction to pay according to the terms and conditions of a contract or other business arrangement)	72
Liquidity (results from a business's failure to pay its debts and obligations when due as a result of the inability to convert assets into cash or the failure to procure adequate funding to cover those obligations)	64
Market (the exposure of a business to losses or adverse changes in revenue or expenses in revenue due to declines in the value of a security resulting from factors specially related to a particular company or general or industry-specific market factors, such as real or perceived adverse economic conditions)	52
Foreign Exchange (the exposure of a business to losses or adverse changes in revenue or expenses in revenue due to movements in foreign exchange rates)	51
Energy (the exposure of a business to losses or adverse changes in revenue or expenses in revenue due to movements in energy prices)	39
Non-Agricultural Commodities (the exposure of a business to losses or adverse changes in revenue or expenses due to movements in the price of non-agricultural commodities, such as copper, titanium, or rubber)	20
Agricultural Commodities (the exposure of a business to losses or adverse changes in revenue or expenses due to movements in the price of agricultural commodities, such as corn, soybeans, or frozen concentrated orange juice)	13

Interest Rate Risk

Given the volatility of interest rates over the past two and a half years as well as the impact that interest rates have on borrowing and investing, it is not surprising that a large number of respondents cited interest rate as a major risk. As shown in the table above, nearly five out of six financial professionals deem interest rates a major area of financial risk to their organizations. Still, despite the prevalence of interest rate risk, only a third of survey participants consider this risk as having a "significant" impact on their organizations' profitability. Eleven percent of respondents indicate that the risk from their organizations' exposure to interest rate volatility was a "5" ("very significant") on a five-point scale, while 20 percent gave a "4" rating using the same scale. According to 31 percent of respondents, interest rate exposure leads to a more moderate risk to profitability (giving it a "3"

rating), while for 38 percent of organizations, the risk is relatively minimal (a rating of “1” or “2”). Part of the reason why organizations do not view this risk as more significant may be due to the fact that while interest rate risk is rather broad, it is not particularly deep. While almost all organizations have some exposure to interest risks, for the vast majority of borrowers, the financial impact of this exposure is relatively small as a function of their total cost of doing business.

Impact of Interest Rate Risk on Organizations’ Profitability
(Percent Distribution of Organizations with Exposure to Interest Rate Volatility)

Very significant (5)	11%
4	20
3	31
2	30
Not significant (1)	8

When mitigating interest rate risk, organizations primarily focus on reducing the volatility of their cash flow and their profitability. Forty-six percent of organizations that manage interest rate risk do so in order to reduce the variability in their cash flow while 45 percent aim to reduce the variability in their earnings. Forty-five percent manage interest rate risk to achieve the lowest cost.

**Organization’s Primary Risk Management Objectives
When Hedging Against Interest Rate Risk**
(Percent of Organizations with Exposure to Interest Rate Volatility)

Reduce variability in cash flow	46%
Reduce variability in earnings	45
Achieve the lowest cost	45
Perform better than un-hedged position	14
No defined objective	8
Generate trading profits	5
Other	5

The vast majority of organizations that manage their interest rate risk use over-the-counter (OTC) swaps (72 percent). Other instruments used to mitigate interest rate risk include:

- Over-the-counter (OTC) forwards (13 percent)
- Exchange traded futures (ten percent)
- Over-the-counter (OTC) options (eight percent)
- Exchange traded options (seven percent).

Instruments Used for Managing Interest Rate Risk
(Percent of Organizations with Exposure to Interest Rate Volatility)

Over-the-Counter: Swaps	72%
Over-the-Counter: Forwards	13
Exchange Traded: Futures	10
Over-the-Counter: Options	8
Exchange Traded: Options	7
Other	10

Eighty-three percent of organizations apply hedge accounting to over-the-counter swaps that are used to manage interest rate risk. Eighteen percent apply hedge accounting to over-the-counter forwards, while eight percent of organizations do the same to exchange traded futures, exchange traded options and over-the-counter options that they use to manage interest rate risk.

Application of Hedge Accounting when Managing Interest Rate Risk
(Percent of Organizations with Exposure to Interest Rate Volatility)

Over-the-Counter: Swaps	83%
Over-the-Counter: Forwards	18
Exchange Traded: Futures	8
Exchange Traded: Options	8
Over-the-Counter: Options	8

While a number of factors influence the use of particular instruments to mitigate interest rate risk, cost and senior management buy-in are most critical. Nearly four out of five survey respondents indicate that the cost of the transactions was an important factor when selecting the tools used to mitigate interest rate risk. Just short of three-quarters of survey respondents report that the instruments used to mitigate interest rate risk were selected because the senior management of their organization was both familiar and comfortable with the tools. Other factors considered when selecting interest rate risk instruments include:

- Relationship with financial institution (64 percent)
- Impact on credit availability (61 percent)
- The ability to apply hedge accounting treatment to transaction (54 percent).

Important Factors when Selecting Interest Rate Risk Instruments
(Percent of Organizations with Exposure to Interest Rate Volatility)

Cost of the transaction	79%
Senior management familiarity/comfort with instrument	73
Relationship with financial institution	64
Impact on credit availability	61
Ability to apply hedge accounting treatment to transaction	54

Foreign Exchange (FX) Risk

As the financial crisis spread across the globe and many governments responded with a variety of initiatives to stabilize markets and soothe the fears of market participants, major currencies experienced pronounced volatility. Against the backdrop of more recent concerns, including fears about the fiscal crisis in Greece and its impact on the Euro, exposure to foreign exchange risk continues to be an important variable that many organizations must manage.

Just over half of organizations identify foreign exchange risk as a major area of financial risk exposure. Two out of five survey participants indicate that this type of risk has a “significant” impact on their organizations’ profitability. Fourteen percent indicate that the risk from their organizations’ exposure to foreign exchange volatility was a “5” on a five-point scale while 26 percent rated the issue a “4.” Foreign exchange exposure is considered a more moderate risk to profitability (a “3” rating) for 27 percent of organizations, while the risk is relatively minimal (a “1” or “2” rating) for 33 percent of respondents.

Impact of Foreign Exchange Risk on Organizations’ Profitability
(Percent Distribution of Organizations with Exposure to Foreign Exchange Volatility)

Very significant (5)	14%
4	26
3	27
2	26
Not significant (1)	7

When mitigating foreign exchange risk, organizations focus primarily on reducing the volatility on cash flow and profitability resulting from the uncertainty. Seventy-two percent of organizations that manage their foreign exchange risk do so in order to reduce the variability in their cash flow while 60 percent aim to reduce the variability in their earnings. Other objectives are far less important, including:

- Achieving the lowest cost (28 percent)
- Performing better than an un-hedged position (19 percent).

Organization's Primary Risk Management Objective for Foreign Exchange Risk
(Percent of Organizations with Exposure to Foreign Exchange Volatility)

Reduce variability in earnings	72%
Reduce variability in cash flow	60
Achieve the lowest cost	28
Perform better than un-hedged position	19
No defined objective	7
Generate trading profits	1
Other	4

Because the goal of most organizations is to reduce volatility, it is not surprising that over-the-counter forwards are a highly utilized tool. Over-the-counter forwards are the overwhelming choice for organizations that choose to manage their foreign exchange risk (80 percent). Roughly a quarter of organizations also use over-the-counter options (27 percent) as well as over-the-counter swaps (23 percent). Other instruments used to mitigate foreign exchange include:

- Exchange traded futures (12 percent)
- Exchange traded options (three percent).

Instruments Used for Managing Foreign Exchange Risk
(Percent of Organizations with Exposure to Foreign Exchange Volatility)

Over-the-Counter: Forwards	80%
Over-the-Counter: Options	27
Over-the-Counter: Swaps	23
Exchange Traded: Futures	12
Exchange Traded: Options	3
Other	4

Eighty percent of organizations apply hedge accounting to over-the-counter forwards that are used to manage their foreign exchange risk. A third of organizations apply hedge accounting to over-the-counter swaps while 29 percent do the same for over-the-counter options.

Application of Hedge Accounting when Managing Foreign Exchange Risk
(Percent of Organizations with Exposure to Foreign Exchange Volatility)

Over-the-Counter: Forwards	80%
Over-the-Counter: Swaps	33
Over-the-Counter: Options	29
Exchange Traded: Futures	10
Exchange Traded: Options	*

Cost and senior management buy-in are the most critical factors influencing the selection of foreign exchange risk instruments. Seventy-two percent of survey respondents indicate that the cost of the transactions was an important factor when selecting the tools to mitigate foreign exchange risk. Two-thirds of organizations select instruments because their senior management is both familiar and comfortable with the tools. Other factors considered with selecting foreign exchange risk instruments include:

- Relationship with financial institution (56 percent)
- Ability to apply hedge account treatment to transaction (51 percent)
- Impact on credit availability (37 percent).

Important Factors when Selecting Foreign Exchange Risk Instruments
(Percent Rating Very Important/Important)

Cost of the transaction	72%
Senior management familiarity/comfort with instrument	67
Relationship with financial institution	56
Ability to apply hedge accounting treatment to transaction	51
Impact on credit availability	37

Energy Risk

Nearly two out of five organizations responding to the survey are exposed to risk associated with volatile energy prices. For many of them, that exposure has significant implications for profitability. Nearly half of all survey participants indicate that energy risk has a “significant” impact on their organizations’ profitability. Twenty-seven percent of respondents report that the risk from their organizations’ exposure to energy price volatility was a “5” on a five-point scale while 22 percent gave a “4” rating. For 24 percent of survey respondents, energy price risk is a moderate risk to profitability (rating it a “3”), while the risk is relatively minimal (a “1” or “2” rating) for 27 percent of respondents.

Impact of Energy Risk on Organizations' Profitability
(Percent Distribution of Organizations with Exposure to Energy Price Volatility)

Very significant (5)	27%
4	22
3	24
2	22
Not significant (1)	5

Organizations that manage their exposure to energy price risk have three main goals: reducing cash flow variability (62 percent), achieving the lowest cost (58 percent) and reducing the variability in earnings (56 percent). Twenty percent of organizations manage their exposure to energy price risk in order to perform better than if they had an un-hedged position while 12 percent do so in an attempt to generate trading profits.

Organization's Primary Risk Management Objective for Energy Risk
(Percent of Organizations with Exposure to Energy Price Volatility)

Reduce variability in cash flow	62%
Achieve the lowest cost	58
Reduce variability in earnings	56
Perform better than un-hedged position	20
Generate trading profits	12
No defined objective	8
Other	2

Organizations may use a variety of instruments to hedge against energy price risk. Forty-one percent of organizations use physical forwards while 38 percent use inventory builds. The over-the-counter instruments used to manage energy price volatility are:

- Swaps (30 percent)
- Forwards (26 percent)
- Options (22 percent)

Organizations also may use exchange traded instruments to hedge against energy price risk, including:

- Futures (22 percent)
- Options (11 percent).

Instruments Used for Managing Energy Risk
(Percent of Organizations with Exposure to Energy Price Volatility)

Physical forwards	41%
Inventory builds	38
Over-the-Counter: Swaps	30
Over-the-Counter: Forwards	26
Exchange Traded: Futures	22
Over-the-Counter: Options	22
Insurance	13
Exchange Traded: Options	11
Other	11

Forty-two percent of organizations apply hedge accounting to physical forwards that are used to manage energy price risk. Thirty-one percent of organizations apply hedge accounting to over-the-counter forwards while 28 percent do the same for over-the-counter swaps. Organizations use hedge accounting also when using:

- Exchange traded options (22 percent)
- Over-the-counter options (22 percent).

Application of Hedge Accounting when Managing Energy Risk
(Percent of Organizations with Exposure to Energy Price Volatility)

Physical forwards	42%
Over-the-Counter: Forwards	31
Over-the-Counter: Swaps	28
Exchange Traded: Futures	22
Over-the-Counter: Options	22
Exchange Traded: Options	8
Other	*

Cost and senior management familiarity/comfort are the most critical factors influencing the selection of energy price risk instruments. Seventy-six percent of respondents indicate that the cost of the transactions was an important factor when selecting the tools to mitigate energy price risk. Seventy percent of organizations choose particular instruments because their senior management is both familiar and comfortable with the tools. Other factors considered when selecting energy risk instruments are:

- Impact on credit availability (44 percent)
- Ability to apply hedge accounting treatment to transaction (41 percent)
- Relationship with financial institution (39 percent).

Important Factors when Selecting Energy Risk Instruments
(Percent Rating Very Important/Important)

Cost of the transaction	76%
Senior management familiarity/ comfort with instrument	70
Impact on credit availability	44
Ability to apply hedge accounting treatment to transaction	41
Relationship with financial institution	39

Non-Agricultural Commodities

Twenty percent of organizations responding to the survey are exposed to risk associated with non-agricultural commodities, yet this risk tends to have a relatively moderate impact on profitability. Thirty-six percent of organizations with exposure to non-agricultural commodity risk indicate that the uncertainty could have a “significant” impact on their organizations’ profitability. Thirteen percent of respondents indicate that their organizations’ exposure to non-agricultural commodity risk was a “5” on a five-point scale while 23 percent gave a “4” rating using the same scale. For 34 percent of survey respondents, non-agricultural risk could have a moderate impact to profitability (a rating of “3”), while the risk is relatively minimal (a rating of “1” or “2”) for 30 percent of respondents.

Impact of Non-Agricultural Commodity Risk on Organizations’ Profitability
(Percent Distribution of Organizations with Exposure to Non-Agricultural Commodity Volatility)

Very significant (5)	13%
4	23
3	34
2	23
Not significant (1)	7

Organizations manage their non-agricultural commodity risk to reduce uncertainty surrounding earnings and cash flow and to lower expenses. Sixty-three percent of organizations that manage their non-agricultural commodity risk do so in order to reduce variability in earnings while 48 percent do so to reduce unpredictability in cash flow. Forty-eight percent of organizations manage their non-agricultural risk to achieve the lowest cost.

**Organization's Primary Risk Management Objective
for Non-Agricultural Commodity Risk**
(Percent of Organizations with Exposure to Non-Agricultural Commodity Volatility)

Reduce variability in earnings	63%
Reduce variability in cash flow	48
Achieve the lowest cost	48
Perform better than un-hedged position	11
No defined objective	11
Generate trading profits	4
Other	*

More than half of organizations with exposure to non-agricultural commodity risk use inventory builds to mitigate such risk. Other instruments used to manage non-agricultural commodity volatility include:

- Physical forwards (29 percent)
- Over-the-counter forwards (19 percent)
- Over-the-counter swaps (14 percent)
- Over-the-counter options (14 percent)
- Long-term contracts (14 percent).

Instruments Used for Managing Non-Agricultural Commodity Risk
Percent of Organizations with Exposure to Non-Agricultural Commodity Volatility)

Inventory builds	57%
Physical forwards	29
Over-the-Counter: Forwards	19
Over-the-Counter: Swaps	14
Over-the-Counter: Options	14
Long-term contracts	14
Insurance	10
Exchange Traded: Futures	5
Exchange Traded: Options	*
Other	6

Thirty-eight percent of organizations apply hedge accounting to over-the-counter swaps that they use to manage exposure to non-agricultural commodity risk. Thirty-eight percent of organizations also apply hedge accounting to over-the-counter options while 25 percent do the same for over-the-counter forwards.

Application of Hedge Accounting when Managing Non-Agricultural Commodity Risk
Percent of Organizations with Exposure to Non-Agricultural Commodity Volatility)

Over-the-Counter: Swaps	38%
Over-the-Counter: Options	38
Over-the-Counter: Forwards	25
Exchange Traded: Futures	*
Exchange Traded: Options	*
Other	*

Cost and senior management familiarity/comfort are the most critical factors influencing the selection of non-agricultural commodity risk instruments. Seventy-nine percent of survey respondents indicate that the cost of the transactions was an important factor when selecting the tools to mitigate non-agricultural commodity risk while 58 percent of organizations select particular instruments because their senior management is both familiar and comfortable with the tools. Other factors considered with choosing non-agricultural commodity risk instruments include:

- Impact on credit availability (44 percent)
- Ability to apply hedge accounting treatment to the transaction (29 percent)
- Relationship with financial institution (25 percent).

Important Factors when Selecting Non-Agricultural Commodity Risk Instruments
(Percent Rating Very Important/Important)

Cost of the transaction	79%
Senior management familiarity/comfort with instrument	58
Impact on credit availability	44
Ability to apply hedge accounting treatment to transaction	29
Relationship with financial institution	25

Agricultural Commodities

Only 13 percent of organizations responding to the survey are exposed to risk associated with agricultural commodities. But for those organizations exposed to this risk, the impact on profitability can be very significant. Eighty percent of organizations with exposure to agricultural commodity risk indicate that this type of risk has a “significant” impact on their organizations’ profitability. Sixty percent of respondents indicate that the impact from their organizations’ exposure to agricultural commodity risk was a “5” on a five-point scale while 20 percent gave a “4” rating. Only five percent of survey respondents indicate that agricultural risk is a moderate risk to profitability (a “3” rating), while the risk is relatively minimal (a “1” or “2” rating) for 15 percent of respondents.

Impact of Agricultural Commodity Risk on Organizations’ Profitability
(Percent Distribution of Organizations with Exposure to Agricultural Commodity Volatility)

Very significant (5)	60%
4	20
3	5
2	10
Not significant (1)	5

Organizations manage their exposure to agricultural commodity risk to reduce uncertainty surrounding their earnings and cash flow and to lower expenses. Eighty-one percent manage their agricultural commodity risk in order to reduce variability in earnings while 71 percent do so to reduce variability in cash flow. Sixty-seven percent manage their agricultural risk to achieve the lowest cost. A smaller percentage—24 percent—manage their agricultural commodity risk because they believe they can perform better than they would in an un-hedged position.

Organization's Primary Risk Management Objective for Agricultural Commodity Risk
(Percent of Organizations with Exposure to Agricultural Commodity Volatility)

Reduce variability in earnings	81%
Reduce variability in cash flow	71
Achieve the lowest cost	67
Perform better than un-hedged position	24
Generate trading profits	5
No defined objective	*
Other	5

Nearly half of organizations exposed to agricultural commodity risk use physical forwards (47 percent) and inventory builds (47 percent) to mitigate the risk. Other instruments used to mitigate agricultural commodity volatility include:

- Over-the-counter forwards (27 percent)
- Exchange traded futures (26 percent)
- Over-the-counter options (21 percent).

Instruments Used for Managing Agricultural Commodity Risk
(Percent of Organizations with Exposure to Agricultural Commodity Volatility)

Physical forwards	47%
Inventory builds	47
Over-the-Counter: Forwards	27
Exchange Traded: Futures	26
Exchange Traded: Options	21
Over-the-Counter: Options	21
Over-the-Counter: Swaps	11
Insurance	11
Other	5

Fifty-six percent of organizations apply hedge accounting to their use of over-the-counter forwards that they use to manage agricultural commodity risk while 44 percent apply hedge accounting in their use of exchange traded futures. Thirty-three percent of organizations also apply hedge accounting to exchange traded options while 22 percent do the same for over-the-counter swaps.

Application of Hedge Accounting when Managing Agricultural Commodity Risk
(Percent of Organizations with Exposure to Agricultural Commodity Volatility)

Over-the-Counter: Forwards	56%
Exchange Traded: Futures	44
Exchange Traded: Options	33
Over-the-Counter: Swaps	22
Over-the-Counter: Options	33
Other	11

Cost and senior management familiarity/comfort are the most critical factors influencing the selection of agricultural commodity risk instruments. Seventy-eight percent of survey respondents indicate that the cost of the transactions was an important factor when selecting the tools to mitigate their agricultural commodity risk exposures. Fifty-three percent of organizations select particular instruments because their senior management is both familiar and comfortable with the tools. Other factors considered with selecting instruments to mitigate agricultural commodity risk include:

- The ability to apply hedge accounting treatment to transaction (32 percent)
- Relationship with financial institution (32 percent)
- Impact on credit availability (26 percent).

Important Factors when Selecting Agricultural Commodity Risk Instruments
(Percent Rating Very Important/Important)

Cost of the transaction	78%
Senior management familiarity/comfort with instrument	53
Ability to apply hedge accounting treatment to transaction	32
Relationship with financial institution	32
Impact on credit availability	26

Liquidity

Liquidity is to a business what oxygen is to a living organism. Regardless of the overall health or financial well-being of the business, even short periods of disruptions in liquidity can prove fatal. Nearly two-thirds of organizations responding to the survey are exposed to liquidity risk, with more than half of respondents indicating the exposure can have a major impact on profitability. Nineteen percent of respondents indicate that liquidity risk was a “5” on a five-point scale while 34 percent gave a rating of “4.” A quarter of survey respondents indicate that liquidity risk is a moderate risk to profitability (a rating of “3”), while the risk is relatively minimal (a “1” or “2” rating) for 22 percent of respondents.

Impact of Liquidity Risk on Organizations’ Profitability
(Percent Distribution of Organizations with Exposure to Liquidity Risk)

Very significant (5)	19%
4	34
3	25
2	18
Not significant (1)	4

The primary risk objective of organizations that choose to manage their liquidity risk is the desire to reduce the variability in cash flow resulting from that risk. Thirty-one percent of organizations that hedge against liquidity risk do so in order to lower costs while 22 percent hope to reduce the variability in earnings.

Organization’s Primary Risk Management Objective for Liquidity Risk
(Percent of Organizations with Exposure to Liquidity Risk)

Reduce variability in cash flow	57%
Achieve the lowest cost	31
Reduce variability in earnings	22
No defined objective	15
Protect cash position	9
Perform better than un-hedged position	5
Generate trading profits	3
Other	19

The range of responses AFP received concerning the tools to manage liquidity risk was quite broad. The challenge in providing liquidity coverage is that often it is a qualitative rather than a quantitative cost decision. The tools respondents use include:

- High cash balances
- Liquid balance sheet
- Lines of credit
- Pro-active debt management
- Improved cash forecasting
- Diversifying funding sources

Credit Risk

Credit risk has been a broad, catch-all challenge that both organizations and corporate treasury professionals have had to re-assess since the onset of the financial crisis. Whether it is credit extended to an organization, or credit extended by the organization to its customers and/or vendors, the price of credit and the potential for risk has increased dramatically.

More than seven out of ten organizations responding to the survey indicate they have exposure to credit risk. For 38 percent of these organizations, the risk has critical impacts on profitability. Sixteen percent of respondents indicate that the risk associated with credit has a “very significant” (“5” on a five-point scale) impact on profitability while 22 percent gave a rating of “4” using the same scale. Forty-four percent of survey respondents indicate that credit risk is a moderate risk to profitability (a rating of “3”), while the risk is relatively minimal (a rating of “1” or “2”) for 18 percent of respondents.

Impact of Credit Risk on Organizations’ Profitability
(Percent Distribution of Organizations with Exposure to Credit Risk)

Very significant (5)	16%
4	22
3	44
2	15
Not significant (1)	3

The primary objectives of organizations that choose to manage their exposure to credit risk are a reduction in the variability in cash flow (50 percent of organizations) and a reduction in variability in earnings (45 percent). Twenty-six percent of organizations that hedge against credit risk do so in order to lower costs.

Organization's Primary Risk Management Objective for Credit Risk
(Percent of Organizations with Exposure to Credit Risk)

Reduce variability in cash flow	50%
Reduce variability in earnings	45
Achieve the lowest cost	26
No defined objective	15
Perform better than un-hedged position	6
Generate trading profits	3
Other	7

Nearly half of organizations exposed to credit risk use credit insurance to mitigate the risk while 15 percent use over-the-counter swaps.

Instruments Used for Managing Credit Risk
(Percent of Organizations with Exposure to Credit Risk)

Credit Insurance	49%
Over-the-Counter: Swaps	15
Exchange Traded: Options	4
Over-the-Counter: Forwards	4
Over-the-Counter: Options	2
Other	20

Sixty-four percent of organizations apply hedge accounting to their over-the-counter swaps used to manage credit risk while 21 percent use hedge accounting for over-the-counter options.

Application of Hedge Accounting when Managing Credit Risk
(Percent of Organizations with Exposure to Credit Risk)

Over-the-Counter: Swaps	64%
Over-the-Counter: Options	21
Exchange Traded: Options	14
Over-the-Counter: Forwards	14

Cost and senior management familiarity/comfort are the most critical factors influencing the selection of credit risk instruments. Seventy-two percent of respondents indicate that the cost of the transactions was an important factor when selecting the tools to mitigate exposure to credit risk; two-thirds of organizations select particular instruments because their senior management is both familiar and comfortable with the tools. Other factors considered with selecting credit risk instruments are:

- Impact on credit availability (59 percent)
- Relationship with financial institution (50 percent)
- The ability to apply hedge account treatment to transaction (18 percent).

Important Factors when Selecting Credit Risk Instruments
(Percent Rating Very Important/Important)

Cost of the transaction	72%
Senior management familiarity/comfort with instrument	66
Impact on credit availability	59
Relationship with financial institution	50
Ability to apply hedge accounting treatment to transaction	18

Market Risk

Market risk goes to the core of the business. Organizations must monitor the environment, assess threats and opportunities, decide on actions to take, and execute those plans. Market risk is somewhat unique in that it represents an external risk that is difficult at best to predict. Similar to liquidity risk, there are no standard tools available to hedge the risk.

Just over half of survey respondents report that their organization is exposed to market risks. For nearly two-thirds of these organizations, the risks can have a significant impact on their organizations' profitability. Twenty-two percent of respondents indicate that market risk was a "5" on a five-point scale while 42 percent gave a rating of "4" using the same scale. Twenty-one percent of survey respondents indicate that market risk has a moderate impact on profitability (a rating of "3"), while the risk is relatively minimal (a rating of "1" or "2") for 15 percent of respondents.

Impact of Market Risk on Organizations' Profitability
(Percent Distribution of Organizations with Exposure to Market Risk)

Very significant (5)	22%
4	42
3	21
2	10
Not significant (1)	5

A desire to reduce the variability in earnings (61 percent) and cash flow (44 percent) resulting from market risk are the primary objectives of organizations that choose to manage their market risk. Twenty-eight percent of organizations that hedge against market risk do so to lower costs.

Organization's Primary Risk Management Objective for Market Risk
(Percent of Organizations with Exposure to Market Risk)

Reduce variability in earnings	61%
Reduce variability in cash flow	44
Achieve the lowest cost	28
No defined objective	18
Generate trading profits	15
Perform better than un-hedged position	10
Other	8

Similar to liquidity risk, market risk mitigation involves a very broad approach based on the overall strategy of the organization. Some of the thoughts of the respondents included:

- Expand markets, customers, and offerings
- Business market diversification

Impact of Regulation on Decision to Hedge

Fifty-five percent of organizations do not fully mitigate the known financial risks due to hedge accounting concerns. Thirty-five percent of organizations leave up to 20 percent of known financial risks un-hedged as a result of concerns associated with hedge accounting. Nine percent leave between 21 and 40 percent of their known financial risks un-hedged. For some organizations, a large percentage of financial risk is kept un-hedged—11 percent of survey respondents indicate that they knowingly leave at least 41 percent of their financial risks un-hedged because of hedge accounting concerns.

Percent of Unmanaged Financial Risks Due to Hedge Accounting Concerns
(Percent Distribution)

None	45%
0-20%	35
21-40%	9
41-60%	5
61-80%	1
81-100%	5

Most organizations expect to continue using the same hedging instruments—and at the same level—even if they were unable to apply hedge accounting to the transactions. Fourteen percent of organizations anticipate they would “somewhat” reduce their hedging activities while 12 percent expect to “significantly” reduce their hedging activity. Thirteen percent anticipate shifting to alternative instruments should they be unable to apply hedge accounting to the instruments that they currently use.

**Anticipated Impact on Hedging Transactions Should
Organizations Be Unable to Apply Hedge Accounting**
(Percent Distribution)

Organization would continue to hedge at same level and using the same instruments as today	61%
Organization would somewhat reduce hedging activities, leaving the company exposed to somewhat more risk	14
Organization would continue to hedge at same level, but using different instruments	13
Organization would significantly reduce hedging activities, leaving company exposed to significantly more risk	12

Three-quarters of the organizations that use risk management instruments indicate that the tools had neither defaulted nor failed to perform as had been expected. If an organization did suffer from either a default or a less than satisfactory experience, such developments impacted 20 percent or less of the hedging instruments that the organization uses.

**Percentage of Risk Management Instruments
That Defaulted or Otherwise Failed to Perform as Expected**
(Percent Distribution of Organizations that Use Risk Management Instruments)

None	75%
1-20%	18
21-40%	3
41-60%	2
61-80%	2
81-100%	2

Conclusions

Financial risk management has been catapulted to the forefront of importance since the onset of the global financial crisis. The ability to identify, measure and manage the multitude of risks challenging an organization is more critical than ever to an organization's success and survival. Senior management, Boards of Directors, suppliers, analysts, investors, rating agencies, and others are scrutinizing the risk management practices of organizations to identify and manage potential problems before they occur.

Interest rate and credit risk are the most common financial risks facing an organization. While liquidity and market risk are slightly less common, they are actually considered more threatening to corporate profitability. Part of the reason for the higher significance placed on liquidity and market risk may be that there are no easy, off-the-shelf instruments to minimize these risks. Both liquidity and market risk can severely damage an organization, or even destroy it, in ways and with a speed not typically seen with interest rate and credit risk.

While far fewer organizations report that they had an exposure to energy or agricultural commodity risk, those that did report an exposure indicate that these risks represent a significant threat to profitability. In many cases, agricultural commodities and energy are critical components of an organization's products, so changes in the price or availability of such products have a pervasive impact on the business. For those organizations that do have these exposures, effective risk management is critical to their competitiveness and profitability.

Organizations have a multitude of tools from which to choose to manage a number of financial risks. For many types of financial risk, organizations primarily use common financial tools to mitigate those risks. Some of the most common tools include OTC swaps for interest rate, energy and non-agricultural commodities risk, credit insurance for credit risk, or OTC forwards for foreign exchange and agricultural commodities risk. Liquidity and market risk require a more holistic approach to risk management. This approach involves managing the balance sheet of the organization, diversification of business lines, and operating in multiple geographic locations.

The main reasons organizations hedge is to minimize volatility to their earnings and cash flow and to reduce their all-in costs. The instruments organizations utilize are typically determined by the cost savings of the tool as well as senior management's familiarity and comfort with the hedging strategy.

For the most common forms of financial risks, the ability to apply hedge accounting treatment to risk management transactions is an important factor when selecting risk management tools. Concerns about the ability to apply hedge accounting to their risk management transactions has led more than half of all organizations participating in the survey to leave at least some portion of their risks unmanaged, although the magnitude of these unmanaged risks currently appears to be low.

While three quarters of survey respondents indicate that none of the instruments used in their organizations' risk management strategies had defaulted, regulators are actively pursuing reform of the OTC derivatives market due to losses incurred from speculative uses of these tools. Some of these reforms could adversely impact the availability of some instruments, make their use cost prohibitive, or make it difficult or impractical to apply hedge accounting. Due to the importance of applying hedge accounting when selecting risk management instruments, any changes that would likely result in higher levels of risks being retained or left unmanaged are of concern. Nearly 40 percent of respondents indicate that loss of hedge accounting treatment would reduce their risk management activities, exposing their organizations to higher levels of risk.

About the Survey

In November 2009, AFP sent a 43-question survey to corporate practitioner members of the association that asked about the impact of the recession and the uncertainty in the financial markets have on organizations' financial risk management practices. By the end of November, AFP received 226 responses generating a response rate of approximately eight percent (adjusted for undelivered email). The response to the survey is the basis of this report. The tables below summarize the characteristics of the respondents to the survey.

Industry Classification

(Percentage Distribution)

Manufacturing	25%
Banking/Financial services	10
Retail (including wholesale/distribution)	10
Energy (including utilities)	9
Health services	9
Government	6
Software/Technology	6
Business services/Consulting	5
Telecommunications/Media	5
Insurance	4
Non-profit (including education)	4
Real estate	3
Construction	2
Transportation	2
Hospitality/Travel	*

Annual Revenues
(Percentage Distribution)

Under \$50 million	8%
\$50-99.9 million	1
\$100-249.9 million	12
\$250-499.9 million	11
\$500-999.9 million	17
\$1-4.9 billion	31
\$5-9.9 billion	9
\$10-20 billion	7
Over \$20 billion	4

Ownership Type
(Percentage Distribution)

Publicly owned	41%
Privately held	40
Non-profit (non-for-profit)	9
Government (or government owned entity)	10

AFP Research

AFP Research provides financial professionals with proprietary and timely research that drives business performance. The AFP Research team is led by Director of Research, Kevin A. Roth, PhD, who is joined by four research analysts. AFP Research also draws on the knowledge of the Association's members and its subject matter experts in areas that include bank relationship management, risk management, payments, and financial accounting and reporting. Study reports on a variety of topics, including AFP's annual compensation survey, are available online at www.AFPonline.org/research.

**About the Association for Financial Professionals**

The Association for Financial Professionals (AFP) headquartered in Bethesda, Maryland, supports more than 16,000 individual members from a wide range of industries throughout all stages of their careers in various aspects of treasury and financial management. AFP is the preferred resource for financial professionals for continuing education, financial tools and publications, career development, certifications, research, representation to legislators and regulators, and the development of industry standards.

General Inquiries AFP@AFPonline.org

Web Site www.AFPonline.org

Phone 301.907.2862