The London Institute of Banking & Finance

Managing Foreign Currency Risk – the dos and don'ts!

In light of the recent volatility in the foreign exchange markets, this Industry Insight reviews the approaches and mechanisms available for managing foreign currency risk when trading overseas.

The opportunity to trade overseas is appealing to many businesses as they look for growth in new markets and acquire goods and services internationally. However, with this brings variatons in currencies and exchange rate movements which can impact business profits, cash flows, asset values and a competitive position. The recent, well-documented, volatility in the foreign exchange markets is a timely reminder, if it were necessary, of the need for those trading overseas to have a viable strategy in managing foreign exchange exposure. Exchange rate movements will always be unpredictable and the underlying risks have not changed: it is just the situation that is new. This Industry Insight will review the approaches available to ensure the most effective strategy is chosen for managing foreign currency risk and the mechanisms available to support the decision.

Using the euro to illustrate how those risks may manifest themselves in reality, the below graph demonstrates the value of the euro - € - against the British Pound - £ - over the last 12 months.

Frankly it doesn't matter if you are buying or selling foreign currency or domestic currency, there is always currency exchange risk for someone somewhere in the transaction. The drivers behind foreign exchange volatility will be many and often complex. In September 2015, a survey among The London Institute of Banking & Finance's Certificate in International Trade and Finance (CITF®) students found that the key issue they predicted for the next few months was the shrinking economy in China. Add to this the anticipated interest rate changes, economic performance in the EU, USA etc and six months or a year from now, completely different issues may have emerged which is why preparation and knowledge is key.

Let's take an example of a UK exporter selling goods to the Eurozone. The deal is stuck for a regular shipment of goods to say France, with a sale price of £10,000 per month. The time is October 2014. The UK exporter has a good product, well priced and is confident of being able to insist on payment in pounds. The buyer in France is prepared to take the foreign exchange risk as the euro had been relatively stable.

British Pound - Euro Exchange Rate July 2014 – June 2015

Fast-forward to March 2015 and the picture is very different; the euro having lost some 10% in value over the period. But the UK exporter is safe isn't it? Goods have been priced in pounds so there will be no foreign currency loss. This is true, however if the goods were worth importing to France when a euro was worth £0.79, are they still desirable now that the euro has dipped to just £0.70? Are there other manufacturers within the Eurozone that the buyer could switch to? In other words, has the UK exporter just become uncompetitive, not because the product or service has somehow become inferior, but entirely because of external factors?

This example demonstrates the importance and the necessity for every organisation trading internationally to have a strategy for managing foreign exchange and that this is kept under constant review. In a recent survey of

The London Institute of Banking & Finance's CITF® students, reassuringly 75% stated they or their clients had a strategy in place for managing foreign exchange risks, but clearly there is still plenty of room for improvement.

But what are the strategies that could be adopted? There are various tried and tested methods of hedging foreign exchange exposure, but first, thought needs to be given on understanding an organisation's exposure and how to react.

Do Nothing

Having established that risks exist, it may seem a little strange to think that 'Doing Nothing' is any sort of strategy at all. What this does not mean, of course, is that an organisation relies on inertia. As a considered act, provided it is made after carefully weighing up the pros and cons before making a decision to take no action, this is entirely legitimate.

Some of the possible considerations towards taking this strategy are:

- o Transactions are low in both frequency and value so the management time spent in hedging the exposure would be disproportionate to the risks
- o The net margin is sufficiently high to absorb even significant adverse movements
- o Over a period the movements both up and down in the exchange rate is such that the overall effect is neutral

Fix Everything

The philosophy behind the strategy is that organisations make their profit from the underlying transaction rather than by playing in the foreign market. Therefore, the message is to eliminate the foreign exchange exposure and stick to what it is best at.

The risk of adverse movements in the exchange rate therefore no longer exists, but equally in the event that rates move favourably, fixing everything also removes the ability to make an extra turn of profit.

Hedge Part

Essentially this is all about getting certainty for a percentage of an organisation's exposure and 'taking a view' on the balance. For example, the exchange rate could be fixed for individual large transactions whilst the higher volume, lower value transactions could be left to the vagaries of the market.

The important message for any organisation is that if it is exposed to movements in the exchange rate then it needs strategies to manage that exposure. If ultimately it decides to take no action, this must be a conscious decision rather than a glorious accident.

When an organisation is confident with their chosen strategy, it is time to review the mechanisms which can be employed to support the strategy.

Foreign Currency Bank Accounts

These are perfect when there are sales and receipts in the same currency. For example, UK firms that are actively trading with Eurozone countries may use receipts in euro to cover payments to European suppliers. This will avoid, at least in part, exposure in euro whilst at the same time eliminating conversion costs incurred when buying and selling currency. Surplus balances or deficits may be corrected from time to time at the prevailing spot rate.

Currency accounts can also be useful way of hedging exposure even when exposure is limited to either sales or receipts.

Using the UK exporter as an example again, but this time the situation involves frequent sales to the Eurozone but no receipts. The total sales over a three month period amount to €10,000 made up of relatively small amounts to a range of buyers. The UK exporter could borrow €10,000 in anticipation of those receipts and convert at spot to pounds thereby fixing the exchange rate. The company's buyers are then instructed to pay to the euro denominated currency account until the balance is gradually brought back to zero.

All major banks offer bank accounts in a wide range of currencies, but it is worth conducting some research to see which ones will pay interest on credit balances and are competitive on debit interest rates should the need arise.

Forward Exchange Contracts

Once a deal is struck and buyer and seller are committed to a transaction, then the exchange rate may be fixed by entering into a 'forward exchange contract'. For example, if the UK Exporter has sold a piece of machinery for €50,000 payable in six months' time, it may 'lock in' the rate by agreeing to sell the euro to its bank in exchange for pounds sterling. The rate is fixed at the outset so the exporter knows with certainty the amount it will be receiving. The certainty element of this mechanism could be why this option proved to be most popular among

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The London Institute of Banking & Finance's Certificate in International Trade and Finance students, with 49% selecting this as the most efficient way of dealing with foreign exchange volatility.

The contract is binding on both parties so if the euros fail to arrive for whatever reason, then the contract will be closed at the prevailing spot rate with the profit or loss being for the account of the UK exporter. This means whilst the forward contract locks in certainty, it should only be entered into if there is a very high level of confidence that the funds will be received.

Pure Currency Options

For organisations unwilling to lock in to a fixed exchange rate, there are pure currency options. These give the buyer the right, but critically not the obligation, to buy or sell currency at the rate or 'strike price' agreed. Conceptually this is a form of insurance; even the terminology is similar with premiums payable based on the type of currency, amount, and duration of the option.

Buyers of pure currency options may seek to cover at a certain rate of exchange however, as with insurance, the closer the desired rate is to the current spot rate, i.e. the more likely it is that the option will be exercised, then the more expensive the premium will be. In spite of this, if all is required is a 'back stop' i.e. the UK exporter is prepared to risk some loss but not be completely exposed, then the premiums can be relatively modest.

Options are ideal at the tendering stage of a contract where there is still some uncertainty and organisations do not yet have the level of confidence to commit. They are also used to protect against possible adverse movements in exchange rates where there is an expectation that the future movement will be favourable. This way the downside is protected but importantly the 'upside' is left open. If the UK exporter now selling in US Dollars is expecting the dollar to appreciate, it may be time to take out a currency option as protection if the rate moves the wrong way, but take the benefit if the dollar does indeed rise as anticipated.

It is not true to say that the permutations of foreign currency hedging strategies are endless but there are numerous variations available. In the survey, a CITF® student rightfully commented that the chosen strategy should depend on the situation of each company and its needs in a specific period of time; what is suitable for one company may not be the same for another one. Therefore, an individual approach and a separate evaluation for the company's needs of foreign currency should be taken.

In terms of available products, this Industry Insight has focussed on what are rather patronisingly called 'vanilla', but there are plenty of other flavours available too. If in doubt it is worth spending time talking to the experts. However, before making any decisions it is critical to understand what each product actually does and what its costs and risks are.

Finally, once again, organisations need to consider what they are trying to achieve in terms of managing foreign exchange exposure and make arrangements accordingly. Remember 'Doing Nothing' as a strategy is fine but it has to be chosen, rather than by default through inertia.

This Industry Insight has been produced by The London Institute of Banking & Finance, a leading provider of professional and academic qualifications to those aspiring to, or already undertaking, a career within the financial services industry. Formerly The Chartered Institute of Bankers, our roots stretch back to 1879 and we have been at the forefront of providing industry-leading professional education for over 130 years.

The results included in this Industry Insight were taken from a survey of The London Institute of Banking & Finance's Certificate in International Trade & Finance (CITF®) students.