Managing Currency Exchange Risk in International Trade

The Importance of Managing Foreign Exchange Exposure for Companies

To hedge or not to hedge – that is the question

With increasing international trade, currency volatility poses significant risks. The brief advocates for proactive FX risk management, highlighting common strategies such as taking a no action approach to hedging all potential currency exposure.

We look at how firms can address the issues raised and the frequently used market instruments to achieve their objectives, plus practical considerations for finance professionals that manage their firm's treasury functions.

The Importance of Hedging Foreign Exchange (FX) Exposure

If you run a business that trades internationally the issue of Foreign Currency exposure introduces risks that are only fully understood after it's too late to act.

Most finance and treasury professionals are familiar to the concept of managing different business risks using various 'hedging' products.

It is possible to mitigate a variety of undesirable consequences such as interest rate hikes, rising energy prices and legal litigation. Currency is often an afterthought as its often considered a negligible risk, but if circumstances conspire against your firm, it can be far costlier than executives realise.

Exchange rates have always been unpredictable and there are many drivers behind currency market movements, too many to make forecasting rates accurate to any degree.

There has been extreme volatility in currency markets as global supply chain issues related to the Covid pandemic and the War in Ukraine impact

The risks have always been present, but we have lived through a significant uptick in fluctuations recently. Central banks responses to these problems have added to the impact upon currencies and their perceived value relative to each other.

A 2017 UK government study looking at the value of imports into the UK concluded that the market was worth an estimated £270bn a year and was forecast to rise to £400bn + by the year 2030, as we look to an increasingly global market to source the goods and services, we take for granted every day.

Therefore, in today's globalized economy, companies are increasingly exposed to the fluctuations in foreign exchange (FX) rates, of course this issue is not limited to the U.K. Currency volatility can feature in a company's overall financial performance, leading to potential losses or reduced profitability.

To mitigate these risks, it is crucial for businesses to at least consider implementing effective FX hedging strategies. This article explores the reasons why companies should think about hedging their FX exposure and highlights the benefits effective planning can provide.

British Pound - US Dollar | Exchange Rate 2020 to July 2023

Whether you are buying or selling currency, importing, or exporting there is going to be exchange rate risk for someone within the transaction at some point along the way.

Importers

Let's take the example of a U.K. importer paying for goods from the U.S.

The importer agrees to a contract for a shipment of goods worth $1 million USD in November 2022 for delivery 3 months later.

The U.S. supplier expects to be paid in dollars and therefore the U.K. buyer assumes the exchange rate risk for this period.

There was a big drop in the GBPUSD rate in September of that year following a disastrous budget delivered by the then new Prime Minister, media speculation at the time suggested that 1 pound may soon be worth less than 1 dollar, the first-time sterling had fallen close to parity with the dollar since the 80's.

The cost of the USD in pounds sterling at this point is £943,300.

Fast forward to delivery in 3 months and the same $1 million now costs around £800k as the pound's value has rebounded nicely following a period of relative political stability. Nothing else about the deal had changed the U.S. seller had not cut their price, the 143k reduction in cost is down solely to the exchange rate fluctuation.

In this case the deal would have worked out great for the importer but imagine if the situation was reversed and now they were faced with a 143k extra unexpected cost, this may represent the entire profit margin and more on the goods to be sold on in the U.K.

2022 Deloitte Global Treasury Risks report

A 2022 Deloitte report on the subject of global treasury risks surveying 245 large multinational firms found that 23% of respondents had reported back that they had 'inadequate FX skills and knowledge' at management level and 9% of respondents did not actively engage in any proactive approach to managing FX exposure risk at all.

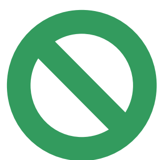
23% had inadequate FX skills and knowledge

Risk reducing strategies

While many firms both large and small have a strategy for managing this risk there is still much that can be improved.

There are various financial instruments that companies can rely on to hedge foreign exchange risk that have been used for decades as growth in international trade has become the norm. The first thing to consider is understanding the organizations FX exposure holistically - determining if it’s actually a matter of concern, and if so to what degree.

Taking no action



Recognizing the presence of risks, it may initially appear counterintuitive to consider "No Action" as a viable strategy. However, it is important to clarify that this approach does not imply relying on inertia or inaction without thoughtful consideration. When a decision is made to refrain from doing something after carefully evaluating the advantages and disadvantages, it can be a legitimate course of action. Several factors that may contribute to a company choosing this strategy include:

The frequency and value of transactions are comparatively low, rendering the time and effort invested in ‘hedging’ the FX exposure disproportionate to the associated risks.

The net profit margin is sufficiently robust to absorb potential adverse fluctuations, even if they are abnormally large due to a significant global event, say another Covid type shock.

Over long periods of time, the fluctuations in the exchange rate exhibit a balanced pattern, resulting in an expected neutral overall impact. It may be that the company also has both overseas customers and suppliers or operates subsidiaries overseas and there is a sort of ‘natural hedge’ that comes into play.

Hedge it all, remove market risk.

The rationale behind this strategy is rooted in the belief that firms generate their profits primarily from the core transactions they engage in,

rather than speculating in the foreign exchange market. Consequently, the emphasis is on eliminating foreign exchange exposure and focusing on what the organization excels at. Senior management can fall into the trap of trying to 'time the market' and therefore may expend unnessasary time and effort into attempting to predict future market moves – (something even professional FX hedge fund managers cannot do very well).

By hedging all risk of unfavourable fluctuations in rates the exposure is effectively mitigated. However, it is important to note that by adopting this approach, the potential for capitalizing on advantageous movements in exchange rates is also relinquished, if everything is fixed - there maybe no opportunity to generate upside gain from a favourable market move.

Partial Hedge, reducing market risk.

Some firms will take a more 'fluid' approach depending upon their own 'market view'.

By analysing currency trends, the firm might decide that it thinks there is a higher probability of a favourable movement and therefore may take a staged approach to hedging risk. In our first example above the U.K. importer could have hedged half their $1m exposure and therefore bought the remaining dollars on the 'spot market' nearer to the time of delivery. Having realised a partial gain, they are also reducing risk and benefiting from a favourable move.

There are endless permutations of this strategy, a company could hedge in any number of trades and any % of its total exposure at any time it likes. It could also reduce its hedged position size, or it could set predetermined limits at which to execute these hedge trades and do so automatically. It really depends upon the management team and their knowledge of the market, the FX exposure they are manging and understanding of all the potential risks involved.

Risks in Hedging products

As with any financial product there is a multitude of risk elements that must be considered, not just the exchange rate risk.

This was evident in 2008 post the Lehman Brothers downfall when a series of banks and other institutional counterparties wobbled and some ultimately failed leaving some customers 'holding the bag'.

There is the potential for human error in calculating and executing transactions as well as technological failures due to rare unforeseen errors and banks using old legacy software. Geopolitics or regulations may also affect a company's ability to make and receive certain payments – for example soon after Russia invaded the Ukraine, banks in many Western countries banned all trade in the Russian Ruble, RUB and Russian banks were denied access to the international SWIFT settlements network for payments.

Is the ultimate trading counterparty offering the risk instruments solid?

What are the commonly used hedging instruments?

Deliverable Forward contracts

Once a firm has some certainty on its currency exposure its possible to fix an exchange rate for future delivery. This instrument is referred to as a 'forward currency contract'.

Like a fixed rate mortgage in principle;

- the buyer agrees to the currency exchange price,
- decides the amount and 'value date' and
- fixes these terms,

Example

A U.K. importer of timber needs 1m Euros to pay a German supplier in 3 months time. They can 'lock in' the current exchange rate by agreeing to enter a forward contract and paying a deposit of around 5-10% of the total contract value.

At expiry of the forward, referred to as 'settlement date' or 'value date' the remainder of the contract value is due in GBP, once these funds are sent the Euros can be delivered to the German supplier at the exchange rate previously agreed.

Benefits

The reason this is a popular instrument among businesses is that is removes the exchange rate risk inherent in international trade and gives the importer in this case certainty over the future cost of its imported goods.

Generally, amendments to forward contracts are possible, changing the settlement date or amount is often a requirement most counterparties can comply with. If in the earlier example the German supplier fails to deliver the timber products the contract can be 'sold back' but this is at the prevailing market rate therefore market risk is a factor if the deal does not proceed. Therefore, these instruments are best used when there is some certainty a currency transaction will be needed.

Limitations

The downside of using forward contracts is the lack of upside potential, should the exchange rate move in the companies favour during the contract term, meaning the firm could buy 1m Euros in 3 months time at a better rate than the fixed exchange level, thus they (or the forward contract seller) won't benefit from this favourable market movement.

Vanilla Currency Options

Currency options are inherently more complicated products. They are only available to clients that classify as 'market professionals'. They offer the right but not the obligation to exchange at an agreed 'strike price' and future date defined at the outset.

Options operate more like an insurance product, in that the client has the choice over whether to 'exercise' (carry out) their right to buy the currency at the option strike price.

The cost of the contract is an upfront payment called the 'premium' and is a cost incurred regardless of the outcome.

Example

Using the same example as above the firm importing timber for delivery in 3 months and needing to buy Euros, can agree a 3-month dated 'call (buy) Euro option contract'.

They pay the premium, the price of which is determined by the strike price chosen (exchange rate), the length of the contract as well as other variables referred to as the 'Greeks'. These are mathematical calculations related to measures of expected market volatility, among other things.

At the 3 months mark the importer can choose to either let the option 'expire' and buy the Euros at the prevailing spot rate – something they would do if the market had moved in their favour. Or they can exercise the option and buy the Euros at the agreed strike price – this would make sense if the market rate had depreciated to such an extent that to buy the Euros at spot would be more expensive for them.

Why would a firm use this instrument?

Simply, the potential for 'upside gain,'. Unlike the forward contract if there is a favourable market move the importer can benefit from this whilst simultaneously limiting the downside FX risk.

The disadvantage with this approach is that it can be comparatively expensive as a 'hedge' due to the upfront cost of the premium payment. Unlike forward contracts you have no flexibility to alter the amount or expiry date*.

(*European style options have fixed expiries)

Foreign Currency Accounts

The ability to hold multiple currencies in online wallets or manage different currency accounts for the same entity at one institution. These become particularly useful in scenarios where a firm's sales and receipts share the same currency.

A U.K. business actively engaged in trade with countries in the Eurozone might utilise Euro receipts to cover payments to European suppliers. This approach helps mitigate exposure to the Euro, while simultaneously eliminating conversion expenses associated with currency transactions. Any excess or shortfall in balances can be periodically adjusted based on the prevailing spot rate.

Foreign Currency accounts also offer a valuable means of hedging future expected FX exposure, even if that exposure is confined to either sales or receipts.

Example

To illustrate using a UK exporter, consider a situation involving frequent sales to the Eurozone but no incoming receipts. Over a three-month period, total sales amount to €250,000, distributed among various buyers in smaller amounts.

In this scenario, the UK exporter could borrow €250,000 in anticipation of those incoming receipts and then convert it to pounds at the current exchange rate. The exporter's buyers would be directed to deposit funds into the euro-denominated currency account until the balance gradually returns to zero.

Benefits

Foreign currency accounts are available to most firms and recent developments mean clients can if required have their own, named multi-currency account with a single IBAN (International bank account number) capable of receiving, sending, and holding different currencies securely.

Other Currency Related Market Instruments

Firms can use a wide variety of other available instruments to help them manage the process of foreign exchange trading and risk. These instruments are often only required where the currency exposure is exceptionally large or complex requiring a bespoke approach. Over recent years FX execution algorithms have become increasingly popular.

These are automated trading tools that look to remove human traders from the equation and are designed to reduce 'market impact' and eke out marginal but significant improvements in the total cost of execution when engaging in large currency deals.

Non deliverable forwards (NDFs) and Currency Swaps are also methods of mitigating exposure related to FX and bespoke currency option contract strategies can be created on demand with an almost endless number of variables tailored to specific clients and situations.

Bottom line

Ultimately, organisations must assess their goals for handling foreign exchange risk and make appropriate arrangements. It's important to note that opting for a "Take no action" approach can be a valid strategy, but it should be a conscious decision rather than a default choice driven by inaction.

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