

A Hedgebook eBook

EFFECTIVE FOREIGN EXCHANGE (FX) RISK MANAGEMENT FOR SMEs UNDER COVID-19



Guidance for exporters and importers
to better manage their FX risk.

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INTRODUCTION

It has become a cliché that the world has changed but there is also no escaping that it has indeed changed. For SMEs the impact has been dramatic, and even more so for those that are exposed to fluctuating exchange risks. Brexit brought its own issues but Covid-19 has doubled down on those companies that buy and sell goods and services overseas. However, even though we haven't seen the world impacted like this in most of our living memory, volatile exchange rates and managing them is nothing new.

Every day SMEs face risks to the profitability of their businesses from moving exchange rates. In fact many exporters and importers cite the volatility in the exchange rate as the main constraint to growing their business. This is not a surprise when you consider the extreme exchange rate fluctuations of all freely-traded currencies that Covid-19 has caused. Yet for many it remains a confusing and complex area where seat-of-the-pants decisions are as common as considered evaluation.

In this eBook we take the mystery out of managing foreign exchange risks and apply historical learnings to managing in the current Covid-19 environment.



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*...foreign
exchange risk is
the likelihood that
a movement in
exchange rates
will result in the
company receiving
a lower amount
of their domestic
currency than
originally planned
or anticipated.*

WHAT IS FOREIGN EXCHANGE (FX) RISK?

Let's start with the basics. For companies that sell their goods and services overseas and get paid in a foreign currency (i.e.. Exporters), foreign exchange risk is the likelihood that a movement in exchange rates will result in the company receiving a lower amount of their domestic currency than originally planned or anticipated. For companies that import and pay foreign suppliers in foreign currency (i.e.. Importers), it is the likelihood that a change in exchange rates will mean the company has to pay more than planned or anticipated.



WHY HEDGE YOUR FX RISK?

Managing a company's FX risk may seem complex, costly or time-consuming. Sometimes it is also perceived to be speculative and therefore a potentially dangerous pastime. However doing nothing can be risky as well, especially if exchange rates move against you.

Companies can reduce their exposure to FX by managing these risks, but can also achieve the following benefits:

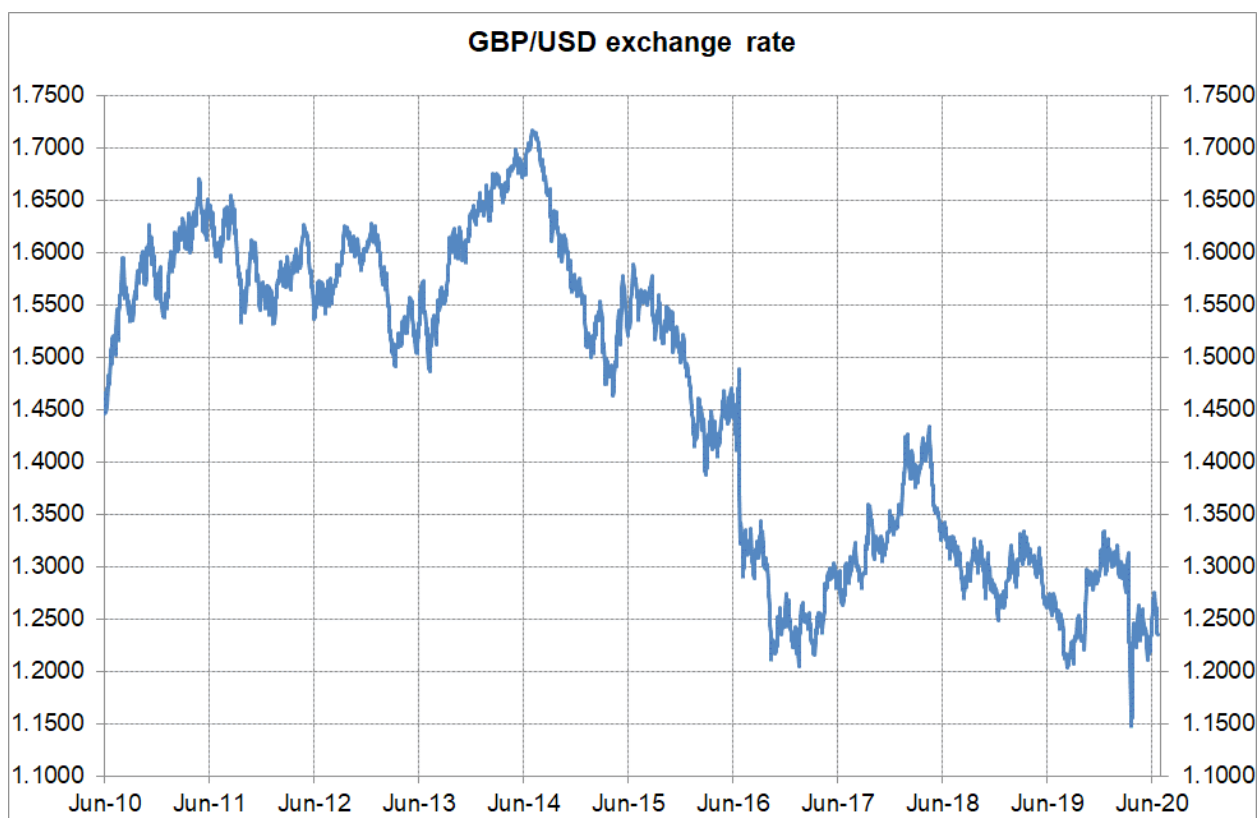
- Minimise the effects of exchange rate movements on profit margins
- Increase the predictability of future cashflows
- Take away the need to try and predict where exchange rates are heading
- Help with the pricing of products sold overseas
- Slow down the effect on a company's competitiveness if the exchange rate moves against you

It makes sense that if risks can be reduced then steps should be taken to protect the company. Often the purpose of hedging FX risk is to smooth the severe upturns and downturns that are seen in the FX markets. Hedging though, doesn't need to be complicated. Understanding the basics is reasonably straightforward and banks, brokers and advisers are on hand if assistance is required.

DRILL DOWN:

DO I REALLY NEED TO HEDGE?

Many importers and exporters, particularly smaller and medium sized ones, do not actively manage their foreign exchange risk. This is risky given the profitability impact an unfavourable move in the currency can have. As the chart shows, large movements in the GBP/USD exchange rate, admittedly one of the more volatile currencies, are commonplace.



These exchange rate fluctuations directly impact the profit margins of companies that export or import. For example, if a UK importer is buying from a US supplier and the goods cost USD 500,000 and has based the price on a GBP/USD exchange rate of 1.3500, then this means the UK importer expects to pay GBP 370,370. If the importer hasn't hedged the risk using FX forwards or options then they are exposed to the movement in the exchange rate. If, at the time it has to make the USD 500,000 payment, the GBP/USD has moved lower to 1.2500, then the importer will have to pay GBP 400,000. This means the UK company is paying GBP 29,630 more than they would have done if they had hedged at 1.3500.

MANAGING YOUR FX RISK

As with most business practices, if you are disciplined about following a process when managing your foreign exchange risks then you can mitigate some of the pitfalls that many exporters and importers fall into.

This simple 6 step process is a logical approach which helps reduce the risks that a more informal approach can bring.



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Be careful that you are clear that the amount you are covering is the foreign amount or the domestic amount. It is easy to be confused on this.

STEP 1 - IDENTIFY THE FX EXPOSURE

This involves identifying and measuring the foreign exchange exposures that you need to manage. For an exporter it will be the expected receipts in a foreign currency for sales you have made. For an importer it will be the payment in a foreign currency for goods or services that you have bought.

You will need to think about the timing of the receipt or payment. What date do I need to hedge to? As an exporter, are you certain that you will receive funds on a certain day, week or month? Often the timing is less certain for an exporter than an importer. For an importer, it may be an invoice that will need to be paid on a certain day, based on the agreed payment terms with the supplier.

Obviously the amount is important. For an importer it is likely you will have certainty over this, especially if it is based on an invoice. For an exporter it is often less certain, so as a general rule it is better to err on the side of caution and cover a lesser amount rather than being over covered. It maybe that you expect to receive £100,000 but you may only cover £80,000 as history shows that some of these receipts do not arrive until the following month. Be careful that you are clear that the amount you are covering is the foreign amount or the domestic amount. It is easy to be confused on this.

Whether you are an importer or an exporter you may have some offsetting risks eg. As an exporter you are receiving regular amounts of foreign currency, but you may also have some payments to make in the same foreign currency. From a risk management point of view it reduces your risk if you can offset these two amounts, the incoming and the outgoing, so that you only hedge the net amount. Again this will depend on the timing of the receipt and the payment.

For an importer you would normally only cover the known amounts you have to pay, unless you are regularly making payments every month. For exporters it is more likely that you will cover not only committed receipts but also you may cover forecasted receipts. This means that you need to have confidence that you will receive ongoing receipts out into the future. Depending on the currency you are dealing with there may be an advantage to hedge further out through the impact of forward points (discussed separately).

DRILL DOWN:

HOW ARE FX FORWARD POINTS CALCULATED?

A common misunderstanding is that FX forward points are based on the market's view on the direction of exchange rates. This is not true. Foreign exchange forward points are the time value adjustment made to the spot rate to reflect a future date. The forward FX market is very deep and liquid and is used by an array of participants for trading and hedging purposes. In the corporate world many importers and exporters hedge future foreign currency commitments or forecasts using forward exchange contracts (FECs).

The table below shows a selection of the forward points and outright rates for a number of currency pairs (June 2020):

	GBP/USD		GBP/EUR		EUR/USD		USD/JPY		GBP/AUD	
Spot		1.2345		1.1045		1.1175		106.8500		1.8080
3 month	6	1.2351	-17.5	1.1028	24	1.1199	-15	106.7000	5	1.8085
6 month	12	1.2357	-35	1.1010	47	1.1222	-31	106.5400	15	1.8095
1 year	25	1.2370	-75	1.0970	99	1.1274	-75	106.1000	48	1.8128
2 year	47	1.2392	-153	1.0892	200	1.1375	-155	105.3000	115	1.8195

Table 1: Forward points and outright rates

For example, the GBP/USD 1-year forward points are +25, while the GBP/USD spot rate is 1.2345. Therefore, a forward rate of $1.2345 + 0.0025 = 1.2370$ can be secured for a commitment or forecast in one year's time.

But how did the GBP/USD 1-year forward points come to be +25?

The common misunderstanding is that they are traded like the spot rate i.e. based on currency traders' views for the outlook of a currency's fundamentals. This is incorrect. FX points are mathematically derived by the prevailing interest rate markets.

Using our example of the GBP/USD 1-year forward points the +25 is a result of the 1-year US and UK interest rate outlook. Often different countries have materially different interest rate differentials (New Zealand has historically been a good example of this), however, in the current environment many countries have dramatically cut interest rates causing FX forward points to be much lower than has historically been the case. The chart below shows the UK interest rate yield curve versus the US and the corresponding FX forward points.

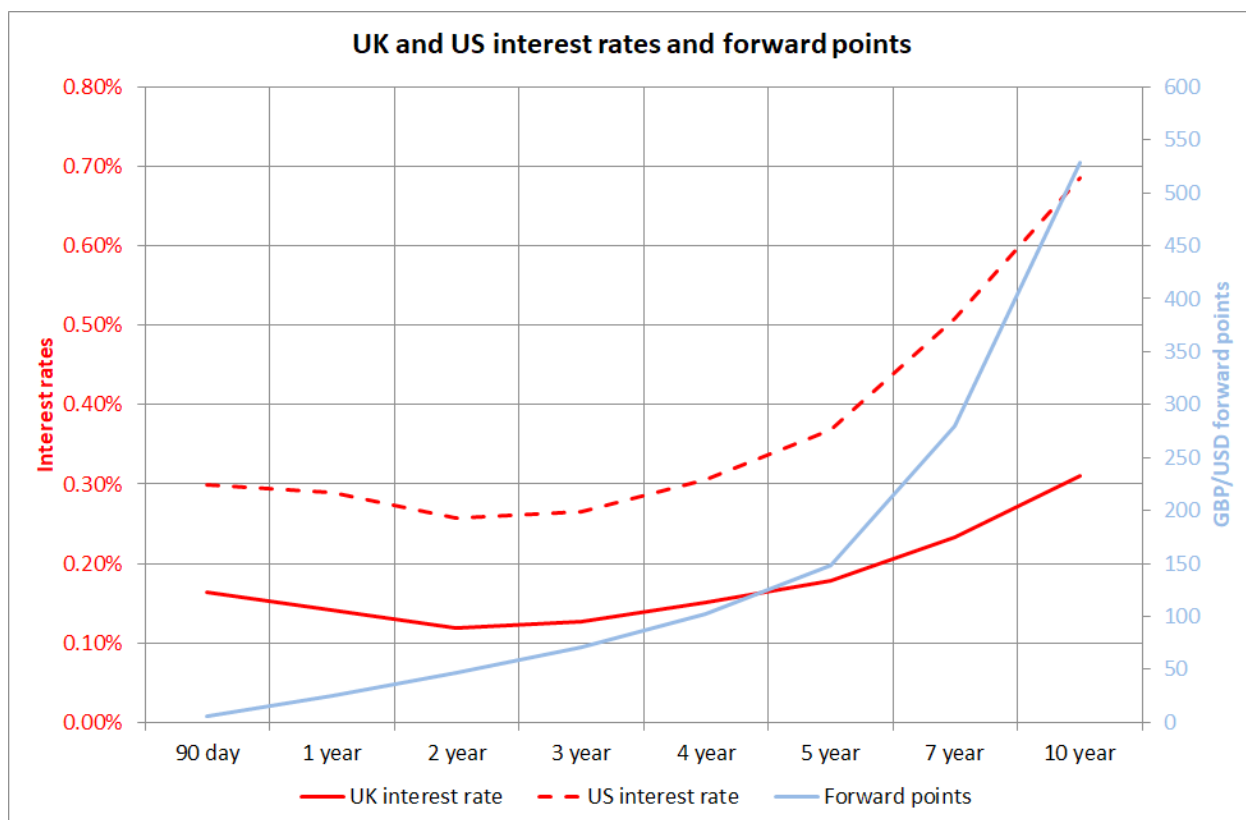


Chart 1: UK and US interest rates and the GBP/USD forward points

The interest rate market is telling us that the US 1-year swap rate is 0.29% while in the UK it is 0.14%. So how does this equate to +25 FX points?

EXAMPLE

USD 1,000,000 at a spot rate of 1.2345 = GBP 810,045

If USD 1,000,000 is invested for one year at a US interest rate of 0.29% per annum, at the end of one year USD 1,000,000 is USD 1,002,893.

If GBP 810,045 is invested for one year at a UK interest rate of 0.14% per annum, at the end of one year GBP 810,045 is GBP 811,192.

The equivalent exchange rate is USD 1,002,893 divided by GBP 811,192 = 1.2363.

$1.2345 - 1.2363 = +0.0018$ (or 18 FX points in the parlance of the FX markets).



The bid/ask spread of the FX and interest rate markets accounts for the 7 FX point balance. The example serves to provide a “back of the envelope” guide to calculating FX forward points and outright rates.

Even though the calculation of the forward points is mathematically derived from the interest rate market, interest rates themselves are the market’s expectation of the outlook for an economy’s fundamentals i.e. subjective. Therefore, the FX forward points are derived from traders positioning on interest rate differentials.

Exporters from countries with higher interest rate environments benefit from the negative forward points, while it is a cost to importers. An exporter wants a weak base currency so large negative forward points are an economic advantage. With an upward sloping interest rate yield curve (or more correctly positive interest rate differential) forward points will be more negative the longer the time horizon.

An importer wants a strong currency therefore negative forward points are detrimental to the hedged conversion rate. The impact of negative forward points is a reason that exporters often have longer term hedging horizons compared to importers because the impact of forward points are not penal.

Forward exchange contracts are therefore a flexible, and relatively easy to understand, hedging tool that is commonly used to bring certainty to those grappling with FX exposures and the volatility of the financial markets.

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For most companies it is important to protect the budget rates that have been agreed prior to the start of the financial year.

STEP 2 - DEVELOP YOUR FX RISK MANAGEMENT POLICY

Once you have identified your FX exposure it is then important to formulate a risk management policy that you follow in a disciplined way. This policy can be developed by yourself or you can use your bank or a treasury adviser/consultant to help you.

Depending on the size of your organisation, normally the board of directors would approve the policy and give senior management the authority to act within it. The only time senior management would go back to the board would be if they wanted to do something that was outside of the policy.

Why your risk management policy might be different to another organisation's is:

- Your risk appetite – are your shareholders/directors risk averse?
- Your competitive situation – do your competitors' hedge?
- Are you an importer or exporter?

The areas that a normal risk management policy will cover off are as follows:

- What are the objectives of the policy?
- What are the Board's and management's responsibilities
- When should the FX exposure be hedged?
- What hedging instruments can be used and under what circumstances?
- How is the performance of the company's hedging measured?
- What are the reporting requirements?

STEP 3 - ASCERTAIN AND MEASURE YOUR BUDGET RATES, COSTING RATES AND OTHER GOALS

For most companies it is important to protect the budget rates that have been agreed prior to the start of the financial year. For importers it may be a costing rate for a particular job or event that is important.

These may well be the underlying reasons to hedge, so that these rates are fully protected. It is important that these rates are identified and measured. Treasury management software today can help track and measure these key rates to make the hedging decision easier.

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You need to have good visibility over your expected cashflows, the hedging you may already have in place and where exchange rates currently are.



STEP 4 - FORMULATE YOUR HEDGING STRATEGY

Having a risk management policy is not enough to ensure success with your FX hedging. You also need to formulate a hedging strategy that works within your policy and gives you the outcomes you desire.

It is vitally important that you have access to accurate information when looking at your strategy. You need to have good visibility over your expected cashflows, the hedging you may already have in place and where exchange rates currently are.

You may require some outside help to formulate your strategy. Again your bank or a treasury adviser/consultant can assist with this in terms of the instruments you should use, the exposures you are hedging and the amount of risk you are prepared to take.

STEP 5 - EXECUTE YOUR HEDGING STRATEGY

Once the hedging strategy has been formulated the next step is to execute. Just as it is important to understand the exposures you are hedging, it is also important that you understand the impact of the hedging you are putting in place. For those using FX forwards this is simpler than if you are also using options as a hedging instrument.

The old saying that if you can't explain to your board the instruments you are entering into and the impact on your FX position then you probably shouldn't be entering into them still stands. Having access to treasury management software that shows the outcomes of the hedging strategy helps with the understanding and with the decision to enter into the strategy or not.

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Within options there are many different types but for small to medium sized importers and exporters most use vanilla or simple option structures.

STEP 6 - EVALUATE THE RESULTS AND ADJUST IF NECESSARY

The final step in the hedging process is to evaluate and measure the results, and if necessary adjust the strategy.

The basis of the evaluation will depend on the overriding reason to hedge. Was it to protect a budget rate, a costing rate or merely to give some certainty of cashflow?

To be able to measure these results you need to be able to accurately track the hedges you have put in place and compare, for example, to the budget rate or the spot rate on the day. This will require the ability to measure the weighted average exchange rate achieved for a particular period and to compare against the yardstick you have chosen. This is possible within a spreadsheet but easier with a system.

WHAT ARE THE FINANCIAL INSTRUMENTS USED TO MANAGE FX RISK?

There are two instruments that are normally used to manage FX risks, FX forwards and FX options. Within options there are many different types but for small to medium sized importers and exporters most use vanilla or simple option structures.

FORWARD CONTRACTS

Forward contracts allow a company to fix the exchange rate at which it will buy or sell an agreed amount of foreign currency in the future. They are the most commonly used FX hedging instrument due to their flexibility, as they can easily match future transaction exposures.

For example, if a UK exporter expects to receive USD 100,000 on 15 September they can lock in a rate today for that date by selling USD 100,000 and buying their own currency. This rate is a combination of the current spot rate (i.e. today's exchange rate) plus or minus an adjustment for forward points to 15 September. The forward point adjustment is explained separately. By entering into the forward contract the company has fixed the rate that the expected receipts will be converted into their domestic currency, no matter if the exchange rate moves up, down or stays the same between now and 15 September.

Forward contracts are easy to use and there is no purchase price – hence their popularity with importers and exporters. However, there is a contractual commitment to deliver to a bank or FX broker a fixed quantity of foreign exchange at a future date. If you can't deliver the funds on the agreed day then the forward can be terminated or extended to a new value date.



FX OPTIONS

FX options are an alternative hedging instrument to forward contracts which give more flexibility and are often used where there is a lower level of certainty in the expected exposures, or if there is a poor track record in the accuracy of forecasts for actual exposures. They do however, come at a cost. This cost may be in the form of paying out money for the purchase of the option or by giving up some potential upside or downside depending on exchange rate movements. The cost is called the premium and is no different from the premium on an insurance policy.

FX options can also be sold however this is widely discouraged for importers and exporters unless they are part of a collar option (see below). When an option is sold the seller receives rather than pays the premium. However this means that the buyer, not the seller, decides whether to exercise the option or not. This does not reduce the risk as it leaves the downside risk completely exposed.

For example, if a UK exporter expects to receive USD 100,000 on 15 September, instead of locking in a fixed rate via a Forward contract, they can enter into an FX option. This gives them the opportunity to achieve a better rate than the forward contract but there is a cost involved, the premium. If the agreed rate (or strike price) on the option is 1.3000, this is the worst case the exporter can expect. If the exchange rate on the maturity date of the option is above 1.3000, this is worse for the exporter, i.e. they will receive less domestic currency, so therefore they will exercise the option. If the exchange rate is below 1.3000, this is better for the exporter, i.e. they will receive more domestic currency, so therefore they won't exercise the option and will enter into a spot transaction at the improved rate.

A variation on the purchased vanilla option is the zero-cost collar option. Many importers and exporters shy away from paying a premium for an option and so an option with no premium is more attractive. A zero-cost collar is when the company simultaneously buys and sells an option with the premium paid for the bought option offsetting the premium received for selling an option.

As you are not paying a premium, you do not get unlimited upside, as you do with an outright bought option, but equally you limit your downside. Effectively you lock in a range of outcomes, a best case whereby the sold option is exercised by the counterparty, a worst case whereby you exercise the option that you have bought, or if the exchange rate is between the ranges neither option is exercised and you are free to do a spot FX deal at the current exchange rate.

There are other option types which can be used by importers and exporters, some of the more common ones are leveraged or ratio options, participating forwards and knock in or knock out options.

It is important that for any hedging instrument used that it is fully understood, and this is even more important for these, more exotic type options.

A leveraged, or ratio option is where the exporter or importer buys one option and sells two, three or more options at the same time. The advantage of doing these types of options is that it improves your best case rate. The disadvantage is that if the sold options are exercised by the counterparty, you may end up with more cover than you originally wanted, at a rate you are no longer happy with. Many companies have got into trouble using leveraged or ratio options however if the ratio is low, i.e. 2 times and the implications are fully understood they do have some merit.

Participating forwards are similar to a ratio option but at a single strike rate. The bought and the sold option have the same strike rate but different notional amounts. The advantage of the participating forward is that the strike or exercise rate is at a better rate than the FX forward that could be done at the same time.

The disadvantage is that you don't know how much cover you will have as you don't know if you will exercise the bought option or the counterparty will exercise the sold amount. It is also more difficult to understand your overall position given the unknown notional amount unless you are using a treasury management system.

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However, in the current environment where working from home is common, having a single source of truth, as opposed to sharing an error ridden spreadsheet is becoming the norm.



SPREADSHEETS OR TREASURY MANAGEMENT SYSTEMS

Many importers and exporters use spreadsheets to manage their foreign exchange risks. This is because most are comfortable using spreadsheets, they are easily available and of course, they are free. Spreadsheets are also very flexible which makes it easy to provide specific board reporting if necessary. However, in the current environment where working from home is common, having a single source of truth, as opposed to sharing an error ridden spreadsheet is becoming the norm.

There are other risks with using spreadsheets and many of these are well documented. Some of the areas to watch out for are:

- **Key man risk** – often spreadsheets are owned by one person and if that person leaves then it can be difficult to understand how that particular spreadsheet works
- **Error prone** – spreadsheets are notoriously error prone as they are difficult to audit. Cells are often copied incorrectly, formulas can be damaged and links can be broken
- **Loss of data** – failure to back up properly and frequently can lead to loss of vital information, as well as wasting valuable time.
- **Lack of control and auditability** – spreadsheets lack the control and checking processes of systems as well being difficult to audit

There are however alternatives to using spreadsheets to manage your FX risks. Treasury management systems which capture FX exposures (expected cashflows) and hedging have been around for many years. However traditionally they have been very expensive (£30,000 plus per year) with sophisticated functionality which is not appropriate for most importers and exporters, especially those in the SME space.

The treasury management system landscape has changed in recent times with the move towards cloud based apps. Now there are online treasury systems which are less than £5,000 per year, and some as little as £2,000 per year, which provide basic deal capture functionality, along with valuations of the FX hedges and analysis tools to help with better decision making.

A key aspect, as outlined above, to FX risk management is having visibility over your exposures (or cashflows) and your hedging. Combine this with the latest exchange rates and treasury systems soon prove their value over spreadsheets, along with covering off some of the key risks.

SUMMARY

Covid-19 has changed the world but the basics of FX risk management in this new world remain the same. FX risk management is not easy, but exchange rate volatility is something importers and exporters learn to live with. The danger is that management of foreign exchange risks becomes based too much on whether you think the currency is going up or down. As we are all aware of, no one knows where the currency is heading. We can have an educated guess but when the profitability, and sometimes the survival, of a company depends on getting it right a practical approach is what is required.

Following some basic rules as outlined above, getting some advice and making sure you have complete visibility over your position will help to smooth out some of the potentially harmful effects of foreign exchange volatility. In most cases good foreign exchange management will buy you some time to adjust your prices, or possibly shield you from the extreme moves that can really harm a business, it doesn't mean taking a view on the currency and putting all your eggs in one basket.

Make informed decisions by having the best possible visibility over your foreign exchange position and you will go a long way to taking some of the stress out of what can be a very stressful element of your business at a very stressful time.



Hedgebook

ABOUT HEDGEBOOK

Hedgebook started in 2011 with a mission to help businesses of all sizes make sense of treasury risk, devise profit-protecting strategies and collaborate more efficiently with their bank and broker via our market-leading SaaS platform.

That mission – informed by the four pillars below – continues to underpin everything we do today.

- Accessible – we make treasury technology accessible and affordable for all companies.
- Intuitive – our tools are easy to use and simplify the management of complex instruments.
- Responsive – we pride ourselves on being open and approachable, and responsive to the needs of our clients.
- Knowledgeable – our deep knowledge and expertise is trusted and relied on by our clients and partners.

Headquartered in the United Kingdom, founded in New Zealand, and with a global client base, Hedgebook delivers for finance professionals. To find out more, contact the author, here

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