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Hedging Risk and Setting Budget Rates

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You can't predict the future. But you can prepare for it

Managing a cross-border business brings with it a range of opportunities for growth, as well as some challenges!

An informed approach to managing global payments and foreign currency exposure—for one payment or thousands—will benefit your business, saving time, protecting your bottom line, and allowing you to take advantage of new opportunities.

The foreign exchange market can feel, well, 'foreign'. What moves markets? Why does one currency weaken and another rise? In the following pages, we'll discuss some of the causes and effects of currency volatility, and strategies for staying on top of your foreign currency exposures and mitigating risk.

What causes market volatility?

In an interconnected, globalized economy, several factors cause fluctuation in the relative value of currencies. Geopolitical and economic shocks, political and social instability, the fundamental health of the underlying economy, interest rates and inflation, and the balance of trade can all cause currency movement. In some cases, even a hint of instability or change in monetary policy can cause volatility.

Types of risk

Depending on your purpose for participating in international trade, you may be subject to different kinds of risk. Here are four types of risk to be aware of as you begin your planning process.

Transactional Risk

This occurs when one is exchanging one currency for another to buy or sell goods and services. This is the most common kind of risk, as a change in the underlying currency rates can impact your cost and your revenues.

Translational (Balance Sheet) Risk

This affects the value of assets and liabilities held abroad. Translational risk can occur when a foreign-denominated investment, loan, or asset needs to be valued in the home currency (the 'functional currency') for reporting or accounting purposes. If the relative value of either currency changes from one reporting period to the next, it can show up on the balance sheet as a loss or gain.

Economic Risk

This is caused by external factors, such as a natural disasters, political shakeups, geopolitical stress, sovereign default, or dramatic changes in a country's monetary policy, and typically affect revenues generated abroad. The ongoing pandemic and the crisis in Ukraine are two recent examples of this kind of risk; both have enormous economic implications.

Operational Risk

This can occur at any point in the accounting process. As a business grows and complexity increases, legacy systems and practices for processing transactions, reconciling invoices, and reporting may not keep up. Efficiency (and profits) can be affected by manual errors and the extra time spent to track and correct them; opportunities for growth or investment may be missed as a result.

Tips on planning

A disciplined financial planning process is both a health-check for your business and the foundation of your overall business strategy. Whatever your objectives are--increasing market share, launching new products, exploring new supply chains or reaching a specific revenue or profit target—the process requires accurate budgeting, careful planning and thoughtful execution.

Many business owners and financial executives periodically take stock of their financial plans, reviewing performance against projections and benchmarks before diving into planning for the future. Most business owners and finance managers undertake these reviews at least annually, while some review quarterly or semi-annually.

There are other occasions when a temperature check might be a good idea. Perhaps you introduced a new product line, expanded to a new market or changes suppliers. If your business goals or the operating environment changes, it's wise to take a step back and review again.

The end of the fiscal year is as good a time as any, so let's dive in.

Here are some questions to address in your evaluation:

Looking back

- Were my projected FX requirements on point? What was different from what I expected?
- Were my margins affected by currency movement?
- How did my budget rate hold up in the market?
- Did I need to reprice my inventory to account for currency volatility?
- What changed in my business during the past year?
- Did I have enough flexibility in my hedging strategy to protect against downside risk, or take advantage of new opportunities?

Looking ahead

- Where am I exposed to currency risk?
- What do I expect will change in my business?
  - In the next three months / six months / twelve months?
  - Am I planning new products? Expanding to new markets? Working with new suppliers?
- What are my volume projections for currencies I will send or receive?
  - How far in advance can I project these volumes?
- Will I need to set varying budget rates across all my inventory, or can I use the same rate for each currency pair?
- Do I have a specific margin I need to achieve?
- How often can I revise my budget level, and how might it affect my pricing and margin?
- How much flexibility do I need to build into my planning?

And most important, what is most important to you?

This is truly the pivotal question as it speaks to your individual business goals:

- Maintaining enough flexibility in my planning to weather uncertainty ahead
- Protecting my margins
- The ability to seize new opportunities as they arise without worrying about currency conversion costs

What would you add to this list?

Setting a budget rate

Some companies make only a handful of global payments each year, and simply pay invoices as they come due. If you have a high volume of payments across multiple currencies, though, setting a budget rate—a benchmark exchange rate between your home currency and your trading currencies—will aid you in your planning.

There is no hard and fast method for setting a budget rate. Some companies use the current spot or forward rate (or a blend of the two). Others may use an average of currency pricing over a given period (for example, the past three months or the past 100 days).

Some companies are able to review and re-set budget rates quarterly; others less frequently.

What you do depends on your company's treasury policy, lessons learned from past experience and your projections for the year ahead.

Factors you may consider are:

- Where your exposures are, and how that is changing
- How often you can review or change your budgeted rate (and your pricing)
- What drives your profits
- And the externalities—the market factors—for each currency pair you are trading

Addressing these questions can provide you more accurate budget figures ,and indicate where you might need protection from currency volatility. It give you a foundation for planning and pricing for the year ahead, and a benchmark against which to evaluate performance.

With your currency pricing levels set, you can manage your exposures by hedging your foreign exchange (FX) risk at those pricing levels, providing you not only with more accurate budget figures, but also with protection from volatility.

Devising a hedging strategy

To many people, ‘hedging’ sounds like gambling. In practice it should be anything but.

Your hedging strategy, aligned to your business goals and risk appetite, would take into account the currency pairs, volumes and the flexibility you require. A portfolio of solutions, utilizing different tools and varying the durations and amounts of the hedge, is an approach that can be adapted to changeable market conditions.

Hedging and risk management tools

In foreign exchange, there is a distinct hierarchy of approaches that, when blended, give you a firm strategic foundation.

Spot Transaction: You need to make a payment for delivery in one to two days’ time, at the prevailing rate of exchange. This is the simplest transaction, most suitable for occasional transactions and when you need to maintain flexibility.

Rate order (Market order): You want to make a payment when a currency reaches a specific rate within a specific time frame. If the currency doesn’t reach the rate within your time frame, you can choose to buy or sell the currency at the prevailing market rate or try again another day.

Outright (Fixed) forward contract: Imagine you expect delivery of goods or equipment in a few months’ time. Rather than purchasing and holding the currency until the payment is due, tying up cash flow, a forward contract locks in the exchange rate for that specific amount of currency for the fixed date in the future. You can use your budgeted rate as the base rate for the payment, adding certainty to your costs. While it may require a small deposit, it frees up cash flow until it’s time to purchase the balance of the currency at that locked-in rate. The duration can range from a few months to up to two years (and in some special cases, even longer).

Please bear in mind that with a forward contract, you are committed to the purchase or sale of the currency whatever the prevailing market rate is on the expiry date.

Flexible forward contract: Locks in the exchange rate for a series of payments over a specified period of time. As with an Outright forward, you are committed to the purchase of the currency at the agreed rate, but you can draw it down at any time over the term.

Currency options and FX structured products: These products give you the right, but not the obligation, to buy or sell currency at a fixed rate at a future date. They protect on the downside, but can also let you take advantage of market movement in your favor.

A premium-structured option offers more upside potential, while a zero- premium option offers less. These approaches are more complex, and are not suitable for every client. Your Account Manager will inform you of the risks and help you determine whether this hedging approach is right for you, and guide you on the structures that can help you achieve your goals.

How we can help

We support our clients by helping to develop solutions to mitigate the impact of volatility on the bottom line, so they can plan more confidently and more effectively.

Our practice is to work alongside a client to understand their business, their challenges, their ambitions and their goals. A transaction analysis, reviewing past trades, can uncover opportunities to increase efficiencies in processes and pricing.

Our process helps clients identify exposures, calculate risk, and devise a tailored strategy.

In many cases, and particularly in volatile markets or uncertain economic environments, we propose a layered approach, blending tools, hedged percentages and contract duration to build in flexibility.

Each business—and each market—is unique: there is no 'one-size-fits-all' solution. Ours is a dynamic and iterative approach: we periodically evaluate performance to ensure our strategy is on track, or to make necessary adjustments, is part of our process.

Moving forward

If recent events have taught us anything, it's this: planning for the future isn't necessarily one-and-done. It's prudent to set a goal, but also to acknowledge that the path won't always be smooth and climate—and direction—could change quickly.

As an example, you may decide to make spot payments until you feel more certain about the direction of your business and the markets, or look at layering short-duration hedges for a portion of your exposures, incorporating more longer-term hedging strategies into your future financial planning at a later date.

The approach you take is ultimately up to you. Nonetheless it's important to take the time to consider how your business could be affected by FX volatility. Even if you decide to change nothing, it is a more informed decision.

It can help to consult a trusted and experienced FX specialist like Corpay. We can be a resource for you for market insight, strategies, and support. With an open conversation and a few data points, we perform a trade audit to find areas to increase efficiency, and a risk analysis so we can develop an approach tailored to your business goals and risk appetite. And there is no obligation: the analysis is complimentary.

Corpay benefits in brief

- Competitive rates of exchange on more than 145 currencies
- In-country delivery of 117 currencies
- Reduced wire fees on global payments
- Access to our secure online trading platform, Corpay Cross-Border, anytime and anywhere
- Proactive strategic support from a dedicated FX strategist
- Multi-currency holding accounts and cross-currency capability; saving time and money
- Favourable deposit terms on hedging products to free up more cashflow
- Free, non-obligatory trading facilities; set up your Corpay account in a matter of hours

For more information about Corpay and our global payments and risk management solutions, and to schedule your complimentary FX risk consultation or online demo, please contact us at Payments.Corpay.com/Contact-Us/Cross-Border.

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