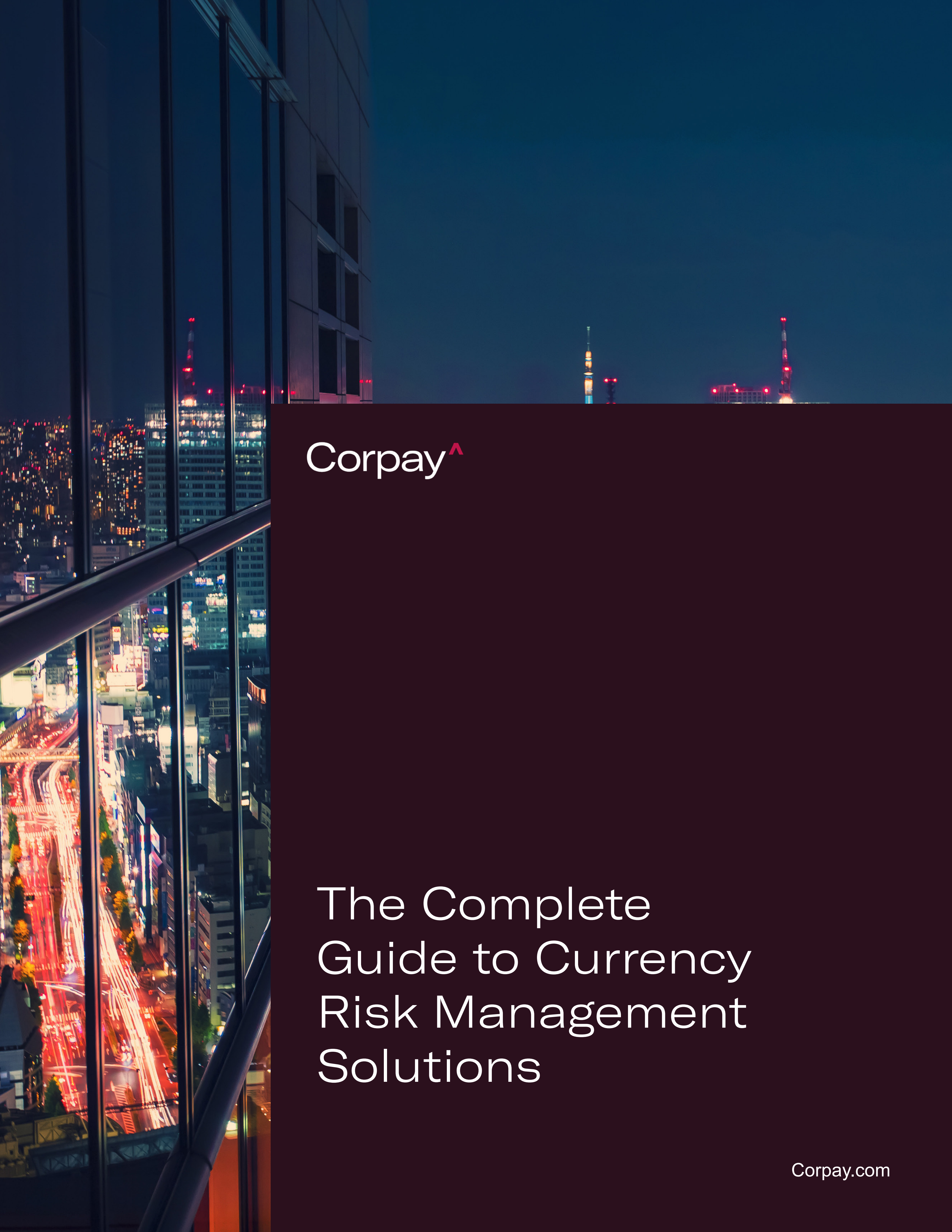

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The Complete Guide to Currency Risk Management Solutions

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Businesses looking to embark on foreign exchange hedging can use this guide to understand their own business requirements, review the different types of FX hedging products available and understand how these products can be used as part of a robust hedging strategy.

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What is FX Hedging

Hedging is used by businesses to manage their currency exposure. If a business needs to buy or sell one currency for another, they are exposed to fluctuations in the foreign exchange market that could affect their costs (or revenues) and ultimately their profit.

By booking a hedge, businesses protect an exchange rate against a specified sum of currency for a desired timescale, providing businesses with certainty.

There are a range of products that can be used for hedging, depending on the businesses objective and the exposure they are trying to protect.

Typically, a business would hedge their foreign exchange (FX) exposure to protect its profit margin from market volatility. Hedging is most common in businesses that have an exposure to a secondary currency and have fixed prices on their products or services.

What are the benefits of foreign exchange hedging?

- Protection from adverse currency market movements
- Easier forecasting – as more certainty over future prices
- Improved customer relations due to consistency in pricing of products and services

What are the risks associated with foreign exchange hedging?

- Fixing the price can be a disadvantage if the exchange rate improves versus the hedged price
- If you are protected at a worse rate than the prevailing market rate your products could end up costing more than your competitors
- Cashflow may be impacted, as you may have to pay deposits or premiums upfront

When implementing a hedging strategy it is important you weigh up the risk versus the rewards and decide whether it's the right thing for your business. Here's a checklist of questions you should ask yourself before you embark.

Currency Hedging Checklist

Here are five questions to ask yourself before you start using hedging to manage your FX risk.

01 What do I hope to achieve from my FX hedging strategy?

As with any strategy you need to have a clearly defined goal. To a certain extent, your goal will help you determine whether to hedge and which may be the most suitable foreign exchange hedging products to meet your needs.

As the currency market has been volatile in recent times, your goal may simply be to protect your business from foreign exchange losses. Adverse currency market movements can have a direct impact on your company's profitability. In this scenario you might consider using a foreign exchange forward contract. This allows you to fix the FX rate for a set time period.

02 What impact would a 10% move in the FX market have on my business?

You may think a 10% currency market move is unlikely but, given the current political and economic environment, we cannot rule it out. Put your foreign currency exposure in the context of your profit margins. If you're an importer or exporter with a profit margin of 10% or less then a swing of this degree could wipe out your profit and may result in you making a loss.

Also consider if you're in a very price competitive commoditised industry. A couple of percent variation in your price due to a 10% move in the currency market may result in competitors taking business from you. In this situation FX hedging may be a good option. It allows you to fix the exchange rate for a set time period and accurately forecast your profitability on future sales over this period.

If you have a much larger profit margin than 10%, you may think you can absorb the losses if the market moves against you and enjoy the gains when the market moves for you. However, even in this situation you may decide to hedge 50% of your exposure when the market is favourable. You then know you have a fixed rate on a share of your currency exposure for times when the market is against you.

03 How easily and quickly can you re-adjust pricing with customers or suppliers?

If your business prices each piece of work individually and the time between quotation and acceptance is relatively short, you're probably less sensitive to currency market movements. In this scenario you may decide to adjust your pricing according to the FX rate when you provide a new quote to customers.

If, however, your pricing is only updated once or twice a year (in a catalogue, for example) you're more at risk from currency market movements.

Many retailers and travel companies fall into this category. If you are an importer or exporter in this situation you may choose to fix the FX rate for the catalogue period in order to protect yourself from any adverse currency market movements.

04 Can I accurately forecast business currency requirements?

Is it possible to accurately forecast how much currency you're going to need to buy or sell over the next one, three, six or twelve months? If you're a well-established business this is much easier as you have historical data to help forecast future requirements.

You may find forecasting more challenging if you have:

- a new business
- just started working with a new overseas distributor
- a new product/service and don't know how well it will sell

Most forward contracts and structured products require you to commit to an agreed sum of currency over a set time period. Therefore, should there be a significant drop in your currency requirement, you are still committed to the contracted amount of currency. Whilst you may be able to sell the contract back to the market, if the contract has devalued you may be liable for any losses.

If there is a level of uncertainty over your requirements you can still protect yourself using foreign exchange hedging products but you may choose to only hedge 50% of your requirements and use the daily currency rate (spot market) for anything else you need. In this way you limit the potential downside if the FX rate moves against you and won't leave yourself over-committed should your situation change.

05 Do I have cashflow that can support my currency hedging requirements?

If your business is tight on cashflow, you may need to think about the following:

- Can I afford to pay a deposit of 5% of the total currency hedged up front? Some providers may ask you for an upfront deposit to secure the currency contract that is returned once the contract has matured. This gives the provider security should you default.
- Can I afford to make further deposit payments if the currency market moves more than 5% against the contract? If the market devalues the contract by more than 5%, some providers may ask for an additional deposit payment, which could be another 5% of the value of the contract. This is often known as a "margin call".
- Will I have the funds available when the contract matures to cover the contract? On maturity you may be obliged to pay the remaining balance of the contract. Therefore, you need to make sure you have the funds available to settle with your provider.

Hedging means you lock in the currency value for the exposure regardless of how the FX market may change in that timeframe.

Before you go ahead and start using foreign exchange hedging products from a third party provider, you may decide to manage the FX risk using internal hedging whereby you adjust your business practices rather than use hedging products or instruments.

Internal Hedging

Examples of internal hedging include:

Invoice in home currency
You may decide to invoice in your home currency to avoid FX risk. However, that can add operational risk. In addition, many customers may prefer to use their own currency so you need to balance both business needs – FX management and a positive customer experience.

Matching:
You try to time your need for currency according to when you are receiving payments in that currency. It's not always easy to predict, however, as payments can be late.

What Are the Different FX Transactions?

Spot transaction

A foreign exchange spot transaction is the quickest foreign exchange transaction, normally settled in two days. Two parties agree to exchange currency at the FX rate at the time of trade, or 'on the spot'. For some businesses this provides a challenge, as they are unable to forecast the exact date they will need to, or be able to settle the contract.

Forward contract

A forward contract is the agreement to exchange one currency for another at an agreed point in the future, known as the maturity date. Foreign exchange forward contracts are normally used to hedge certain foreign currency cash flows (as opposed to uncertain).

Example

ABC Ltd. agrees to buy USD $135,000 from CAD at a rate of 0.7600. The maturity date is set for December 31st 2019. On the maturity date ABC Ltd. sends their counterparty CAD 178,000 and USD $135,000 is sent to ABC Ltd.'s USD account.

Open and Flexible Forwards

Open or flexible forward contracts allow the business to draw currency from the contract at any time they with within a pre-agreed time period.

Example

BC Ltd. agrees to buy USD $135,000 for CAD at a rate of 0.7600. The maturity date is set for December 31st 2019. ABC Ltd. decides to draw down from the contract three times during the contract period USD $35,000, $50,000 and $50,000. Each time ABC Ltd. draws down from the contract they send their counterparty the equivalent value in CAD at the agreed exchange rate and the USD are placed in ABC Ltd.'s USD account. If your business has certainty over future FX exposure but less certainty over timings then this slightly more flexible contract may be a useful part of your hedging strategy.

Vanilla Options: Insurance Contract

A vanilla option gives a business the right (but not the obligation) to exchange one currency with another currency at a pre-agreed exchange rate on a specified date in the future. Foreign exchange options are normally used to hedge uncertain foreign currency cash flows (as opposed to certain). Just like house or car insurance, a premium is payable upfront. Open or flexible forward contracts allow the business to draw currency from the contract at any time they wish within a pre-agreed time period.

Layered Hedge

A layered hedge is where a business will have a number of separate forward contracts in place with different expiration dates to cover a certain percentage (if not all) of their FX risk over a set time period. Businesses may book new contracts every week, month or quarter for a specified expiration date in line with their forecasted or committed exposure.

Here's an example of the duration and level of cover a business may take using layered hedges.

Along with the benefit of offering protection against adverse currency market movements, this strategy ensures a business is constantly monitoring and evaluating its FX risk and FX exposure. In addition, it minimises period-to-period price deviations as the shorter the period between booking hedges, the less likely the volatility from hedge to hedge.

An overview of common FX hedging strategies and how they can be used to achieve different goals:

Forsecast Transactions	*Hedge Ratio
0-3 month	90%
3-6 month	70%
6-12 month	50%
12-18 month	30%

**Hedge ratio: the proportion of a business's foreign exchange exposure that is hedged versus unhedged.*

FX Hedging Strategies

Using market orders for hedging

Businesses often use budgeted rates in order to set pricing and to formulate and monitor their hedging strategy. Sometimes achieving those budgeted rates is reliant on the timing of execution of the currency deal. Due to market volatility, the time a business books a hedge can make a big difference to the rate of exchange due to normal currency market fluctuations. A market order is an agreement to buy or sell currency when a certain rate is achieved. Most business do not have the time or resource to watch the currency market 24/7, so this offers a way of catching peaks or troughs during times of greater currency market volatility such as overnight markets. There are two common types of market order.

- **Limit order:** an order is placed to automatically buy or sell currency when an exchange rate more preferable than the current market rate is reached. This type of order is used if businesses are hoping to optimise a short-term move in their favour.
- **Stop loss:** an order is placed to automatically buy or sell a currency when an exchange rate less favourable than the current market is reached. These are normally used as a way of protecting a business against losses if the currency market moves adversely and provides a security blanket.

Using a combination of a stop loss and limit order ensures the business is always booking currency deals within a pre-defined range of currency rates. If the currency market triggers the limit order, the deal is booked at the best-case rate. If the currency market triggers the stop loss the deal is booked at a worst-case rate.

Mixing hedging products

Some businesses may choose to hedge using a mixture of products to achieve different goals. Here is an example of how this might work:

- **20% spot market:** The business relies on the spot market for 20% of their foreign exchange exposure. This 20% will be booked at the prevailing market rate when required or when the business decides the rate is favourable.
- **40% forward contracts:** The business relies on forward contracts to give them certainty over the FX rate for 40% of their FX exposure. Forward contract could be booked to cover between 1-12 months of their forecasted foreign exchange exposure.
- **40% options products:** The business uses options products for a proportion of their foreign exchange exposure. This may give them guaranteed protection at a known rate whilst offering potential for future rebates.

Book your free hedging consultation today

Within this guide we have taken you through some of the main considerations when hedging. Foreign exchange hedging carries with it risks and we recommend speaking with a specialist or seeking professional advice when undertaking any hedging strategy.

If you would like a free hedging consultation please contact one of our team by visiting us.cambridgefx.com/hedgingguide or email us at InfoFX@Corpay.com.

To learn more, visit
Corpay.com