Identifying and Managing Foreign Exchange Risk

Foreign Exchange Management

Do not enter into this trade unless you fully understand and are willing to assume the risks associated with it. HSBC Bank provides foreign exchange risk management solutions to customers on a strictly non-advised basis.

This document is a presentation for information purposes only and is not a solicitation of a transaction

HSBC

Global Banking and Markets

Identifying the Risk

Businesses that trade internationally or have operations overseas are likely to be exposed to foreign exchange risk arising from volatility in the currency markets.

The most common cause of foreign exchange exposure arises from having to make overseas payments for your imports priced in a foreign currency or receiving foreign currency receipts for your exports. However, exposure can also arise from:

- Foreign currency borrowing/deposits
- Overseas subsidiaries
- Assets located overseas

The impact that exchange rate fluctuations have on profitability will vary but in many cases it can be significant. FX risk is best explained with an example.

Example scenario

The following is a simplified extract from a profit and loss account of a UK exporter that regularly receives revenue in US dollars.

£000s	Converted at FX Rate - £1.00 = $1.60
Sales revenues	1,500
Variable costs	1,200
Gross Profit	300
Fixed Costs	200
Net Profit	100

In this example, the UK exporter received $2.40 million at a GBP/USD exchange rate of £1.00 = $1.60 which was converted into sales revenue worth £1.5 million, all costs are incurred in Sterling.

Consider the impact of, in this case, a c11% adverse movement in the exchange rate to £1.00 = $1.78. After this FX move, the next receipt of $2.4 million will be converted into sales of approximately £1.35 million. This decline in sales revenue puts the company into a loss-making situation.

£000s	Converted at FX Rate - £1.00 = $1.60	Impact at FX Rate - £1.00 = $1.78	Response to FX Rate - £1.00 = $1.78
Sales revenues	1,500	1,350	2,700
Variable costs	1,200	1,200	2,400
Gross Profit	300	150	300
Fixed Costs	200	200	200
Net Profit	100	-50	100

The response column in the table above (3rd column) shows that following an 11% adverse exchange rate movement, all other things unchanged, this company would need to almost double its sales turnover to restore profitability to previous levels!

Effective management of FX risk is therefore crucial but does not need to be unnecessarily complicated. At HSBC, we advocate the use of a simple four-point plan to help you adopt a structured approach.

The Four Point Plan

Point 1 – Understand your exposures

There are numerous factors to take into account when assessing your exposure to foreign exchange rate risk, for example:

- What proportion of your business relates to imports or exports?
- What currencies are involved?
- What are the timings of payments?
- What impact would an adverse rate movement have on your profitability?
- Is the level of overseas business likely to change?
- Do you pay and receive in the same foreign currency – it may be possible to mitigate the exchange risk by using a foreign currency bank account?

Point 2 – Understand the products

There are three alternative methods available to manage foreign exchange risk.

- **Do nothing and buy or sell your currency in the spot market.**
  You act on the day you want to buy or sell your foreign currency. We will quote you an exchange rate and the transaction will settle two working days later. While simple, this approach means you will not know how much Sterling you will need to pay or receive for your foreign currency until the day in question. This can be a high-risk strategy as the exchange rate may have moved significantly since you agreed the price with your customer/supplier. If rates have moved the wrong way, your profit will be reduced accordingly.
- **Lock in to fixed rates**
  As soon as you become aware of a need to exchange foreign exchange at a future date, you can fix the exchange rate by booking a forward exchange contract. This approach provides certainty but you could suffer an opportunity loss if rates subsequently move in your favour and you are obliged to transact at the forward contract rate.
- **Use flexible products**
  Currency options (where available) will offer you the potential for upside benefit if rates move in your favour – like a spot deal, but will provide protection against adverse rate movements – like a forward exchange contract. For this flexibility, we will normally charge a premium although there are a range of alternative structured option products available where an up-front premium is not required.

Point 3 – Develop a strategy

It may not always be best to adopt any one of the three alternatives in isolation to manage your foreign exchange risk. Many businesses, depending on their attitude to risk, view of the currency markets, willingness to pay premiums and a host of other factors, will adopt a portfolio approach and use a combination of spot, forward exchange contracts and currency options (where available). HSBC will work with you to help you understand the products available, allowing you to develop a strategy that best meets the requirements of your business.

For example, in an uncertain exchange rate environment, you may decide to transact 25 per cent. of your currency in spot, fix 25 per cent. with a forward exchange contract and cover 50 per cent. with flexible solutions such as an option. This way, if rates move in your favour, you will benefit on 75 per cent of your exposure (spot and options) while if rates move against you, you are protected on 75 per cent (forward exchange contracts and options). This is a balanced approach that provides flexibility, and avoids you paying a premium for all of your protection.

Point 4 – Implement it

It is often tempting to defer a decision to implement your foreign exchange risk management strategy, perhaps in the hope that rates may move in your favour in the short term. Historically, currency markets have been extremely volatile and unpredictable, therefore once you have formulated a strategy, you may choose to implement it in order to, where possible, protect your profits.

Summary

For many businesses, the impact of exchange rate volatility can be significant. HSBC has a team of specialists available to help you develop an appropriate strategy for your business – please contact your HSBC relationship manager for further details.

Contact point

For further information, please contact your local Global Markets Office.