HOW TO MANAGE FOREIGN EXCHANGE RISK

Tips to manage foreign exchange risk

Foreign exchange risk is the risk that a business's financial performance or position will be affected by fluctuations in exchange rates between currencies. Government policy, changes to supply chain, customer flows and general economic factors are likely to contribute to this risk.

This risk is most acute for businesses that trade in more than one currency, for example an exporter or an importer. However, exposure can also arise for businesses with foreign currency borrowing or deposits, overseas subsidiaries and/or assets located overseas.

Foreign exchange risk should be managed to minimise the impact of fluctuations in exchange rates on your profitability, cash flow, and asset valuations.

Unless you are a foreign currency trader, your foreign exchange risks should be managed in a way that allows you to focus on your business, without exposing it to unnecessary risks. Sound foreign exchange risk management will allow you to prepare more accurate business forecasts and cash flows, enhancing your ability to obtain the financing you need.

The following tips can help you manage foreign exchange risk:

- Develop and maintain a register of foreign currency exposures, and if you have taken measures to reduce that exposure (such as a hedge), record that next to the exposure.
- Where you receive and make payments in a foreign currency, you should do a cash flow forecast in that foreign currency, including focusing on differences in the timing of receipts and payments. Determine how much currency risk is acceptable for your business. Note that not all foreign exchange risks need to be managed and some risks may be offset by other transactions.
- You should test the sensitivity of your cash flow forecasts by estimating your cash flows at different exchange rates. The exchange rates you choose for such sensitivity analysis could be based on an arbitrary guess or the probability of certain exchange rates using historical data. Many bank websites provide forward rate currency forecasts that you could also use.
- Establish foreign currency bank accounts to deposit receipts in a foreign currency and use that account and/or loan facilities in that foreign currency to manage payments in that currency.
- You can also consider negotiating with your suppliers/customers to bring forward or delay payments to limit the impact of adverse exchange rate movements or benefit from favourable ones. If you are dealing with transactions in multiple currencies, you could also time payments and receipts to offset currency positions for currencies that tend to move together. Real time alerts can be set up on a foreign exchange international payments platform to help you manage the timing of payments to suit your foreign exchange rate risk appetite.

- There are a number of products that you can purchase from your bank or financial institution to reduce your exposure to foreign currency risk. The extent to which these products reduce your risk does vary and therefore the cost of such products also varies. To determine which product is right for you, you should understand how each product works, what they cost and determine how much risk you are prepared to take. You could find that a particular product significantly reduces your risk, however, the cost of that product and your risk appetite may lead you to determine that it is not worth it. In such a circumstance, products that give you less protection but cost less may be more suitable.
- The main products available to manage foreign exchange risk are:
    - A forward exchange contract: This enables you to lock in an agreed exchange rate until an agreed date, The downside of a forward contract is that if the exchange rate moves in your favour, you lose that advantage. The cost of the forward exchange contract is built into the exchange rate set in the contract. If you have a range of settlement dates then, you can also consider a window forward contract. Such contracts typically offer more convenient rates but carry a higher price that a standard forward contract.
    - A foreign currency option: Such a product gives you the right, but not the obligation, to purchase or sell foreign currency at an agreed value at an agreed future date. It protects you from unfavourable movements in currency but also enables you to benefit from favourable movements. This is likely to be more expensive than forward exchange contracts and commonly an up-front payment (a premium) is required to purchase the option.
- Managing FX risk requires continual monitoring. Speak to a suitable expert at your bank (who may not be your business banker) about the options available to you to manage your foreign exchange risk

For more information on managing foreign exchange risk including a glossary of terms, see [here.]