

Identifying and managing Foreign Exchange Risk

Identifying the risk

Businesses that trade 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 pay invoices for imported raw materials priced in a foreign currency or receiving foreign currency for your exported finished goods.

The impact that exchange rate fluctuations have on profitability will vary but in many cases it can be significant.

The following is a simplified extract from a profit and loss account of an exporter that receives revenues in a foreign currency. It shows the impact of, in this case a ten per cent local currency appreciation.

Sales down 10% due to local currency appreciation

	BEFORE (AMD)	AFTER (AMD)	RESPONSE
Sales Revenues (in foreign currency)	1500	1350	2700 (+100%)
Variable Costs (in local currency)	1200	1200	2400
Gross Profit	300	150	300
Fixed Costs (in local currency)	200	200	200
Net Profit	100	-50	100

Costs unchanged as incurred in local currency

The table shows that following a ten per cent exchange rate movement, this company will need to double its turnover to restore profitability to previous levels!

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Managing the risk

Managing foreign exchange risk does not have to be complicated. HSBC suggest the use of the following four-point plan:

This simple plan lays the foundations for the management of your foreign exchange exposures:

- ▶ Understand your exposures
- ▶ Understand the products
- ▶ Develop a strategy
- ▶ Implement it

Point 1 - Understand Your Exposures

There are many factors to take into account when assessing your exposure to foreign exchange 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 two basic alternative methods 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 on the deal date. Whilst

simple, this approach means you will not know how much Armenian Dram or foreign currency you will need to pay or receive for your foreign currency or Armenian Dram 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 currency at a future date, you can fix the exchange rate by booking a forward contract. This approach provides certainty but you are not in a position to benefit from any favourable movements in exchange rates between booking the contract and completing the deal.

Point 3 - Develop a Strategy

It may not always be best to adopt any one of the two alternatives in isolation to manage your foreign exchange risk. Many businesses, reflecting their attitude to risk, their view of the currency markets, and other factors, will adopt a portfolio approach - using a combination of spot and forward exchange contracts. HSBC will work with 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 50 per cent of your currency in spot and fix 50 per cent with a forward contract.

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 - it makes sense therefore, once you have

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formulated a strategy, to implement it without delay and ensure your profits are protected.

Summary

For many businesses, the impact of exchange rate volatility can be significant. HSBC has a team of specialists available to advise you on developing an appropriate strategy for your business - please contact HSBC dealing department for further details.