Combating Currency Risk

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For companies who have dealings abroad, managing currency risk is a vital component in controlling liquidity and profitability. Whenever a business enters into an agreement to trade in goods or services priced in a foreign currency, an exposure is immediately created.

The level of currency risk is largely dependant on the length of time before payment is due. For example, if a UK company agrees to buy products priced in Euros, for delivery in three months time, the actual cost (in sterling) will depend on the Sterling/Euro exchange rate when it comes time to pay for the goods.

If the exchange rate was 1.49 when the deal was agreed, but falls to 1.42 by the time payment becomes due, the cost in sterling will be 4.5% higher than originally anticipated.

Similarly, a UK company selling services in the US (and receiving payment in US dollars) may agree a one year contract when the exchange rate is 1.75, but by the time payment is received, the rate may have moved to 1.90. This would result in the sterling amount received being 8.5% below the level anticipated when the contract was agreed. A potentially profitable contract could become a loss maker, simply through adverse currency movement.

If you think the above examples are the exception, it is worth noting that the average GBP/EUR trading range in one year is 7%, and for GBP/USD it is over 12%. For companies dealing in more volatile currencies such as the South African Rand, movements can be in excess of 25% over just a few weeks!

Fortunately, there are a number of strategies that companies can employ to help reduce, or eliminate their currency exposure.

Forward contracts allow you to buy or sell a fixed amount of currency on any date in the future, at a guaranteed exchange rate, with only a small deposit to pay (typically 10%).

The company buying goods priced in Euros can "hedge" their exposure as soon as the contract is agreed. This would involve buying Euros "forward", for delivery in three months (when the Euro payment becomes due), locking in a favorable exchange rate, and removing uncertainty.

In the case of a company selling services priced in US dollars, the appropriate course of action would involve selling US dollars "forward", for settlement in one year (when the US dollar receipt is due). This guarantees the ability to sell the US dollars at the favorable rate of 1.75 in one year, regardless of where the exchange rate is come that time.

Special dealing mechanisms are also available, allowing companies to set target exchange rates, and "worst case" scenarios, depending on market movements. For example, a business that needs to buy US dollars in a few weeks time may want to take advantage of the positive trend, and place a "limit order" at a higher exchange rate than is currently available. Once the market hits this rate, the currency is purchased automatically.

Conversely, a "stop order" can be used to protect against negative currency movements. For example, if the GBP/USD rate is currently 1.90, and the worst acceptable rate for your business is 1.86, a stop order can be triggered if the market falls to this level, in which case currency is purchased automatically. This prevents the client suffering from a sustained fall in the exchange rate. If the market continues to trend higher, the stop order can be moved up, locking in an ever increasing rate of exchange. Stop and Limit orders are usually placed at strategic price levels that can be determined through analysis of recent trends.

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