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HSBC Foreign Exchange Risk Management Solutions

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. However, exposure can also arise from:

- Your competitors having a cost base and/or selling their products in a foreign currency.
- Assets located overseas.
- Foreign currency borrowing or surplus cash balances of overseas subsidiaries.
- Borrowing denominated in foreign currency.

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 10% adverse movement in the exchange rate.

Sales down 10%

	Before	After	Response
Sales	1500	1350	2700 (+100%)
Variable costs	1200	1200	2400
Gross profit	**300**	**150**	**300**
Fixed costs	200	200	200
Net Profit	100	–50	100

The table shows that following a 10% adverse exchange rate movement, **this company will need to double it's turnover to restore profitability to previous levels!**

Effective management of this risk can therefore be critical 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 is a raft of 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 only three basic alternatives for managing 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 2 working days later. Whilst 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 currency 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 – a currency option 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 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.

Part 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, reflecting their attitude to risk, their view of the currency markets, preparedness to pay premiums and a host of other factors, will adopt a portfolio approach – using a combination of spot, forward exchange contracts and currency options, 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 25% of your currency in spot, fix 25% with a forward contract and cover 50% with flexible solutions such as an option. This way, if rates move in your favour, you will benefit on 75% of your exposure (spot and currency options) whilst if rates move against you, you are protected on 75% (forward contracts and currency options). 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 – it makes sense therefore to implement your strategy without delay and ensure your profits are protected.

Next steps

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 your HSBC relationship manager for further details.

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Investments can fluctuate in price or value and prices, values or income may fall against an investor's interests. Changes in rates of exchange and rates of interest may have an adverse effect on the value, price or income of these investments. Past performance is not necessarily a guide to future performance. The levels and bases of taxation can change.

Derivatives can be utilized for the management of investment risk. However, derivative instruments may not be suitable for all investors, as they may be contingent liability transactions. This means that the investor may not only lose all the amount invested, but may also have to pay an additional sum at a later date.

The instruments described in this document may not be suitable for all customers, so therefore please seek advice.

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