A guide to managing currency risk

Nine foreign exchange mistakes your business should avoid

Powering your business.

Money transfer | Currency intelligence

Nine Foreign Exchange Mistakes Your Business Should Avoid

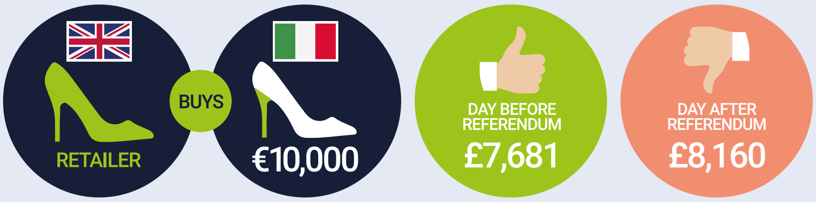
All businesses, large and small, with any exposure to international currencies can find it challenging to manage foreign exchange risk. Smaller businesses, immersed in the day-to-day operations of running their firms and lacking specialist staff, may lack the time and the expertise needed to get a handle on foreign exchange. Larger businesses may have many other priorities that prevent them taking a strategic view of currency risk. While it may be tough to manage foreign exchange, the costs of failing to do so are potentially very high – all the more so given the uncertain times in which we currently live.

Introduction

In the aftermath of the UK's vote to leave the European Union, the value of the pound against the dollar fell **12 per cent** within hours. Three months later the figure had reached **15 per cent***. That can be devastating for a business with FX exposures.

In fact, the world's foreign exchange markets are often volatile and sometimes extremely so. The reaction to Brexit was certainly unusually strong – that **12 per cent one-day drop** is a typical trading range for sterling over a whole year – but far from unprecedented. In 2015, for example, the Swiss Franc rose by 30 per cent against the euro in a single day after the country's central bank changed a key policy.

REFERENDUM IMPACT EXAMPLE:



A British shoe retailer, say, buying €10,000 of Italian shoes one day before the referendum would have paid around £7,681 for its goods; a day later, the bill would have risen to £8,160**

XE supports more than **6,000** businesses a year, all around the world, as they manage their foreign exchange and plan ahead to mitigate the dangers of this kind of volatility. But many more are not confronting this challenge – and making the same mistakes over and over again. In this guide, we set out to identify those mistakes, not least to help more businesses avoid them in the future.

This is not to suggest that all businesses face the same issues. Smaller businesses just getting started with international trade, whether importing or exporting, may be overwhelmed by the decisions they need to make and struggle even with short-term choices. Meanwhile, larger businesses may be more sophisticated, with basic systems in place to manage day-to-day currency transactions, but they often lack a clear idea of the bigger picture, or how to manage risk holistically.

Both types of business are vulnerable to many of the mistakes detailed in this guide. But the biggest mistake of all may be failing to realise that you're not on your own here – for while parts of foreign exchange may be daunting, professional advice and service will help. Some businesses choose to get their support from their banks, but an increasing number are opting to work with specialist advisers such as foreign exchange brokers, which focus purely on currency.

In short, all businesses have an opportunity to learn from their mistakes – and in this bumpy environment, now is the time to do so. This guide can help you start the process.

*Source: Reuters.

**Source: www.bankofengland.co.uk daily spot exchange rates against Sterling: €1.3018 on the 22 June 2016 & €1.2254 on the 24 June 2016.

Content

1

Not knowing whether you're exposed to foreign exchange risk, or how much

Many businesses, particularly at the smaller end, are not aware they have an exposure to foreign exchange risk. Even if they are, they have never quantified the size of the risk they face. If you're in that position, it is more likely that the impact of currency market volatility on your business will come as a nasty shock.

Currency market exposure comes in different forms. Any business selling goods and services overseas will be concerned that a rise in the value of the pound could damage their competitiveness in those markets. Conversely, if you're importing anything from overseas – raw materials, for example – a fall in the value of sterling will make those imports more expensive.

Equally, don't forget balance sheet risk: many UK businesses have international subsidiaries and entities that do their day-to-day business in another currency.
If so, the value of those operations, when accounted for by the UK head office, will be affected by exchange rate movements.

The important principle here is to recognise that a risk exists and then try to assess its potential size. That will require you to make some quantitative assessments, but also some qualitative judgements.

FOR EXAMPLE:

A business that imports €100,000 of European goods each year isn't exposed to €100,000 of currency risk – the pound/euro exchange rate isn't going to fall to zero. In other words, assessing the true value of your exposure going forward will require you to make some estimates of how much volatility in the currency markets is likely – you might do that, for example, by looking at the range in which rates have moved in the past.

Similarly, while those imports potentially present a currency headache, if your business also sells around €100,000 of its output into the single currency area, you already have some protection in place. A fall in the value of sterling would see your import costs increase but could also provide a boost to your export revenues. In other words, you need to focus on your net currency exposure rather than a single element of the risk.

The other factor here is time. How much visibility do you have of your business's costs and revenues going forward? And how far ahead are you able and willing to plan? The further you look ahead, the harder it may be to make accurate assessments.

If you're not sure how to assess currency exposure, quantify the potential risks your business faces, or survey the market outlook for the months ahead, consider reviewing your options with a foreign exchange specialist.

2

Not having a foreign exchange risk management policy

Having quantified its potential currency market exposures, the next step for a business should be to set out a plan for managing this risk. Larger businesses in particular could consider a risk management policy that details the company's approach to foreign exchange risk – this will give you an ongoing framework for managing volatility, so that you don't have to react on an ad hoc basis.

"The nature and detail of your policy will depend on the magnitude of the risk your business faces."

The nature and detail of your policy will depend on the magnitude of the risk your business faces. A company with, say, £1 million turnover is naturally going to be much more concerned about a potential £200,000 net foreign exchange exposure than a business with the same risk but £10 million of sales. In other words, context is important here.

Nevertheless, all risk management policies should cover some basics. They will set out parameters detailing how much foreign exchange risk the business is prepared to accept and over what time periods. They will detail the tools that the company is prepared to use in order to mitigate these risks. They will also specify who at the business is authorised to make decisions.

The aim should be to develop a robust process for managing currency risk on an ongoing basis, in a format that can be shared amongst a group of people rather than devolving all responsibility to a single person. This needs to be a collective policy, widely understood, that the company can apply at all times and that is not abandoned because a key person leaves or is off sick.

Your foreign exchange risk management policy also needs to be updated regularly – at least once a year, say. Inevitably, your business will evolve over time, as may the nature of the risks it faces. As your exposure to particular overseas markets rises or falls, or as the outlook for currency markets changes, so your policy needs to be adjusted accordingly.

But be careful to make strategic planning decisions, rather than falling into the trap of attempting to respond tactically to day-to-day developments.

"Many businesses are not aware they have an exposure to foreign exchange risk. If you're in that position, it is more than likely that the impact of currency market volatility on your business may come as a nasty shock."

Any business that isn't sure how to develop a risk management policy, or what might be appropriate for such a document, should review options with a foreign exchange specialist.

3

Focusing only on the rate

For any business that needs to choose a foreign exchange service, for day-to-day transactions or for more strategic planning over time, the exchange rates it offers are the obvious place to look. Why wouldn't you choose the provider that offers the best possible rate for your money?

The answer is that while rate is important, it's not the only factor that will have an impact on your business's exposure to currency risk. Moreover, businesses that spend all their time focused narrowly on watching rates may miss the bigger picture.

Start from the healthily sceptical view that if something is too good to be true, it almost certainly is. In other words, if you're offered a stand-out exchange rate by a provider, are you missing out on something else? That might be the level of service your business requires, for example, or basic support services – how quickly will your provider intervene if a payment goes wrong, say for example?

"Businesses that spend all their time focused narrowly on watching rates may miss the bigger picture."

It's also important to understand that rate comparisons can be misleading. Foreign exchange markets move so quickly that unless you're comparing rates at a given moment, you may not be comparing like with like. A provider that looks competitive now compared to the rate you were offered by one of its rivals two hours ago may not really be so attractive.

It certainly makes sense to shop around – too many businesses accept the sub-standard services offered by their FX provider just because they've never looked elsewhere – but do so on the basis of value rather than price. What do you need from your foreign exchange service in addition to competitive rates? Are the rates quoted open and transparent so that you always have a clear view of what you're paying, after charges?

In practice, foreign exchange providers offer all sorts of additional value. You may need, say, an online service tailored to your business's specific needs, with authorisation from different people for different types of transaction. You may need the fastest possible service to ensure your payment windows are longer.

Equally, foreign exchange services can watch the currency markets for you. If your business is pre-occupied with trying to time its foreign exchange transactions to get the best rate possible, look for a service that offers rate alerts – notification that the rate has hit a particular level – or market orders – where your transaction automatically goes in at that price.

4

Not understanding the breadth of products available to your business

Many businesses aren't aware of the full range of foreign exchange risk management options. They may think, for example, that any strategy other than buying the required currencies at today's rates – the spot price – is getting into the realms of currency market speculation.

> **"The idea of currency hedging is not to second-guess how foreign exchange markets might move in the days and weeks ahead; rather, the aim is to insure the business against the possibility of adverse movements."**

Hedging, in particular, is widely misunderstood – and therefore rejected. The idea of currency hedging is not to second-guess how foreign exchange markets might move in the days and weeks ahead; rather, the aim is to insure the business against the possibility of adverse movements.

There are a variety of foreign exchange tools you can use to do exactly that, but consider forward contracts as one example. With these transactions, you're simply arranging to buy a certain amount of currency at a set price in the future. So, for example, a chain of grocers might be due to pay a €10,000 bill to overseas suppliers in a month's time. A forward contract specifying today what it will pay in sterling for that €10,000 eliminates the risk that the pound falls in value over the next few weeks so that the grocer has to pay more than expected. This isn't currency speculation or an attempt to second-guess the markets – it's an insurance policy.

It may be, of course, that hedging proves to have been unnecessary. In our example, if sterling doesn't fall against the euro, or even rises, the grocer might feel it was a mistake to lock into a set rate in advance. But that would be to fall back into a mindset of seeing hedging as speculation rather than an insurance policy. You don't, for example, rue having paid for home insurance when you get to the end of the year without your house having burned down.

This is not to suggest that hedging is the right strategy for all businesses – some may take the view that the size of their currency exposure doesn't require this sort of insurance. Even so, don't assume that a foreign exchange provider can't do more to help your business with its currency needs.

5

Getting overwhelmed by complex administration

For businesses with regular foreign exchange needs, it's all too easy for the daily detail of handling payments and other transactions to obscure the bigger picture. You may be so busy processing foreign exchange that you can't take a more strategic view of the business's overall exposure; or your problem may be that such transactions are taking up time that would be more productively spent on other issues. It may even be that manual data entry processes are vulnerable to human error, causing you unnecessary delay.

"It's all too easy for the daily detail of handling payments and other transactions to obscure the bigger picture."

This can often be a particular issue for growing SMEs, where the business owner or founder naturally wants to continue to monitor overseas payments carefully but no longer has time to deal with the mounting administrative burden. They need to retain responsibility for authorising payments – particularly for larger sums – but they don't have time to do all of the processing.

Your currency exchange provider should be able to help you solve this problem. For example, it should be able to create a system that grants some users administrator rights – to do the processing work – while reserving payment authority for specific individuals. They should be able to offer straight-forward processing that is secure and reliable. And they should be able to help you trace delayed payments.

If you don't have access to these sort of services, managing foreign exchange can rapidly become a time-consuming and expensive task for your business. It therefore becomes even more difficult to take a strategic view of your activities in order to manage risk, enable proactive decision-making and plan ahead. Larger organisations can be especially vulnerable to this mistake.

However, businesses that have never looked beyond their current provider for foreign exchange, or shopped around for an alternative partner, may not even be aware that there are other options. If you're getting bogged down in the detail of currency transactions, talk to alternative providers about how they might help you function more effectively.

6

Not having a handle on compliance

Regulatory compliance should be an absolute priority for any organisation involved in currency transactions with overseas customers and suppliers. You will need robust processes in place to generate the information your foreign exchange providers will legally require in order to transact on your behalf. If you don't, there's a danger payments may not go through on time, potentially jeopardising relationships with suppliers and customers, or even adversely affecting your supply chain. Your cash flow may also be damaged.

"Protect your cash flow, supplier and customer relationships and supply chain."

Despite this imperative, regulatory delay is a common problem in foreign exchange. Financial institutions must comply with strict regulation as they conduct foreign exchange transactions on behalf of their customers. Under know-your-customer (KYC) and anti-money laundering (AML) rules, they are required to verify the identities of

all the parties they deal with, including the foreign parties with which your business may have contact. Any hold-ups in the verification process may delay your transaction going ahead.

You should also be careful not to get caught out by unfamiliar overseas banking details. While bank identifiers in the UK are standardised around account numbers and sort codes, the equivalents vary from country to country internationally, and may require you to deal with data such as international bank account numbers (IBANs) and bank identifier codes (BICs).

Your foreign exchange provider should be able to help you handle these potentially confusing variations while remaining compliant. For example, are online systems in place to automate data entry – and to quickly identify mistakes or missing information that may get in the way of your payments being made on time? Does your provider offer simple, jargon-free advice on the information you require from foreign counterparties and where to find it? Can it store payment details on the system so you don't have to keep re-entering them each time a transaction is due?

If you're not sure how to get compliance right, speak to a specialist foreign exchange provider.

7

Poor internal communication

Internal communication issues can get in the way of good foreign exchange practice and risk management, especially as organisations get larger. Business functions that operate in silos and rarely talk to one another may have little idea about how their particular currency market exposures fit into the overall exposure of the company.
In the worst cases, businesses that may even be taking autonomous decisions about transactions and risk management that don't make sense in the context of the business as a whole. Supply chain managers, for example, may be hedging out the risk of higher import prices without understanding what revenues the sales department is expecting to book from overseas.

"understand every aspect of your business's currency exposure"

Such communication breakdowns make it very difficult for your business to approach foreign exchange holistically – to get the best deal possible on rate and service, and to manage risk as effectively as possible. If your business is suffering with this issue, it's important to take action quickly, before risks lurking unseen in one

area of the company or another cause a real problem.
Working with your foreign exchange service provider to develop a robust risk management policy is the best way to counter this danger. Once you better understand every aspect of your business's currency exposure, you'll be able to implement the right processes for dealing with it on a holistic basis – and by embedding these processes in every part of the business, you'll eliminate the danger of any single function causing a problem.

Finally, you should think about how easy – or not – it is to communicate with your foreign exchange provider itself on an ongoing basis. Online systems make day-to-day operations quicker and simpler for most businesses, but there will also be times when you need additional help. Look for a provider that offers a phone-based service that helps you deal with problems as quickly as possible. Do you know, in person, who you can expect to deal with – is there a single person or team responsible for your account, for example? Are you being provided with the information you need about foreign exchange markets to make proactive decisions?

"Are you being provided with the information you need about foreign exchange markets to make proactive decisions?"

8

Working with a foreign exchange provider stuck in rigid processes

One problem that commonly stands in the way of businesses seeking to ensure they're managing currency risk effectively and securing the best value from transactions is that their foreign exchange provider doesn't offer sufficiently flexible terms.

This can be a particular issue for companies for which a hedging strategy might be appropriate but which are put off by the need to make payments in advance or provide margin for their forward positions. Some foreign exchange providers are able to offer more flexible credit terms than others in such situations.

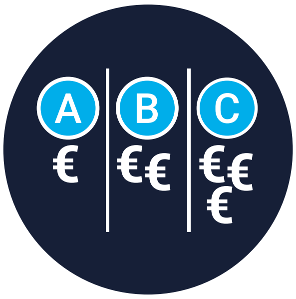
Without such flexibility, a hedging strategy may be considered out of reach for some businesses, even if putting such a strategy in place would substantially reduce the company's exposure to foreign currency risk. In other cases, businesses may be able to take on hedging positions, but not on the terms that would suit their individual circumstances best.

Consider other types of flexibility too. For example, does your foreign exchange provider offer access to different types of payment service? This may be important as you

seek to make payments quickly to different parties in different markets, while ensuring you have as long as possible to complete the transaction. Look for a provider that is able to configure their service to meet your particular needs.

In the end, the key here is to give your business as much room for manoeuvre as possible. Your approach to foreign exchange, whether day-to-day transactions or longer-term risk management, should be determined by business needs, rather than defined by the limitations and inflexibilities of your foreign exchange provider. Talk to different providers about what they might be able to offer.

Give your business as much room for manoeuvre as possible.



9

Not shopping around

"Focusing on foreign exchange can deliver a broad range of benefits, from enhanced value to better risk management."

The lesson of this guide is that focusing on foreign exchange can deliver a broad range of benefits, from enhanced value to better risk management. The key to securing those benefits is to work with a foreign exchange provider that understands your needs and is able to help you to achieve your goals. It may be that your current foreign exchange provider is capable of doing that, but until you review what else is available, you won't know whether it is possible to do better.

Not shopping around for foreign exchange services is therefore a huge mistake. You may be denied better rates, miss out on service opportunities you didn't know existed, and fall short of the strategic approach to foreign exchange required if policies and practices are to reflect the realities of your trading environment. Don't assume your bank will deliver the level and quality of service you need. It's easy to stay with your bank – and you certainly want the security of dealing with a trusted provider – but it may not be able to offer the depth and breadth of currency services on offer from a specialist provider which does nothing but foreign exchange.

This is not to suggest you should fall for rival providers' hype. If a rate sounds too good to be true, for example, it almost certainly is. Also be sceptical about any provider that encourages you to speculate in the currency markets or to persuade you that it can help you second guess exchange rate movements. It might sound counter-intuitive, but the ideal hedging position is one that doesn't deliver a benefit – in other words, you take out insurance against the worst, but hope for the best, that the currency markets don't move against you. In reality, even a successful hedge only buys you some time.

What you need is a provider that takes the time to understand your business's specific needs, rather than offering a generic service. The competitiveness of the exchange rates it offers will, of course, be a factor in your search, but this shouldn't be the only consideration. Rather, you need a provider able to develop a bespoke solution that meets all your foreign exchange needs – including helping you to manage future risk more effectively. Don't settle for anything less.

10

About XE

Empowering International Business

At XE, we live currencies.

We provide a comprehensive range of currency services and products, including our Currency Converter, Market Analysis, Currency Data API and quick, easy and secure Money Transfers for individuals and businesses.

In 2018, we helped nearly 300 million people access information about the currencies that matter to them,and over 350,000 people used us to send money overseas. Thousands of businesses relied on us for information about the currency markets, advice on managing their foreign exchange risk and trusted us with their business-critical payments.

Part of Euronet Worldwide

XE is part of Euronet Worldwide (EWI), a Nasdaq listed global provider of electronic and transaction processing solutions, with a market cap of approximately $7.5bn.

XE Business Services

International Payments and FX risk management form the world's trusted currency authority.

Staying ahead of the competition is hard enough without having to deal with the complexities of foreign exchange. XE can support you to save both time and money, so that you can get on with what you're good at – running your business.

Our solutions can give you reassurance in an uncertain world, and empower your business to make the right decisions.

Spot Contracts | Forward Contracts | Market Orders | Cash Solutions

FX Risk Management & Advisory | Mass Payment Solutions | FX Options & Structured FX Products

By working with XE Business Services, you benefit from:

- **Education and insight.** Our proactive market insight helps our clients plan for any event that may impact their FX exposures.
- **Credit terms.** We work with you to overcome potential liquidity constraints if you use forwards or FX Options. We can offer enhanced credit facilities of up to three years in length over both initial and variation margins (subject to approval).
- **Strategic support.** We support our clients to execute informed hedging strategies, taking the emotion out of hedging and providing structure and clarity.
- **Expertise.** Our dealing team is experienced in supporting businesses with their FX strategies in a number of sectors and jurisdictions, guiding them to make hedging decisions that are right for their business.
- **Speed.** Quick and efficient international payments.
- **Security.** Our parent company, Euronet Worldwide, has a $7.5bn market capitalization, meaning you have the peace of mind that your funds are in safe and secure hands.
- **Flexibility.** Draw down funds early, roll contracts forward or simply settle the cash difference depending on the unique requirements of your business.

Euronet WORLDWIDE

How does FX volatility impact your bottom line?

For more information, and to discuss your own situation and FX exposures in more detail, please contact a member of our team on +44(0) 1753 752 626

business.eu@xe.com

XE, Maxis 1, Western Road, Bracknell, Berkshire, RG12 1RT
Tel: +44(0)1753 752 626   www.xe.com/business