Rialtas na hÉireann
Government of Ireland

GETTING
IRELAND
BREXIT
READY

Currency Risk Management For Irish SMEs

Developed by
the Department of Business,
Enterprise & Innovation

Currency Risk Management

The recent financial crisis, US elections and political uncertainty around Brexit has set a backdrop of a more competitive and unpredictable business environment, one in which firms of all sizes have recognised the importance of financial risk management as a key component of protecting their earnings, profits and working capital.

In particular, companies with exposure to foreign currencies are prioritising and developing their hedging strategies, allowing them to respond more effectively to the challenges of this unpredictable landscape.

Whilst large companies have recognised the importance of this issue, many smaller companies are lagging behind. Recent research by Bord Bia in Ireland suggests that while 50% of businesses impacted by Brexit do have a currency hedging strategy, the figure is significantly lower for firms with turnover of less than €10m.

Currency movements can be sudden and large, as we saw with sterling in the wake of the Brexit referendum. If your business has a material exposure to a non-euro currency you need to be aware that if you do not have a hedging strategy you are taking a gamble with your bottom line.

The guidance that follows will seek to answer many of the questions that Irish SMEs may have when assessing and managing their exposure to foreign currency risk, set out in sections dealing with: the importance of currency risk management; how to assess currency exposure and develop a currency management strategy; practical guidance for companies that have not previously engaged in currency management; and a directory of support services and providers that are available in the market.

Whilst the focus of this guidance will primarily be with respect to sterling related currency risk, the principles can equally be applied to Irish SMEs importing goods from or exporting goods to any non-euro country or market.

My Department, offices and agencies are always available to advise and support businesses. I hope you find it useful.

Heather Humphreys TD

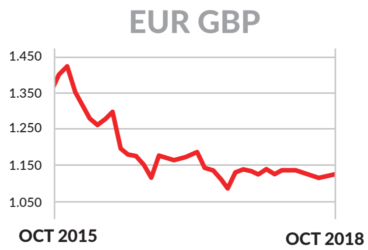
Minister for Business, Enterprise and Innovation.

1 The importance of currency risk management for Irish importers and exporters

Why should Irish SMEs actively manage their currency exposures?

With the UK scheduled to leave the European Union on 31 October 2019, continued uncertainty on the prospects for a Brexit deal is causing volatility on currency markets, particularly with the euro/sterling exchange rate. Weak sterling is a major concern for Irish exporters to the UK.

Since the Brexit vote, the value of sterling has depreciated approximately 13% against the euro and is expected to remain volatile as political and economic uncertainties continue. Similar levels of volatility have been observed in the euro/US dollar rate.



Difficulties stem not only from the transaction exposure of translating sterling sales at a weaker rate but also due to reduced competitiveness against now cheaper local UK alternatives.

But there has been some good news.

There are some Irish industries relying on UK imports that have experienced a "Brexit boom" as euro equivalent prices have fallen in line with weakening sterling (e.g. the construction and automotive industries). The contrasting fortunes of the Irish exporters and importers highlights that the impact of currency exposures, and the management thereof, needs to be carefully considered, and the decision to hedge (or not) is dependent on a number of factors including the company's risk appetite, contractual commitments, payment cycles and underlying business margins. Businesses also need to assess how they may have natural hedges, for example exporters may have inputs from sterling area which have reduced and offset some of the loss of price competitiveness on the output side.

Benefits of Hedging

- Protect your business from financial shocks
- Make future cash flows more predictable
- Improve your financial flexibility through prudent risk policy

2 How to assess currency exposure

Am I exposed to currency risk if I export to non-euro markets in the local currency?

Yes, this is because of the time lag between when a contract denominated in a foreign currency is agreed, and when it is ultimately settled/paid. This exposure also relates to transactions in the near future that have not yet been executed.

I also export to non-euro markets but in euro, do I have an exposure here too?

Yes, you may be running an exposure due to reduced affordability and competitiveness against what are now cheaper local market alternatives.

What about if I have a branch or subsidiary in non-euro markets?

If you have a branch or subsidiary operating in a non-euro currency area you may also be running a financial statement exposure. This could cause problems for you because the retranslation of foreign currency assets and liabilities may affect balance sheet measures and ratios, which can negatively impact any debt covenants.

Maybe I should wait and take my chances?

That would be a gamble. Currency movements can be large and sudden. With no hedge in place you may experience unpredictable swings in cash flows and margins. It is only through fixing the rate that certainty can be achieved with respect to margins and profits, as the euro amount of foreign currency cash flows become predictable.

How do I know if the risk is material?

The size of your exposure can be estimated by identifying the extent to which any foreign currency revenues are not offset by costs in the same foreign currency.

For example, if you are selling £10m of product to the UK in sterling but also incur £7m of sterling denominated expenses then your net exposure to volatility in the sterling exchange rate is £3m sterling. A 10% depreciation in sterling against the euro would translate to an approximately €300,000 euro loss at this exposure level.

3 How to develop a currency management strategy

What should I do if I want to manage my exposure?

Talk to your bank who will advise you about using derivative products for hedging purposes. The use of such products should be considered in the context of their cost and flexibility.

Financial hedging products fall broadly into two types, each with their pros and cons:

(i) Products that fix the exchange rate

Forward foreign exchange contracts are a low-cost product, with no upfront payment, that may be used to fix the exchange rate on expected foreign currency receipts or payments. As the rate is 'locked in', however, you will have no flexibility if exchange rates move in your favour.

Cross currency swaps can also be used to fix the exchange rate on foreign currency funding cash flows. Companies enter into cross currency swaps to hedge long-term borrowing commitments dominated in a foreign currency.

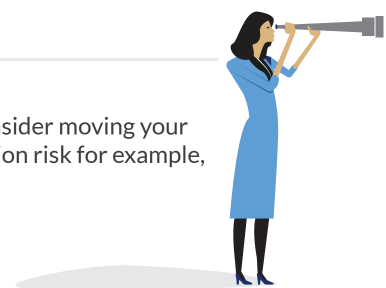
(ii) Products that allow rate flexibility

Your bank may also be able to provide *currency option contracts*. This allows rate flexibility thus avoiding a potential opportunity loss from favourable exchange rate movements whilst also providing protection in the event of unfavourable movements. This flexibility may come at some additional cost depending on the level of exposure you wish to take.

Currency options can also be useful for hedging a contingent exposure. For example, if you are tendering for a project whose revenue flows will be in a foreign currency you could use currency options to hedge the potential exposure, knowing that if you don't win the tender you don't have to exercise the currency option.

What about in the longer term?

In the medium to long run it may be more effective to consider moving your focus to new markets with lower or no currency transaction risk for example, shifting the sales drive from UK to EU markets.



4 Practical Guidance for those new to currency management

How do I put a hedging contract in place?

If you are an SME, the easiest way to begin accessing the hedging market will be through existing banking relationships. Other product providers may be available but you should be comfortable that you are transacting with a reputable and regulated institution.

Discuss your foreign currency risks with your local bank relationship manager who will refer you to the relevant contact in the bank's Treasury Dealing Room, providing you with an overview of foreign exchange hedging products. They will explain the available options appropriate to your company.

If you wish to proceed with putting a hedging strategy in place you can engage with your bank's Treasury Dealing Room about the particular parameters of the hedging product(s) that you require and obtain indicative price quotes. You will receive correspondence from the bank to confirm any trade agreed, and also prior to the maturity date to confirm the settlement terms. This may involve some regulatory reporting requirements, but your bank will assist you with this.

Is it difficult and time consuming?

No, your bank will guide you through the setup process, which they will have done for many other customers like you.

5 Directory of Support Services and Providers

Foreign Exchange Product Providers

For example, banks and investment houses

Market Data Providers

Bloomberg
www.bloomberg.com/ markets/ currencies

Reuters
https://uk.reuters.com/business/ currencies

FTID
https://markets.ft.com/ data/currencies

Industry bodies

Irish Association of Corporate Treasurers
www.treasurers.ie

Regulatory & Government Agencies

Central Bank of Ireland
www.centralbank.ie/

Department of Business, Enterprise and Innovation
https://dbei.gov.ie/en/

Enterprise Ireland
www.prepareforbrexit.com

Enterprise Ireland Currency Risk Calculator
https://www.enterprise-ireland.com/en/UK-Export-Help/Sterling-impact-calculator

Bord Bia
www.bordbia.ie

Reference / Media

The Global Treasurer
www.theglobaltreasurer.com/

Treasury Management International
www.treasury-management.com

6 Glossary

Contract Rate

an agreed exchange rate at which the currency pair will be exchanged. The Contract Rate will always be less favourable than the Forward Exchange Rate available to you at the time.

Currency Option

a contract that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a certain currency at a specified exchange rate on or before a specified date. Should the real market price of the currency be lower than that outlined in the call option (or higher than that outlined in the put option), the holder of the contract can go to the market instead and simply pay the premium for holding the contract.

In its most simple form a currency option acts like an insurance policy. In return for paying an up-front premium the option contract limits downside risk by locking in the strike price, but also allowing companies to benefit from favourable exchange rate movements. More complex or structured option contracts may have a reduced or zero upfront premium, but will involve a less favourable potential payoff profile when compared to the simple version.

Cross Currency Swap

an agreement in which two parties exchange the principal amount of a loan and the interest in one currency for the principal and interest in another currency. Companies enter into currency swaps to hedge a long-term borrowing commitment denominated in a foreign currency.

Derivative

a financial contract which derives its value from the performance of an underlying asset or value such as an interest rate or currency exchange rate.

Forward Foreign Exchange Contract

a contract agreed upon by two entities to buy or sell a certain amount of a currency at a set rate of exchange at a future date.

Forward Exchange Rate

the price of one currency in terms of another currency for delivery on a specified date in the future. This is the rate the bank would make available to you at the relevant time.

Maturity Date

the date set out in the trade confirmation. It is the date on which the outcome of the contract will be determined.

Strike Price

an agreed exchange rate which is used as a reference point when determining whether the option will be exercised. It is the exchange rate at which the currency pair will be exchanged when the option is exercised.

Trade Confirmation

a document issued to you by your bank following the agreement of the trade.

Developed in association with PwC.

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