

Chapter 12

Foreign Exchange Risk Management

Foreign exchange (FX) is a risk factor that is often overlooked by small and medium-sized enterprises (SMEs) that wish to enter, grow, and succeed in the global marketplace. Although most U.S. SME exporters prefer to sell in U.S. dollars, creditworthy foreign buyers today are increasingly demanding to pay in their local currencies. From the viewpoint of a U.S. exporter who chooses to sell in foreign currencies, FX risk is the exposure to potential financial losses due to devaluation of the foreign currency against the U.S. dollar. Obviously, this exposure can be avoided by insisting on selling only in U.S. dollars. However, such an approach may result in losing export opportunities to competitors who are willing to accommodate their foreign buyers by selling in their local currencies. This approach could also result in the non-payment by a foreign buyer who may find it impossible to meet U.S. dollar-denominated payment obligations due to the devaluation of the local currency against the U.S. dollar. While coverage for non-payment could be covered by export credit insurance, such “what-if” protection is meaningless if export opportunities are lost in the first place because of the “payment in U.S. dollars only” policy. Selling in foreign currencies, if FX risk is successfully managed or hedged, can be a viable option for U.S. exporters who wish to enter and remain competitive in the global marketplace.

Key Points

- Most foreign buyers generally prefer to trade in their local currencies to avoid FX risk exposure.
- U.S. SME exporters who choose to trade in foreign currencies can minimize FX exposure by using one of the widely-used FX risk management techniques available in the United States.
- The volatile nature of the FX market poses a great risk of sudden and drastic FX rate movements, which may cause significantly damaging financial losses from otherwise profitable export sales.
- The primary objective of FX risk management is to minimize potential currency losses, not to make a profit from FX rate movements, which are unpredictable and frequent.

CHARACTERISTICS OF A FOREIGN CURRENCY DOMINATED EXPORT SALE

Applicability

Recommended for use (a) in competitive markets and (b) when foreign buyers insist on trading in their local currencies.

Risk

Exporter exposed to the risk of currency exchange loss unless a proper FX risk management technique is used.

Pros

- Enhances export sales terms to help exporters remain competitive
- Reduces non-payment risk because of local currency devaluation

Cons

- Cost of using some FX risk management techniques
- Burden of FX risk management

FX Risk Management Options

A variety of options are available for reducing short-term FX exposure. The following sections list FX risk management techniques considered suitable for new-to-export U.S. SME companies. The FX instruments mentioned below are available in all major currencies and are offered by numerous commercial lenders. However, not all of these techniques may be available in the buyer's country or they may be too expensive to be useful.

Non-Hedging FX Risk Management Techniques

The exporter can avoid FX exposure by using the simplest non-hedging technique: price the sale in a foreign currency. The exporter can then demand cash in advance, and the current spot market rate will determine the U.S. dollar value of the foreign proceeds. A spot transaction is when the exporter and the importer agree to pay using today's exchange rate and settle within two business days. Another non-hedging technique is to net out foreign currency receipts with foreign currency expenditures. For example, the U.S. exporter who exports in pesos to a buyer in Mexico may want to purchase supplies in pesos from a different Mexican trading partner. If the company's export and import transactions with Mexico are comparable in value, pesos are rarely converted into dollars, and FX risk is minimized. The risk is further reduced if those peso-denominated export and import transactions are conducted on a regular basis.

FX Forward Hedges

The most direct method of hedging FX risk is a forward contract, which enables the exporter to sell a set amount of foreign currency at a pre-agreed exchange rate with a delivery date from three days to one year into the future. For example, suppose U.S. goods are sold to a Japanese company for 125 million yen on 30-day terms and that the forward rate for "30-day yen" is 125 yen to the dollar. The U.S. exporter can eliminate FX exposure by contracting to deliver 125 million yen to his bank in 30 days in exchange for payment of \$1 million dollars. Such a forward contract will ensure that the U.S. exporter can convert the 125 million yen into \$1 million, regardless of what may happen to the dollar-yen exchange rate over the next 30 days. However, if the Japanese buyer fails to pay on time, the U.S. exporter will be obligated to deliver 125 million yen in 30 days. Accordingly, when using forward contracts to hedge FX risk, U.S. exporters are advised to pick forward delivery dates conservatively. If the foreign currency is collected sooner, the exporter can hold on to it until the delivery date or can "swap" the old FX contract for a new one with a new delivery date at a minimal cost. Note that there are no fees or charges for forward contracts since the lender hopes to make a "spread" by buying at one price and selling to someone else at a higher price.

FX Options Hedges

If there is serious doubt about whether a foreign currency sale will actually be completed and collected by any particular date, an FX option may be worth considering. Under an FX option, the exporter or the option holder acquires the right, but not the obligation, to deliver an agreed amount of foreign currency to the lender in exchange for dollars at a specified rate on or before the expiration date of the option. As opposed to a forward contract, an FX option has an explicit fee, which is similar to a premium paid for an insurance policy. If the value of the foreign currency goes down, the exporter is protected from loss. On the other hand, if the value of the foreign currency goes up significantly, the exporter can sell the option back to the lender or simply let it expire by selling the foreign currency on the spot market for more dollars than originally expected, but the fee would be forfeited. While FX options hedges provide a high degree of flexibility, they can be significantly more costly than FX forward hedges.