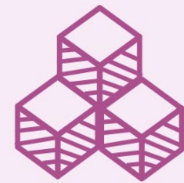

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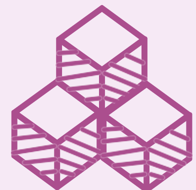
Foreign exchange risk: what is it and mitigation techniques



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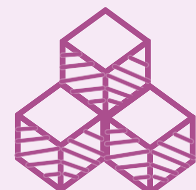
A brief introduction into Foreign Exchange Risk

Seeking for a definition

Foreign Exchange Risk is a typical business risk faced by organisation that have commercial operations with foreign markets.

Multinational organisation fall of course under this category, but they are not the only one. More in general, any organisation that relies on foreign transactions to operation its business – and maintain margins of profitability and sustainability – is exposed to foreign risk exchange.

Given the fluctuations of major currencies in the financial market, the risk for organizations is of closing an economic transaction in an unfavorable exchange rate that negatively impact their overall purchase power



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Implication for business of Currency Fluctuations

Upsides

It is also true that when the domestic currency depreciate compared to foreign currencies, foreign customers are greatly more motivated to buy large quantitates of local goods / services.

Indeed, for small companies operating at local level but somehow greatly exposed to foreign currencies (i.e. see the case for tourism operators), not accepting foreign currencies might be even counter productive as customers might be more inclined to opt for solutions, offers and alternatives that are currency-flexible.

The other way around is also another upside to consider, meaning when it is your domestic currency that appreciate compared to another – at that moment it is your organisation with higher purchase power and flexibility of maneuver

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Foreign Exchange Risk manifests in three ways:

Macroeconomic conditions

Local political (in)stability, governance policies, etc. can all impact the appreciation or depreciation of currencies.

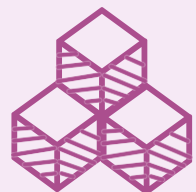
Depending on how stable and long-term oriented these changes are, business organizations can all experiences changes (for the worst or for the better) in cash flow and overall profitability

In-between of transactions

The longer the time in-between the closing of the deal (sing of the contact) and the underlying economic transaction, the higher the exposure to foreign exchange risk. Depending on the market conditions at the moment of the transaction, organizations might get way less than what anticipated and accounted from that specific transaction

Accounting

This happens when an organisation has subsidiaries in different countries, operating under different currencies. Whenever the currency of the subsidiary organizations fluctuates for the worst, this will inevitably impact even the parent company



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Managing the Foreign Exchange Risk

Not a one-size-fits-all approach

Managing Foreign Exchange Risk can fall under two macro-approaches:

- You can either speculate from the opportunities emerging from currencies fluctuations
- ..or more simply, you wish to safeguard the operations of your organisation form undesired currencies moment

Regardless of the above, try to measure and quantify realistically your exposure to foreign exchange risk

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Three common ways to mitigate Foreign Exchange Risk

Forward Contracts

This solution help companies to protect themselves against undesired currency fluctuations.

Seller and client agree *today* (typically, at contract signature) on the amount of the economic transaction (lock-in the price), regardless of currency fluctuations when the transaction will effectively take place.

The counterpart accepts foreign payments

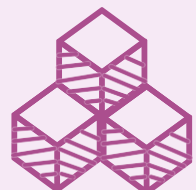
This solution usually comes cash-only advance payments.

Although this solution is particularly ideal for small transaction, very easy and risk-free overall, there needs to be specific willingness from the counterpart

Cost and revenues are in the same currency

This solution might imply two things:

- You can either set and maintain a foreign bank account which operates under that currency only and report accordingly the gain and losses from fluctuations
- Or you can accept and make payments in your local currency only



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In conclusion

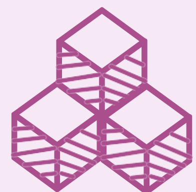
Consulting and expert

Different rules applies at different levels, depending also (and most notably) form the scale and size of the organisation and its operations. It is recommended for you to consult and expert that could guide you through the following:

1. Is it even profitable selling in a country under a different currency regime?

2. Which kind of transactions are most ‘strategic’ under a foreign exchange?

3. Are there are any fees impacting on the profitability of the overall transactions?



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