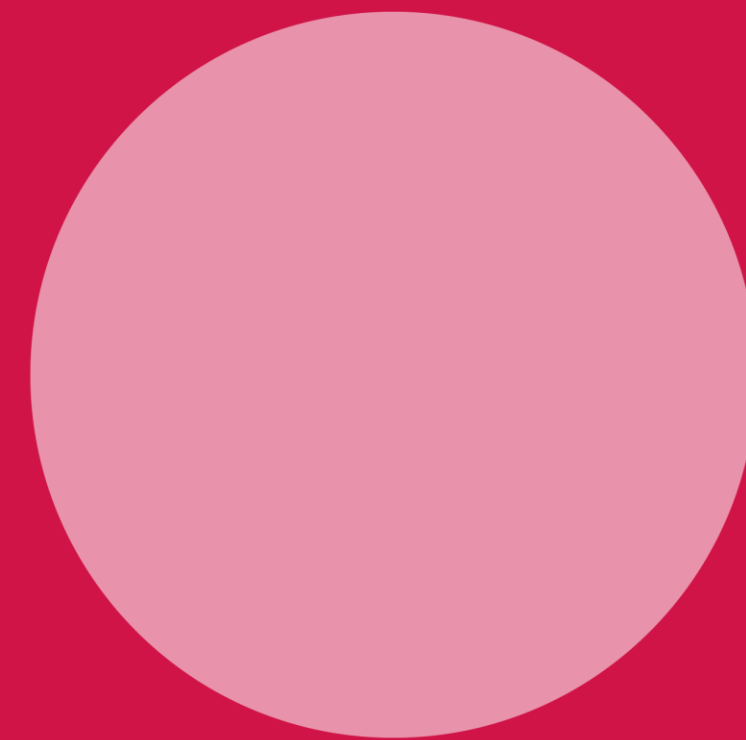
WORLDFIRST

A smarter way to collect, convert and manage payments globally



FX risk management and hedging guide

The next section will introduce how you can hedge against uncertainty with a robust risk management strategy.

What is risk management?

Adopting a strategy to protect your business against foreign exchange risk, exchange rate volatility affecting import & export prices.

Why hedge?

- Introduce predictability to your future FX rates and increase visibility of your cashflow
- Protect your internal budgets and profit margins from foreign currency fluctuations

What can happen if you don’t hedge?

- May eliminate predictability of cashflow and put your internal budget rates at risk
- Your business could suffer potential losses to profit margins because of currency fluctuations
- You could incur raise in prices in order to protect profit margin following a significant change in the rate

Forward contracts

What are forward contracts?

Forward contracts are a hedging product that enable business to protect themselves from currency market volatility by fixing the rate of exchange over a set period on a pre-determined volume of currency. There are different forward strategies which can be executed depending on your individual business needs, including fixed and flexible forwards. All forwards are set-up contingent to the business having a reasonable estimate of the value of the target currency required.

Types of forward contracts

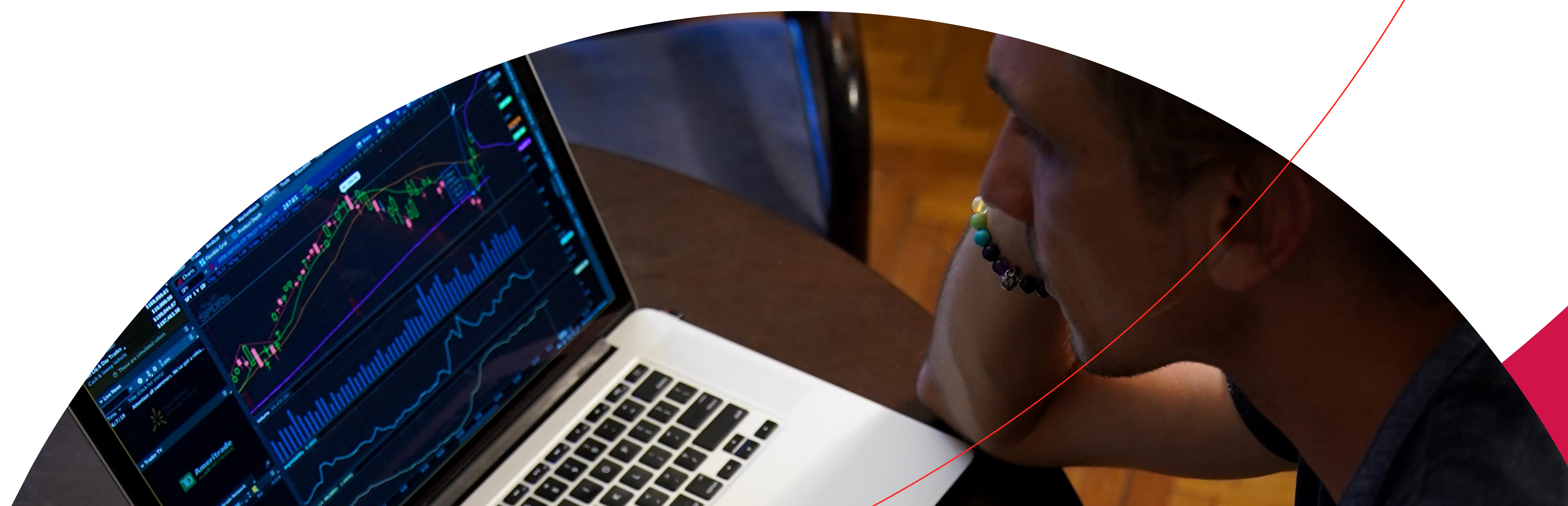
A forward exchange contract with WorldFirst can be entered to facilitate payments for identifiable goods, services or direct investment (making a capital investment in an enterprise to obtain a lasting interest in it). You will be able to lock in a rate 24-months in the future. The main types of forward contracts WorldFirst offers are Fixed, Window and Flexible Forward Contracts. WorldFirst can tailor a contract that suits the SMEs needs to make supplier payments or receive income from their customers in a foreign currency. These are outlined below :

- A fixed forward contract allows an SME to agree on an exchange rate today, for a fixed amount, to be used on an agreed date in the future (which is the maturity date).
- A flexible forward contract gives businesses flexibility on when they take delivery or drawdown from a fixed rate of exchange throughout the contract up until the maturity date.
- A window forward contract allows buyers to purchase a specific amount of foreign currency within a range of settlement dates – known as windows – the windows are utilised to achieve a better exchange rate than that of outright forward contracts.

Why are Forward contracts useful for your business?

It's always important for SMEs to consider the commercial implications before committing to using a forward contract. Below are some examples of where a forward contract might be useful for a business:

- To hedge (lock in) a rate to cover an invoice that is dated in the future.
- To hedge a rate to cover a percentage of a company's forecasted currency requirements for future supplier payments
- To hedge a rate for project work that is paid in stages for up to 24-months
- To protect forecasted exporting revenue from currency volatility
- When profit margins are tight and the ability to adjust the product and pricing is not an option.
- When a business publishes their prices on a website/brochure, and cannot re-price their product if the currency moves negatively against the business eating into their profit margin



Things you also need to consider with forward contracts

- If a currency moves in your favour, you won't be able to capitalise on that opportunity using the pre-booked forward contract, and instead would need to book a spot contact to take advantage of the market movement.

- It is important to consider your risk appetite and evaluate your budget when pre-booking foreign currency. It is a tool to help you achieve your budget rate, however it may be worthwhile considering other strategies if you are unsure of your requirements.

- If the market moves more than 4% a margin call may be required. To put it simply, if a currency swings adversely by a large amount, you may be asked to top up your initial deposit within 24-hours to re-establish the Initial Margin percentage level.

- Forward contracts are traded for the purpose of facilitating payments for identifiable goods or services. For example, entering into a forward contract exchange with WorldFirst in order to pay an upcoming invoice in a foreign currency, or in preparation of an upcoming purchase in a foreign currency, as opposed to trading forwards for speculative purposes.

What are the main benefits of forward contracts?

- A rate can be fixed, providing SME's with certainty over their profit margins. The exchange rate would be locked in for the entire length of the forward contract, providing the buyer with a guaranteed rate of exchange.

- If the live market rate moves against the SME's favour they will not be negatively impacted as they have hedged at a fixed rate.

- A deposit is usually required, and in WorldFirst's case, SMEs can lock in a rate without tying up any liquidity by getting a credit line in place with WorldFirst. WorldFirst's team of helpful FX specialists and 3rd party credit rating providers can set up credit lines on a case by case basis to cover initial deposits.

- WorldFirst will improve the rate when a drawdown occurs. This will reflect the difference in the interest rate between the two currency pairs and is known as the 'interest differential' (IRD). For an example, if one currency has an interest rate of 5% and the other has an interest of 3%, the IRD would be 2 percentage points. In the case of a negative IRD, your relationship manager will always be transparent with you when executing the trade.

Hedging strategies

This section will help determine your hedging objectives, present and evaluate potential challenges, and explore which strategies provide the best solution to your business needs

What are your Hedging objectives?

Forward contracts

Portfolio of spot and forward contracts

Spot deals

Fully Hedged

100% Certainty
0% Flexibility

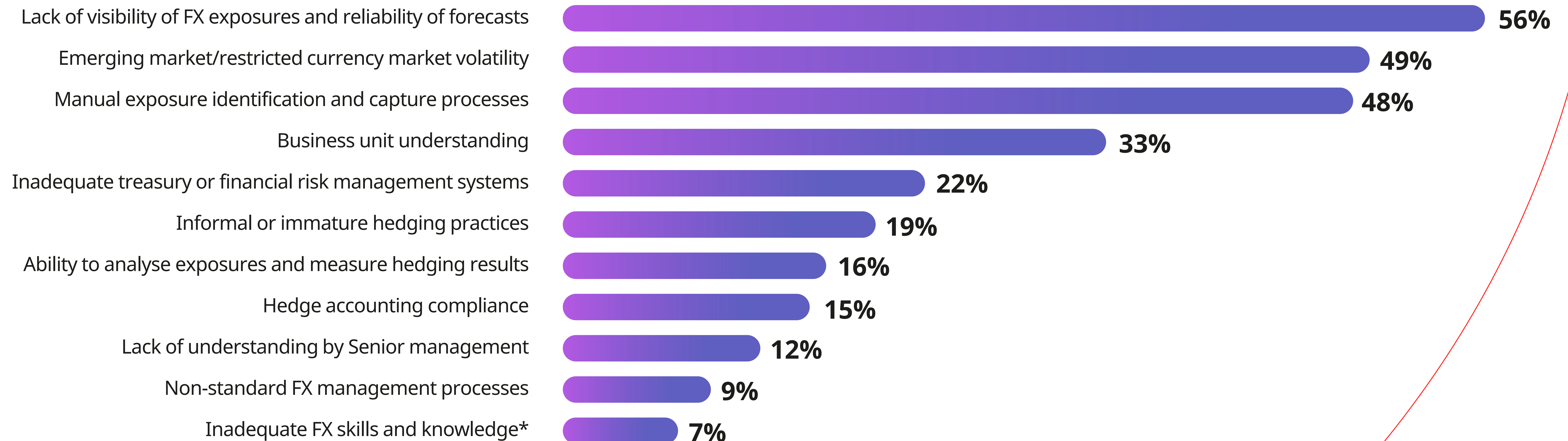
Wholly unhedged

0% Certainty
100% Flexibility

Protection vs potential upside
Portion of the exposure

Challenges in managing FX risk

Challenges faced by corporates



As noted above, over half of businesses have issues with adding forecasted or predicted exposures into any risk management framework. The Impact of such knowledge deficits will only increase as volatility iincreases or businesses take on additional currency risk from emerging markets that can have higher levels of median volatility. 1-In-5 businesses reported that informal or immature hedging practices remained a challenge and having clear and concise processes and procedures to analyse, allocate and hedge away upcoming risks should reduce the possibility of a shock from currency markets.

Static Hedging

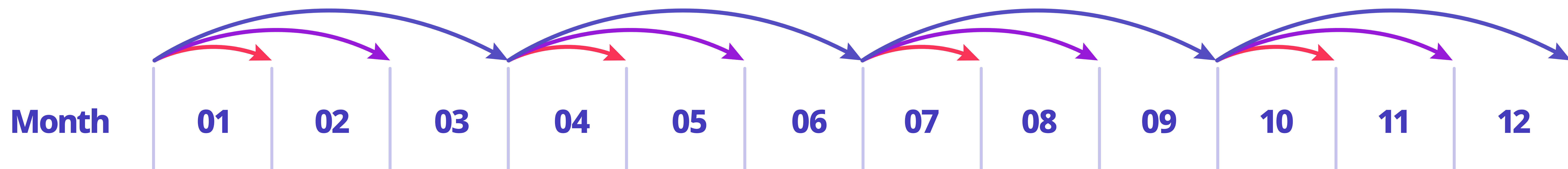
A static hedging program can be used to protect a budget rate by purchasing forward contracts to cover your budget rate for a chosen period. Upon a new hedging period, a new set of forward contracts are purchased to cover the following hedging period.

Static hedging programs are popular with firms that operate with price lists and fixed-cost brochures.

How it works:

A static hedge involves setting one or multiple forward contracts in advance of estimated future cashflows for a defined period.

The example below shows an annual hedge strategy with all contracts for the year being booked at the same time, meaning you receive a protected rate for the entire period.



Static Hedging

Advantages

Allows you to forecast transactable future FX rates

Protect your internal budgets

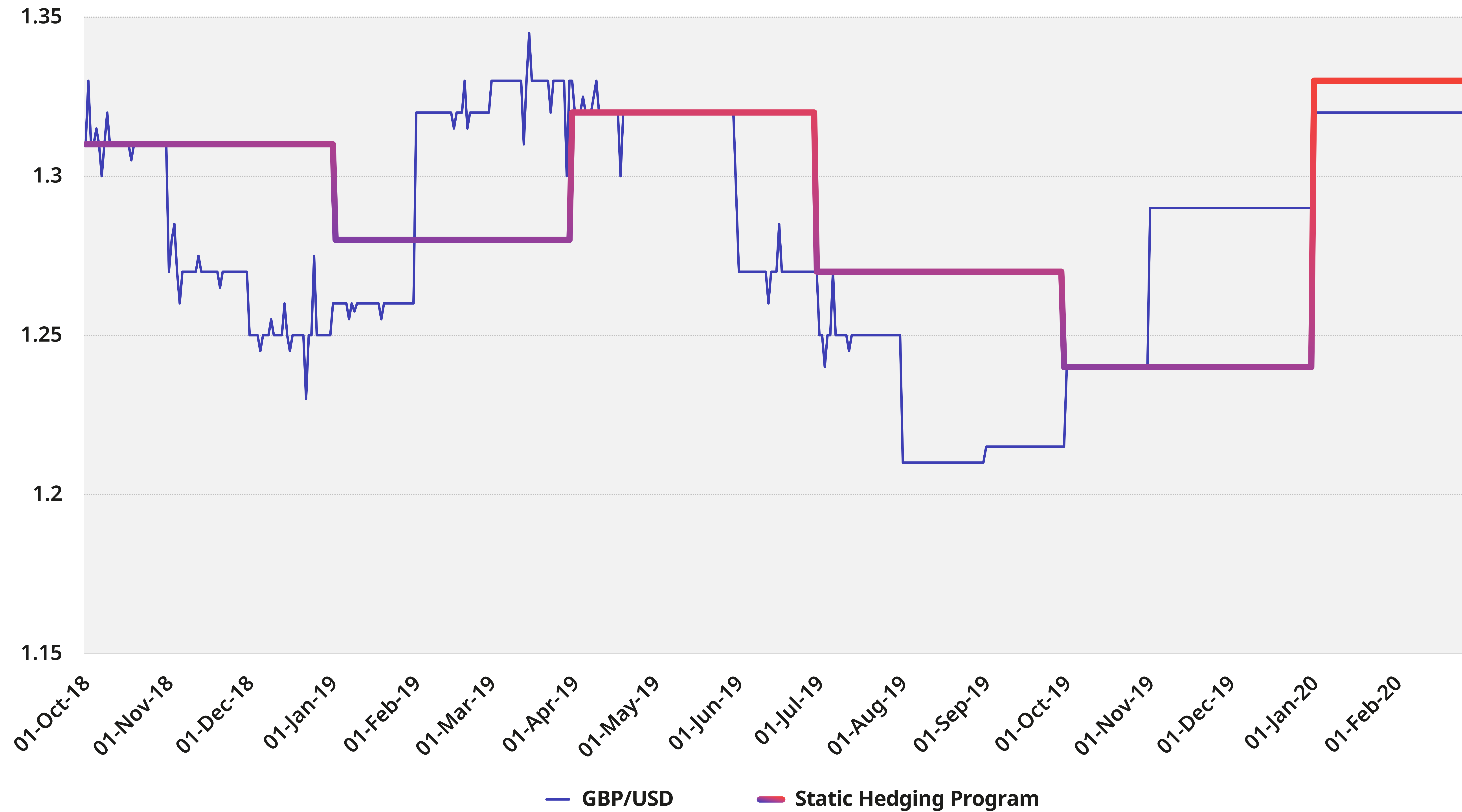
Flexibility can be added on delivery periods

Disadvantages

You do not benefit if rates move in your favour

You could be locked into a rate inferior to the average over the year

Static hedging program



Static hedging program

1.35
1.3
1.25
1.2
1.15

01-Oct-18 01-Nov-18 01-Dec-18 01-Jan-19 01-Feb-19 01-Mar-19 01-Apr-19 01-May-19 01-Jun-19 01-Jul-19 01-Aug-19 01-Sep-19 01-Oct-19 01-Nov-19 01-Dec-19 01-Jan-20 01-Feb-20

GBP/USD — Static Hedging Program

Static hedging program

1.35
1.3
1.25
1.2
1.15

01-Oct-18 01-Nov-18 01-Dec-18 01-Jan-19 01-Feb-19 01-Mar-19 01-Apr-19 01-May-19 01-Jun-19 01-Jul-19 01-Aug-19 01-Sep-19 01-Oct-19 01-Nov-19 01-Dec-19 01-Jan-20 01-Feb-20

GBP/USD   Static Hedging Program

Static hedge
Example 1

- Book 80% for each of the next 4 quarters
- Can only utilise the next quarter requirement when the window opens at the start of each quarter
- Book the remaining 20% for each quarter on the spot market when the rate is above the covered rate

- **Layer 1: 80% at 1.2420**
  Remaining 20% booked on spot
- **Layer 2: 80% at 1.2458**
  Remaining 20% booked on spot
- **Layer 3: 80% at 1.2508**
  Remaining 20% booked on spot
- **Layer 4: 80% at 1.2550**
  Remaining 20% booked on spot

Rolling Hedging

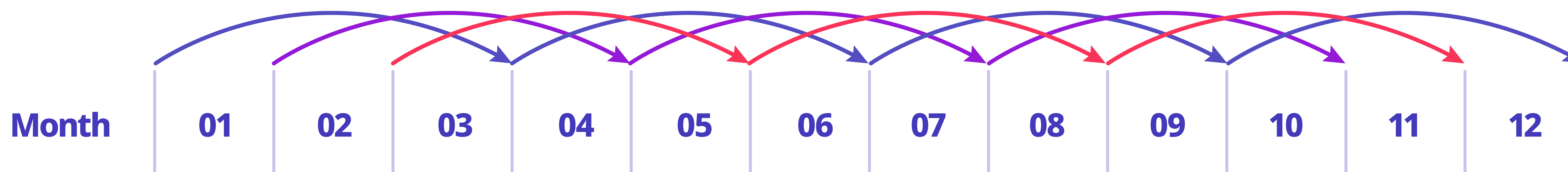
A rolling hedging program could suit a company who receives updated transaction forecasts on their FX exposure throughout the year. Hedges are implemented on the same basis and are booked at regular intervals, allowing a company to gain tangible foresight of the value of their future transactions.

Rolling hedging programs are popular with firms that operate on ongoing market sensitive lead terms.

How it works:

A rolling hedge involves simultaneously opening a new contract as the previous one expires.

The example below shows a quarterly rolling strategy, meaning you are always hedged out 2 months minimum and 3 months at the longest in time.



Rolling Hedging

Advantages

More flexible from a static pre-hedge approach

Introduces predictability to your future FX rates

Adding predictability increases the visibility of your cashflow

Disadvantages

You do not benefit if rates move in your favour

As with a forward contract, you may have to pay an initial deposit

If rates move against you, you may need to pay a margin call in order to keep the position in place

Rolling hedging outcome

1.35
1.3
1.25
1.2
1.15

01-Oct-18 01-Nov-18 01-Dec-18 01-Jan-19 01-Feb-19 01-Mar-19 01-Apr-19 01-May-19 01-Jun-19 01-Jul-19 01-Aug-19 01-Sep-19 01-Oct-19 01-Nov-19 01-Dec-19 01-Jan-20 01-Feb-20

GBP/USD
Static Hedging Program

Rolling hedging outcome

1.35
1.3
1.25
1.2
1.15

01-Oct-18
01-Nov-18
01-Dec-18
01-Jan-19
01-Feb-19
01-Mar-19
01-Apr-19
01-May-19
01-Jun-19
01-Jul-19
01-Aug-19
01-Sep-19
01-Oct-19
01-Nov-19
01-Dec-19
01-Jan-20
01-Feb-20

GBP/USD
Static Hedging Program

Rolling hedging outcome

1.35
1.3
1.25
1.2
1.15

01-Oct-18 01-Nov-18 01-Dec-18 01-Jan-19 01-Feb-19 01-Mar-19 01-Apr-19 01-May-19 01-Jun-19 01-Jul-19 01-Aug-19 01-Sep-19 01-Oct-19 01-Nov-19 01-Dec-19 01-Jan-20 01-Feb-20

GBP/USD   Static Hedging Program

Rolling hedge Example 1

Book 80% of your requirement for the next 3 months, and when the first month finishes book another month's requirement, so you always have 3 months cover in place.

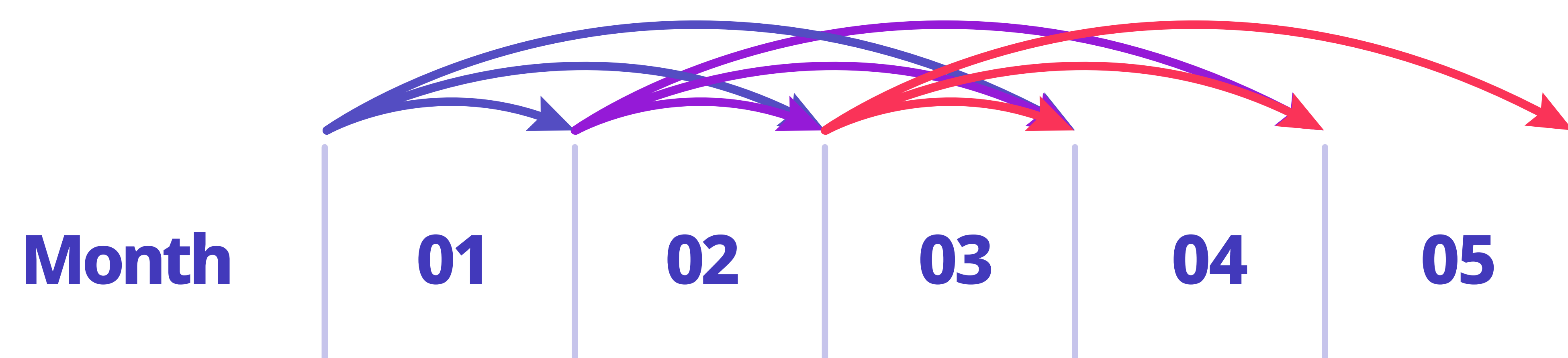
- Book 4 layers for the year
- Book an additional 20% at the end of the previous Quarter for the next 3 Quarters, 60% for the next and so on
- You will always have 80% of your requirement booked for the upcoming quarter, 60% for the next and so on
- Can only utilise the next quarters requirement when the window opens at the start of each quarter
- Book remaining 20% at spot when the rate is beneficial
- The % exposure you want to book depends on your risk appetite

Layered Hedging

A layered hedging program will minimise the volatility of your rates via a 'smoothing' effect by building up the concentration of your hedged exposure over time. As each hedging period begins, forward contracts are bought with similar notionals to cover varying time periods. These forward rates are combined and blended to produce a layered average rate. The longer the length of your strategy and frequency of hedging, the smoother your achieved FX rate becomes.

Layered hedging programs are popular with firms that operate bespoke and fluid pricing models.

How it works:
A layered hedging strategy uses forward contracts with different execution and value dates, unlike a static hedge that sets rates for the whole hedging period. The below shows a continuous rolling hedge, allowing adjustment throughout the period as forecasts become clearer.



Layered Hedging

Advantages

Future FX rates are smoothed, protecting you from the lowest levels reached by the spot market

Hedge ratios for the program are fully customizable

Unlike a static hedge, it creates upside opportunity

Hedging an increasing amount of exposure over time to achieve an 'average' rate for the buckets hedged

Always maintain a base level of downside protection – rate smoothing

Protect min hedge % at all times

Allow to benefit from favorable rate movement

Disadvantages

You do not benefit 100% if rates move in your favour

As with a forward contract, you may have to pay an initial deposit

If rates move against you, you may need to pay a margin call in order to keep the position in place

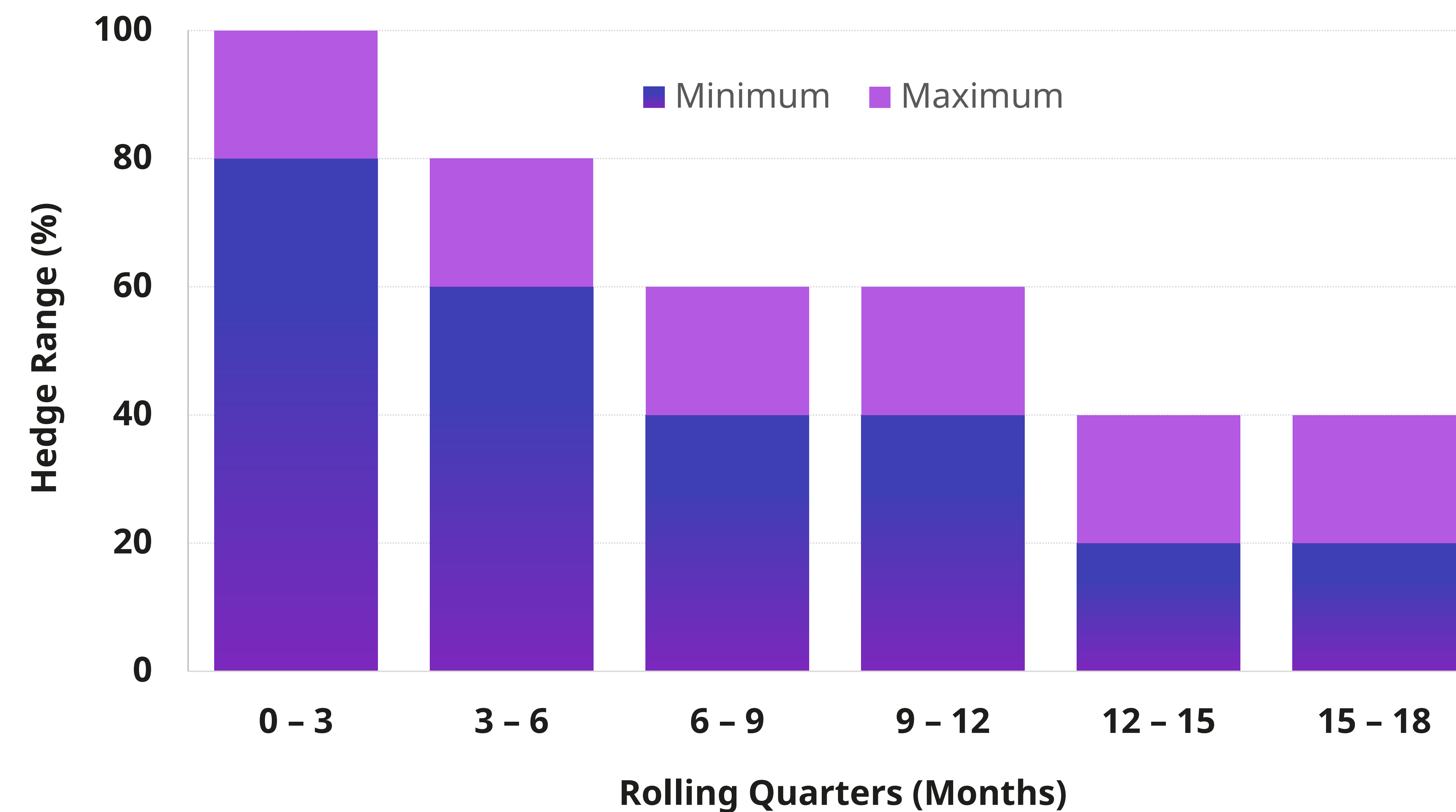
Layered hedging outcome

1.35
1.3
1.25
1.2
1.15

01-Oct-18 01-Nov-18 01-Dec-18 01-Jan-19 01-Feb-19 01-Mar-19 01-Apr-19 01-May-19 01-Jun-19 01-Jul-19 01-Aug-19 01-Sep-19 01-Oct-19 01-Nov-19 01-Dec-19 01-Jan-20 01-Feb-20

GBP/USD
Static Hedging Program

Strategy 2
Layering strategy – continuous rolling hedge



- Typically hedge a higher % of requirement in the short term as confidence in forecast is higher
- As time progresses you simply top up the hedge periods with more forward contracts
- Hedging an increasing amount of exposure over time to achieve an ‘average’ rate for the buckets hedged
- Always maintain a base level of downside protection – rate smoothing
- Protect min hedge % at all times
- Allow to benefit from favorable rate movement

What is a margin call?

A margin call will be triggered if the exchange rate moves significantly against the rate you have secured. This is typically near the point where your initial deposit no longer covers the negative exposure on your position. To put it simply, you may be asked to top up your initial deposit if the exchange rate moves to a less favourable rate. It is important to know that you're still locked in at the rate originally agreed, and this is not an additional fee or charge, but merely a top-up of your deposit.

WorldFirst allows an exchange rate to be locked in for up to 24 months and can require a small initial deposit ranging from 3-10%, depending on the length of the contract.

All FX transactions carry risk and your position could at any point hold a negative value against the current market rate. In this instance, you may be asked at any point up until the settlement date to:

How can we re-establish the initial deposit percentage level?

- To put in place Margin where there has been no Initial Margin
- To increase the Margin level where we determine this is required to cover any risks under the FX Contract

WORLDFIRST

Find out more about the benefits of WorldFirst for your business:

Call: +44 207 801 1065 or
Email: uksales@worldfirst.com
Visit: www.worldfirst.com/uk/business