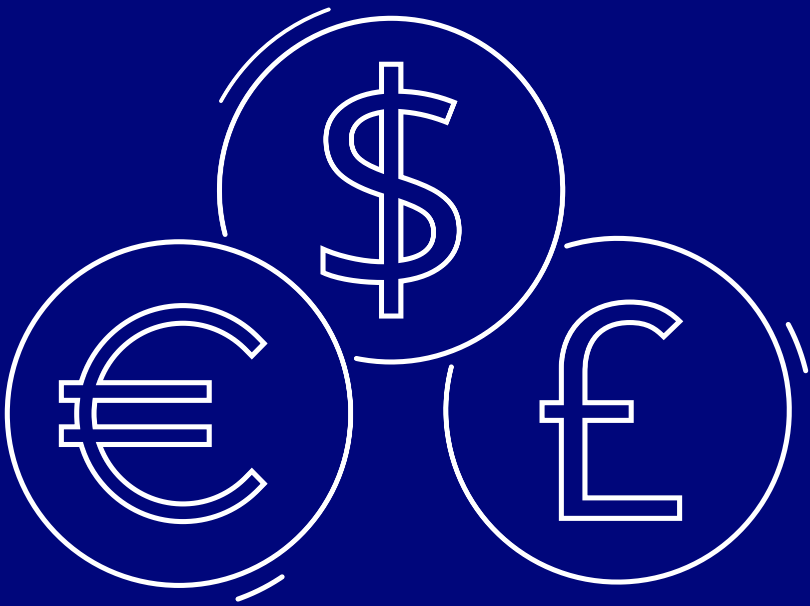


Managing currency risk

A guide for SMEs

Bank of Ireland

Introduction

While the Global Pandemic and more recently the US Presidential Elections have dominated the news this year and overshadowed Brexit negotiations to an extent, the currency markets continue to be the principal route through which the Brexit effect has been felt. At the most extreme levels the Pound fell by over 20% following the referendum vote in June 2016 and we have seen continued volatility in the currency markets since the vote.

As we enter the final weeks of 2020, we will see a new course set for trade arrangements between the UK and EU directly, and between the UK and the rest of the World as a result of the UK leaving the EU's Single Market and Customs Union.

For many businesses, this will herald a period of significant change and uncertainty. For financial markets, the immediate and principal focus will very likely be on the fate of the Pound.

At Bank of Ireland UK Global Markets we make it our business to understand and anticipate the market forces that most affect our customers. Our team of experienced and highly skilled dealers can provide you with the analysis and market intelligence that will allow you to successfully navigate the choppy waters of the post-Brexit world. We offer a range of hedging solutions, from simple to complex that will allow your business to thrive under this environment.

We have put together the following currency risk guide as an aid for our customers in light of Brexit, and hope you find it useful.

Henry Cleary,
Head of Global Markets,
Northern Ireland

Managing currency risk – a step by step guide

In this guide we have outlined a number of key areas which your business may wish to consider when managing currency risk. To begin with, there are a number of factors which may have a direct result on your currency risk exposure.

Key questions to consider are:

1. Has your supply chain been disrupted?
2. Can you still receive or deliver your product/service?
3. Is customer demand reduced?
4. Will lost sales/services be made up over time?
5. Are your forecasts related to sales, costs and operating expenses still accurate?
6. Have payment terms changed impacting the timing of when you make and receive payments?
7. How does this impact your longer term strategic and operational plans?

This guide will cover the following topics:

1. Examining your currency risk exposure
2. What level of risk can you tolerate?
3. Dual Invoicing
4. Forward Contracts
5. Foreign Currency Accounts
6. Ways Bank of Ireland can help your business

We hope this guide is a useful tool for your business, and should you require more information our team of dedicated dealers are on hand to provide support.

Our team can be contacted on 028 9032 2778 from 9am-5pm Monday to Friday.

01 What's your exposure?

The first step towards managing currency risk is to understand and quantify the exposure your business is open to. You need to review your costs and revenues to understand how exposed profit margins are to any changes in foreign currency rates.

For example, your business routinely imports raw material from the Eurozone, and you are invoiced in Euro. If the Euro strengthens against Sterling – each Sterling Pound buys you less Euro – you will end up paying more in Sterling terms for that raw material.

This might seem like bad news, but you need to consider your full supply chain to understand the full picture. Let's imagine you used those raw materials to create finished goods that you then export to the Eurozone, for which you receive Euro in return. By doing that, you have a natural offset or "hedge" against deterioration in the Euro v Sterling exchange rate, as your Euro costs can be matched against your Euro receipts.

However, if you received payment for your Eurozone sales in GBP, and paid for raw materials in Euro, you run the risk that a change in exchange rates could substantially reduce, or indeed, wipe out your profit from sales.

Let's take the following example:

Example

1. You are a manufacturer based in the UK selling goods to the Eurozone. The current £/€ exchange rate is 1.1200 (this means that to get £1 you will need to convert €1.12).
2. It costs you £15,000 to manufacture a container of goods which you then sell into the Eurozone for €22,000.
3. If you convert the Euro into GBP at a rate of 1.1200, then your Sterling profit is €22,000 / 1.1200 = £19,642.86 - £15,000 (GBP costs) = **£4,642.86**.

If the Euro falls in value against sterling by 15%, which means that a Euro is now worth only £0.7650, what is the impact on your business profitability?

1. If you convert the Euro into GBP at a rate of 1.2900, then your Sterling profit is €22,000 / 1.2900 = £17,054.26 - £15,000 (GBP costs) = **£2,054.26** which is a 55% drop in profitability.

02 What level of risk can you tolerate?

You are under no legal or regulatory requirement to protect your business against currency risk. However, every business will have a different risk appetite, so it is wise to set up a robust risk management policy that means you can manage currency risk within the levels you can comfortably tolerate. Once your business has decided on how it is going to manage the risk, the policy should be:

- Formally documented
- Clear and understood by all relevant employees
- Not to be deviated from without a formal process
- Reviewed regularly

Below is a useful reference for how you might create a treasury policy for your business:

Identify, understand & document risks

- What level of currency risk can your business safely tolerate?
- Should you 'fix' or 'float'?
- Is exchange rate risk priced into your products/services?

Define roles and responsibilities

- Who needs to be involved?
- What needs to be done?
- Who needs to know about the policy?

Agree the strategy

Document the policy and agree with stakeholders, so it becomes the policy of the company, not one person.

Execute, monitor, review

This is when the work really begins!

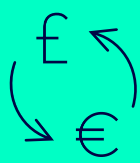
03 Consider Dual Invoicing

Dual Invoicing is one of a number of ways you can manage currency risk.

Simply put, this is getting two prices for anything purchased from abroad – one in GBP and one in the supplier's local currency - and paying the cheaper. By getting two prices you can clearly see the effect of exchange rate differences.

There may be times when it would be favourable for a business to pay in GBP (usually for once-off small amounts), but in summary, the benefits of dual invoicing are:

- Potential to reduce currency conversion costs, offering potential savings
- You have more information to choose the best payment option
- By knowing the true value of your payment, it can strengthen your buying power when dealing with suppliers.



04 Look at Forward Contracts

A forward contract is an agreement with a bank to exchange a specified amount of foreign currency at a specified date in the future, with the exchange rate fixed at the time the contract is entered into.

It is, in effect, "today's rate, in the future".

- You know your cashflow in GBP terms, making budgeting and forecasting easier
- Foreign exchange risk is eliminated
- There is an opportunity to avail of attractive foreign exchange rates prevailing in the market for delivery at a date in the future

NOTE: As the name suggests however, this is a contract and therefore it isn't possible to change the agreed rate and time period once it is established. Therefore, it is important to talk to your bank's treasury specialist to understand fully the benefits and risks associated with a forward contract.

05 Trade smartly with Foreign Currency Deposit Accounts

If you have receipts and payments in the same (non-GBP) currency, then currency accounts may be an option. Bank of Ireland UK has a range of deposit and currency deposit accounts in all major currencies.

The benefits of currency accounts include:

- The ability to "net off" foreign currency payments in and payments out – i.e. pay your suppliers from the money that you have received for sales in that currency
- They can help minimise and manage exchange risk and maximise cash flows efficiently

NOTE: If used incorrectly, you may still be exposed to foreign currency "translation" risk. This can happen when, at the end of the year, the foreign currency in your account may be worth a lot less in GBP terms than it was worth during the year, depending on exchange rate movements. Therefore, you should talk to your bank's treasury specialists to understand fully the benefits and risks associated with currency accounts and the various ways in which this may be managed sensibly.

06 Speak with the experts

At Bank of Ireland UK, we support companies from every sector and scale, from small business to multinational. The Global Markets team have a wealth of expertise across areas such as market rates, funding, treasury and economic trends. In today's market, it is important that companies consider how global events may have impacts on their business, and have a plan in place to protect their finances.

Our treasury team can explain the benefits of having a risk management policy, and how our FX solutions might work for you.

Find out how our team could help find ways to save you time, money, and manage currency risk.

Our Global Markets team are on hand for any queries – call **028 9032 2778**
Monday to Friday, 9am-5pm

Bank of Ireland