Brexit Guide

Protecting against currency risk

Bank of Ireland
Begin

Introduction

Brexit negotiations have dominated the news this year and 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 as we approach the final months of negotiations, volatility is at its highest levels in over two years. The months ahead will set a new course for the trade arrangements between the UK and the EU and the fate of the Pound remains a principal focus for financial markets.

At Bank of Ireland 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 traders 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.

Philip Hartley, *Head of Foreign Exchange, Bank of Ireland Global Markets*

Don’t sit back – prepare.

The clock is ticking towards the UK’s exit from the EU. In this period of uncertainty, it is tempting to adopt a “wait and see” approach, but now is not the time to sit back.

If your company is involved in international trade, now is the time to consider the implications Brexit may have on your business.

The Global Markets team at Bank of Ireland are here to support you and your business as we go through this journey.

This 6 Step Guide will explain how companies can plan for, and reduce currency risk.

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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 UK, and you are invoiced in Sterling. If the Euro weakens against Sterling – each Euro buys you less Sterling – and you will end up paying more in Euro 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 UK market, for which you receive Sterling in return. By doing that, you have a natural offset or "hedge" against deterioration in the Euro v Sterling exchange rate, as your UK costs can be matched against your Sterling receipts.

However, if you received payment for your UK sales in Euro, and paid for raw materials in Sterling, 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 selling goods to the UK. The currency exchange rate is: €1 =£0.90 (one Euro will purchase 90 pence Sterling).
2. You purchase £10,000 worth of raw material from the UK at this exchange rate, and thus will have to pay €11,111.11 for the materials.
3. You sell the finished goods in the UK for €20,000, receiving payment in Euro.
4. Your profit in euro is €8,888.11. In Sterling your profit is €8,888.11 * (0.90) = £7,999.30.

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. Your costs increase to €13,071.90 in Euro terms (i.e. £10,000/£0.7650) from €11,111.11, an increase of €1,960.79.
2. Your Euro profit falls from €8,888.11 to €6,928.01 a reduction of around 22%.

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/ interest rate 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 Euro 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 Euro (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 Euro 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 accounts

If you have receipts and payments in the same (non-Euro) currency, then currency accounts may be an option. Bank of Ireland has a range of deposit and current 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 Euro 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, 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 01 609 4300**

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