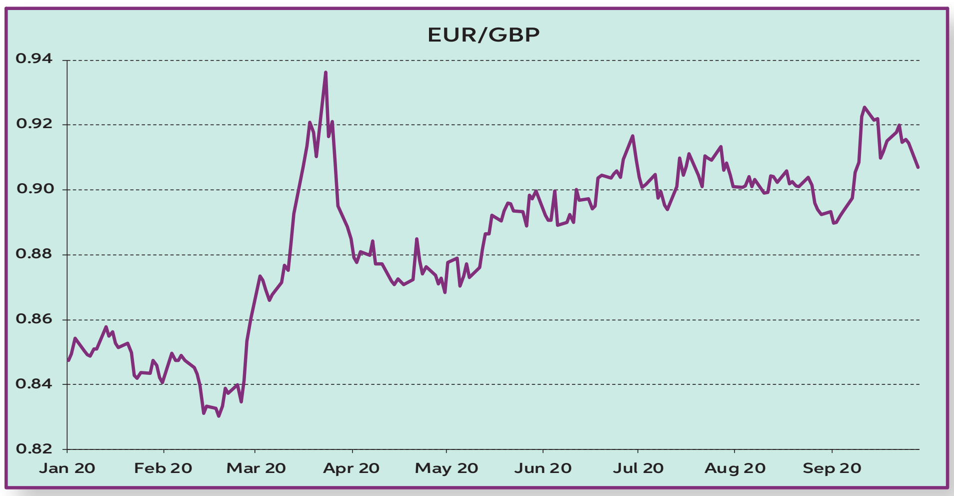
Will your current thinking on managing **foreign exchange (FX) risk survive Brexit?**

The Brexit transition deadline moves closer with growing uncertainty. Sterling volatility is expected to increase as Brexit talks intensify at the next European Council meeting on 15th October. The outcome by year end, be it ‘deal’ or ‘no deal’, will be a market event for the pound and could shift FX trading ranges in either direction. Will your current thinking on managing FX risk survive Brexit?

The economic backdrop in 2020, where we are witnessing a deep Covid-19 recession not seen since the Great Depression in the 1930’s, brings even more uncertainty for businesses facing Brexit. AIB’s latest ‘September Forex and Interest Rate Outlook’ provides some insight into the economic impact so far. The OECD is forecasting sharp drops in global GDP with a contraction of 4.5% in 2020. Continued government fiscal intervention is likely to have a lasting impact.

The US dollar has come under pressure from reduced trade activity due to Covid-19, loss of advantageous interest rates and the uncertainty of the November Presidential election, where shifts in policy could lead to further volatility and downside risk.

The euro has performed well against both the dollar and sterling year to date, as the market has reacted positively to ECB stimulus, but any strengthening of the euro may be limited by negative interest rates and verbal intervention from EU policy makers.



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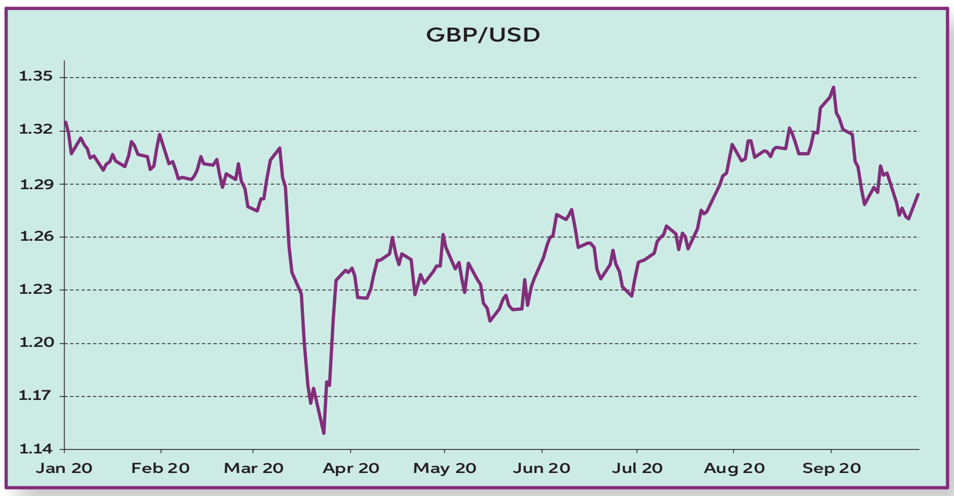

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The economic and political uncertainties of Brexit and Covid-19 have weighed on sterling recently. The UK is expected to see a 10% drop in GDP this year, and it remains to be seen if the Bank of England will adopt a policy of negative interest rates. A ‘no deal’ outcome for the UK could lead to a sudden, further weakening of sterling but it is unclear to what extent the market has priced in a ‘no deal’. If a deal is reached, the extent of any favourable move and positive trend for sterling trend may be limited dependent on the market’s perception of the deal. Either way, we could see new ranges set for EUR/GBP and GBP/USD.

What FX risk do you have in your business?

In the lead up to Brexit, it is critical that you re-evaluate the FX risk in your business and how material the risk is. For many businesses the most significant type of FX risks are 'Transactional' and 'Translational'.

- **Transactional risk** should be evaluated at a fairly granular level, at a business line or even product level to understand the amount of input costs affected by foreign exchange movements. Similarly, quantifying the net exposure of currency payables and receivables from selling abroad is central to any risk assessment exercise. It's important to identify the different currency pairs involved, what proportion of your exposures you typically hedge and for how long. The hedging products you are empowered to transact, and the liquidity available to you may also affect your attitude to risk.
- **Translational risk**, where assets, liabilities or income will change in value with exchange rate movement, needs to be evaluated in the same way. This is to understand the impact on your balance sheet, and for many companies, the potential impact on P&L of more substantial overseas subsidiaries.

Quantifying FX risk under normal trading conditions is not always an exact science and relies on assumptions and often moving goal posts. Due to the negative impact of Covid-19 on business, the backdrop for managing Brexit risk may have significantly increased the difficulty of forecasting FX cash flows. It is essential therefore that business forecasts are updated in a timely manner to the finance or treasury teams, to enable accurate FX forecasting and the implementation of appropriate FX hedging.

Understanding more about the nature of your FX risk

Evaluating the commercial interaction with your suppliers, customers and competitors will help you to understand whether your current approach to hedging is robust.

- **Suppliers** - What flexibility does your business have to negotiate pricing with suppliers? Negotiation times may impact on the duration of hedging that may be required, and what is commercially sensible to commit to given Brexit uncertainty.
- **Customers** – How easily can your business pass on price increases to your customers? You may be committed to unfavourable exchange rates, and it is generally difficult to offset this by increasing prices quickly enough.
- **Competitors** - Is your business in line with the sector/industry best practice for hedging, ensuring you at least minimise any competitive disadvantage resulting from your hedging strategy?

Armed with the understanding of your current exposure, the priority for business management must be whether to accept, reduce or transfer the FX risk identified. The vast majority of businesses tend to accept some FX risk if deemed to be relatively low, but transfer larger FX risk to their banking partners with the use of hedging products. Accurately forecasting of your net exposures will help to reduce the hedging costs involved in transferring the risk to your banks.

How can I reduce my currency exposure without going to my bank?

As part of your contingency planning for Brexit, your business may have considered alternative business strategies, including investing in customer acquisition domestically or using domestic suppliers. There is still time ahead of Brexit to consider some of these measures which may not entirely remove your FX exposure, but could help to reduce it at a time of significant uncertainty. You could consider:

- changing supplier invoicing to your domestic currency
- changing to a domestic supplier
- matching FX payables with receivables as much as possible, thereby creating a natural hedge
- reducing the need for translation hedging by investing abroad
- FX Flex clauses in supplier contracts where balancing payments are made, based on movements from an agreed initial exchange rate on a periodic basis

Evaluating your sensitivity to FX risk

Any FX exposure that cannot be reduced or negated through business strategy or creating a natural hedge should be evaluated to its sensitivity to market volatility in P&L terms.

At a high level, ascertaining what impact a single cent move has on your monthly or quarterly P&L will aid decisions about the amount of exchange rate risk a business can afford or is prepared to carry. In other words, at what rate could your business be vulnerable or face substantial difficulties in the short term?

Time invested in reviewing FX budgets and profitability, at a product or service level, may be particularly important where business margins are <10% and there is much less room for error.

The potential double edged sword of protecting your P&L

The purpose of hedging is to protect your business from large swings in P&L, and to provide time for your business to adjust and renegotiate contracts with customers and suppliers. Market commentators have speculated widely, with differing FX views on a 'deal' or 'no deal' outcome. These views have varied from 10-15% in market swings, maybe more or maybe less, but it unfortunately does pose a hedging conundrum. For example, if your business would typically hedge 50% of your FX exposure using Forward Contracts, this may be appropriate if you are only expecting a 5% shift in rates over your usual hedging term, but what does a 10% or 15% shift look like? Could your business weather this type of swing in P&L terms?

A natural response to this may be to focus on the downside FX risk, and to increase the percentage hedged or the term, in order to provide certainty over a longer period of time. But what would happen if the Brexit outcome moved the market in your favour, and you are committed to a fixed exchange rate? It is also very important to be aware of the potential cost, competitive disadvantage or missed opportunity of being committed to unfavourable exchange rates for an extended period of time.

What hedging tools are available that could help to mitigate the uncertainty created by Brexit?

Spot FX, Forward Contracts and Window Forwards

The majority of businesses that already manage FX risk, whether to manage transactional or translational hedging, use a combination of Spot FX and Forward Contracts. There are various ways to hedge which will depend on your type of business, sector and attitude to risk. The AIB Treasury team can provide more information on the different approaches which include:

- Specific contract hedging
- Cash flow hedging
- Rolling Hedge Strategies
- Different types of layered hedging

Given the increased uncertainty of FX cash flows at the current time, it may be useful for businesses to also consider using Forward Contracts with a Time Option (sometimes known as FX Window Forwards). This product allows you to exchange some or all of the value of the contract before the maturity date, within a specific time period or 'window'. This flexibility provides a solution for businesses that face short term uncertainty on the timing of FX cash flows, but know with certainty that they will happen.

Vanilla FX Option

A Vanilla Option gives your business the right, but not the obligation, to exchange specified currencies at an agreed rate on a future date. You pay an upfront premium for this right. This means you have downside protection and can also benefit fully from any favourable market moves. The cost or premium for this protection will vary depending on the exchange rate level you want to protect, contract duration and market volatility.

The upfront premium paid for a Vanilla Option can be a deterrent to their use with businesses asking 'What if I pay that premium and don't need to use my option?' Well that's usually a good thing, as the market rate you were seeking to avoid having to trade at hasn't occurred, you are still in business and the markets may have moved favourably your way. You don't buy fire insurance and consider it poor value if you don't get to use it!

Other solutions

If the level of upfront premium is still on your mind, you can consider other option products which can provide protection. The trade-offs in these products involve a more limited opportunity to benefit from favourable market moves and the potential obligation to trade some or all of your exposure verses a reduction in the upfront premium, or even a zero premium solution.

In essence, the premium or cost of the protection you buy is offset by premium generated by an option you sell capping your ability to participate fully in a favourable currency move. This means that you have a potential obligation to exchange currency at a known rate in the future unlike the Vanilla option but similar to a Forward Contract.

Two alternative potentially zero upfront premium paid solutions are:

1. A **Participating Forward**, which is a combination of a Vanilla option and a Forward Contract. It effectively embeds the premium cost of a Vanilla Option into the Forward Contract, providing guaranteed protection on 100% of your contract amount, and the ability to benefit from favourable market moves depending on the ratio you have requested of Fixed Forward versus Vanilla Option, e.g. 50:50 or 70:30.
2. A **Forward Extra** provides protection at a specified strike rate, and the ability to benefit from any favourable market moves to a specified barrier level. The opportunity to outperform the comparable Forward Contract rate can be considerable, but there is an opportunity cost if the market rate breaches the specified barrier level. If this were to happen, your outcome would be an obligation to trade at the protected strike rate, which would be less favourable than the Forward Contract rate.

Whilst option products can be designed so they have low or no upfront premium, if you no longer need the option because a cash flow is not going to occur, you will need to sell it back to the bank and you could incur a cost. Don't allow the lure of a zero premium or free upfront costs, sway your decision making. Certainty of cash flow is a key determinant on the appropriateness of an option solution.

What is the right mix of products?

Depending on the extent of your exposures, using a rolling hedge strategy with Forward Contracts may adequately manage your risk. However, for businesses with larger or uncertain FX exposure, FX options could also be considered as a more dynamic alternative way to manage your FX risk.

The tried and tested principle of not having all of your eggs in one basket is certainly a good place to start when considering the alternative ways to hedge. A strategy will always be bespoke to individual businesses, and the attitude to risk should be discussed, documented and agreed by business management across all functions.

The important role of Treasury in your organisation

Whether your business has a finance team or a dedicated treasury team, they have an important role to play in ensuring that treasury policy and hedging strategy remains appropriate. Treasury professionals or your bank treasury relationships can bring specialised skills and experience to the table, to help the business identify, understand and manage FX exposures and risks. With Brexit looming, the finance or treasury team should consider the following priority tasks:

- Stress test your current cash flows and P&L using forecasted high and low exchange rates for appropriate future time horizons.
- Share the forecast FX rates assumptions, P&L impacts and cash flow analysis with the management team.
- Seek feedback and input on the commercial aspects of FX rate movements and their P&L impacts. Consider what new market opportunities open up for sourcing or sales, at the extremities of exchange rate movements and how long it would take to execute them; offsetting some of the FX risk in the current operating model and framing the transition period that you need currency protection for to survive.
- Repeat the exercise until you have documented agreement across the management team.
- If you can't satisfy the P&L risk appetite desired by business management using your current FX hedging strategy, contact your bank who can help you to assess your risk, and talk to you about what products may be appropriate to meet your target risk and P&L profile.

Brexit may bring many different challenges to bear on your business including significant exchange rate volatility. We hope that reading this has helped you to evaluate your FX exposure and manage that risk, so business management can focus on the many other challenges facing business leaders in today's environment.

If you are unfamiliar with these products but think your business should consider the potential benefits of using them, your bank will help you to reach an appropriate solution through a comprehensive discussion and transaction process.

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