



An overview of Foreign Exchange for Business Users

Managing Foreign Currency Risk

Foreign exchange rate volatility can severely impact businesses trading internationally. Businesses must therefore be aware of the unforeseen dangers when dealing in international markets as they can have a huge impact on future profits and cash flow.

Businesses dealing in international markets can protect themselves against adverse market movements and any unnecessary exposure with the right knowledge of how these markets work. The risks presented by the currency exchange market can be avoided with the right help and insight.

Understanding the fundamentals of foreign exchange can provide your business with stability and peace of mind when dealing with foreign companies, payments and receipts.

Exchange Rate Fluctuations

If your company imports or exports goods, a small fluctuation in the exchange rate can have a considerable effect on your profits. Exchange rate movements should not be ignored as money may be lost if the exchange rate fluctuates between placing the order and paying for it. The longer the timeframe of the transaction, the greater the uncertainty and the more likely the cost will rise.

Foreign exchange providers can offer solutions that support your business FX needs and can help maximise your return and minimise your risk.

Currency Products and Solutions

There are many ways to buy foreign currency. The most common are:

- **Spot Contract** - This is the agreement to buy or sell a certain amount of foreign currency at the current market rate for settlement in 2 business days time.
- **Forward Contract** - This is the agreement to buy or sell a certain amount of foreign currency at a pre-agreed rate on a certain date in the future. A Forward Foreign Exchange Rate is based on the spot rate at the time the deal is agreed which is then adjusted to reflect the interest rate differential between the 2 currencies involved.

Protecting Against Rate Fluctuations

A forward contract is a way of covering exchange rate risk by locking in an exchange rate in the future. Dealing solely in the spot market can be a high risk strategy, as exchange rates can move significantly in a short period of time and you could lose significant amounts if the exchange rate moves against you. By locking in a forward exchange rate you know the exchange rate you will achieve, therefore giving you piece of mind.

Case Study

To illustrate the importance of getting foreign exchange strategies right, consider this example:

On 9th January 2010, a toy manufacturer (the client) ordered \$350,000.00 (USD) worth of goods from China, and was provided with an invoice due to be paid on 26th January 2010.

On the same day he decided to buy \$350,000.00 (USD) by forward contract which would mature on 26th January 2010 at an exchange rate of 1.53. This cost him £228,758.17 (GBP). By choosing an appropriate exchange rate ahead of time, the toy manufacturer knew the exact cost of the goods purchased in GBP without being subject to the risk of volatile rate fluctuations which were common at the time.

Between 9th January 2010 and 26th January 2010, sterling weakened by 12% against the USD.

If the client had waited and purchased the \$350,000.00 (USD) at the Spot rate of 1.35 on the 26th January 2010, he would have had to pay £259,259.26, which would have cost him an extra **£30,501.09**.

Small companies face risks

Insight from the Close Brothers FX team suggests that smaller companies (particularly if their margins are tight) are affected significantly when there are movements in exchange rates, which can have a drastic impact on their bottom line. Fixing the exchange rate from the start of a contract ensures a business can accurately forecast costs and profit margins on any export transaction.

Mark Taylor, Head of Foreign Exchange, Close Treasury, says “It’s really important that anybody considering purchasing goods overseas takes into account the volatility of the FX rates. If the exchange rate moves against you it will add a big cost to the overall purchase price.

“One way to avoid exchange rate losses is to forward buy currency at a budgeted exchange rate. This enables you to lock the exchange rate in at today’s rate for a date in the future, enabling you to know your exact purchase costs at the time of pricing.”

For more information on foreign exchange strategies, please contact Mark Taylor on 020 7655 3449, or visit our website www.closetreasury.co.uk/fx.

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