Pricing in foreign currency vs. U.S. dollars - how is your company managing c...
Marie N Hollein
AFP Exchange; Nov/Dec 2002; 22, 6; ABI/INFORM Global
pg. 112

Importers or exporters can boost sales by pricing in the customer's currency. But while this transfers the risk of currency fluctuations to you as the buyer or seller, there are several ways to hedge the risk.

Pricing in Foreign Currency vs. U.S. Dollars —

How is Your Company Managing Currency Risk?

Marie N. Hollein, CCM
Ruesch International

Doing business outside your home country creates exposure to currency movements. But doing business inside your home country can have foreign currency implications as well.

Global business, regardless of geographic borders, generates exposure to currency swings. Unless all exposure is understood and quantified, management decisions put your company at risk not only to margin and profit disruptions, but also to share ramifications.

As companies establish or increase their global presence, strategic plans include increased international sales. Financial results are impacted by non-operating risk, and a company must be prepared to help provide stability to earnings and budgets without additional jeopardy to the company.

Inconsistent risk management practices may arise due to misunderstandings about how managing risk works. Some companies take the approach that managing risk is a zero-sum game — sometimes it works for you, sometimes it works against you. Other companies equate hedging with speculation. And there are still many companies that simply do not understand the risks or methods available to manage them.

So why Hedge at all?

When risk management problems occur, hedging instruments are not to blame. Hedging adds stability to corporate earnings, adds flexibility to financing and can reduce the cost of running a company. When risk policy fails, often it is because of a lack of reporting, a lack of control, or a corporation's limited understanding of risk management practices. Fundamental operating decisions may be off-target because they are based on incomplete information.

Many corporate treasurers have found foreign currency exposure management difficult, onerous and very challenging. The sheer discipline of having to watch almost every aspect of the world news every day is itself demanding, yet fascinating. This is essential whether you are trading foreign currencies for profit on a daily basis, as a few large companies do, or you are deciding whether and when to establish or change a three-, six- or 12-month hedged position.

A common problem in managing currency risk is that companies only realize that they have a risk when the exposure has been generated. However, currency risk management should begin before exposure risks have been generated, otherwise fundamental operating decisions have been taken on the basis of incomplete information.

Company approaches to exposure vary widely, perhaps by the nature of the business, the competition or the culture of the company. A company could accept a high degree of risk and expect commensurate returns or it could be very risk averse and prepared to pay quite a high price for certainty. Indeed it may have no stance on currency at all and take everything as it comes.

To remain competitive in the international marketplace, one needs to make it as easy as possible to compare products and facilitate the monetary exchange of funds. Translating your transaction into your customers' local currency improves communication about prices with the customer, allowing you to compete on a level playing field. Depending on your companies' risk tolerance, you may manage exposures in a way that will permit your firm to participate in favorable currency movements.

What is Risk?

Risk is the uncertainty or volatility of the economic value of a company, arising from economic and financial exposures. It affects all areas of a corporation and has a decisive impact on financial statements.

Financial risk comes in many forms for international corporations:

Transaction risk is the exposure that comes from activities such as importing or exporting, the purchase of equipment/services from foreign companies or financing foreign operations.

Translation risk comes from the consolidation of a foreign subsidiary's financial statements to U.S. general accepted accounting principles (GAAP) standards.

Economic risk results from dividend or royalty cash flows, capital investment for overseas expansion, the purchase or sale of foreign business, or the operation of a joint venture with a foreign partner.

Contingent risk is fixed price bid-to-award currency risk.

Competitive risk is the result of price competition with a foreign competitor.

As companies increase global business, these types of exposures greatly increase. Companies often begin to hedge only after an exposure already has been generated. A risk management program that is well established before specific risks exist can protect companies from such exposures.

What is Risk Management?

Risk management is defined as the process of managing the uncertainty or volatility of the value of a company in accordance with a set of appropriate corporate and financial objectives. In companies with successful risk management programs, management accepts that financial results are impacted by non-operating risk and are willing to do something about it. The best programs involve a common-sense approach to hedging risks that fit with corporate objectives, and provide stability to earnings and budgets without additional risks to the company.

Quoting in a Foreign Currency Versus the U.S. Dollar

Importers or exporters in other countries are looking for sellers or buyers to provide pricing in their own currency rather than the U.S. dollar. Many U.S. companies view foreign exchange as very complex and will avoid having to deal with it. Other companies may not be aware that they have a choice. What these companies fail to realize is there is a choice.

Companies are unaware of the premium that may be associated with the transaction by using only U.S. dollars. A company is still paying for the risk only in dollars, thus paying a dollar premium. This is still a very common practice with many companies.

For example, at one international company, the treasury department took an active role in communicating with the purchasing managers, which led to the discovery that many dollar-invoiced capital purchases were actually originating from offshore manufacturers in various European countries. These suppliers were billing the company in dollars and building their own hedging costs into the dollar price, and in effect, charging three to 12 percent above what it would have cost the company if the price had been in the local currency and the company had been hedging itself.

Once the problem was identified, an agreement was made that required purchasing managers to ask for price quotes in both the local currency and in dollars. This allows the company to perform a hedging cost analysis and advise on the most cost-effective method to purchase materials.

From a customer's view, quoting in their currency takes the foreign exchange element out of the transaction, thus mitigating both confusion in pricing and buyer risk of adverse currency movements. But that means you take the risk.

When quoting in a foreign currency, consider your margins and price sensitivity, the time frame during which the transaction is being consummated, and the likelihood that the transaction will actually occur. All raise the need to manage exposure to currency fluctuations.

To Hedge or Not To Hedge?

Hedging objectives should include eliminating foreign exchange risk, minimizing hedge costs within defined risk parameters, hedging to obtain competitive advantage and minimizing foreign exchange volatility over a specific period of time.

The leaner your margins are, the greater your need to hedge against foreign exchange risk. In a highly competitive market, obviously one cannot build in high margins that would protect you against adverse currency movements. Also, the longer your price offer stands, the more you will need to consider hedging.

Companies can cover their exposures with the following:

Spot Transactions

You may have your foreign currency accounts receivable payments directed through your domestic bank's correspondent banks for immediate conversion and credit to your domestic U.S. dollar account. This is a risky alternative since you are converting proceeds at the current market price, which may differ significantly from that used in initially setting your price quote. Conversely, if you have taken a view that the currency will move in a favorable direction, this technique will allow you to fully participate in that movement.

Option Contracts

A currency option mitigates risk by giving the buyer the right, but not the obligation, to purchase or sell a currency at a specific exchange rate during a set time frame pending bid acceptance. For this right, the buyer pays a one-time premium. The buyer can exercise the option during its term, or allow it to expire.

Currency options denominated in foreign currency define and limit risk associated with future financial commitments to the amount of the premium, while affording unlimited opportunity to participate in any favorable currency rate movements. A company may purchase an option at a strike price that would provide protection at the desired level.

Forward Contracts

Forward contracts also can be used to lock in the exchange rate for payables, receivables or any transaction anticipated on a specific future date. A forward contract guarantees the U.S. dollar value of a business commitment resulting in the purchase or sale of a foreign currency for a future date. This alternative provides the flexibility for the company to specify the currency amounts and delivery date necessary to eliminate the foreign exchange risk.

Window Forwards

These contracts also lock in an exchange rate and offer more flexibility by providing the pricing certainty of a traditional forward contract, but with a flexible delivery date. This product is appropriate for payments that have uncertain due dates.

For example, window forwards allow you to take delivery or make payments in another currency at any time during the anticipated delivery month rather than on a specific date. This guarantees constant pricing over a continuous range of possible delivery/settlement dates, which allows you to obtain efficient price protection and maximum business flexibility. This strategy simplifies accounting and eliminates the cost associated with shifting foreign currency settlement positions from one date to another.

Understand the Opportunities

Depending on company policy, risk appetite and willingness to pay premiums, any number of traditional risk management products can be used to mitigate the risks associated with receiving or sending cross-border payments. Foreign exchange transaction costs should be viewed as a cost of doing international business, similar to freight or insurance. These fees should be factored in when determining your product pricing margins.

It is important to understand the commercial risks and opportunities of the business operations, understand the financial risks and opportunities these business operations create; and understand and maximize the interaction between them. Procedures should be in place to identify and evaluate alternatives for managing risk exposures, to select appropriate actions and to take actions within the stated authority of a company's objectives, policies and procedures.

One of the key drivers in the trend toward strategic, service-oriented treasuries is financial risk management; currency, interest rate and in some cases even commodity risk. Risk management is one of the key areas where treasury has the opportunity to add the most value. The effect of currency movement on the profitability of the company is obviously very important.