Identifying Currency Risk in Global Trade

Alfredo Guzman *Head of Mid-Corps Fixed Income and FX Sales*

When conducting business internationally, your company may be exposed to currency risk—even if you buy and sell in U.S. dollars (USD). Generally, operating in USD is driven by the desire to eliminate currency risk and to make transactions more efficient. However, doing so may not prevent your company from explicit or implicit currency risk.

Identifying Currency Risk

The most common way to identify currency risk is to determine your company's liabilities, assets, expenses, or revenue streams that are denominated in currencies other than USD. The specific currencies and transaction agreement details will determine how you can approach this risk, measure it, account for it, and—most importantly—protect against it.

For example, if your company wants to sell to foreign-based customers in Europe, you must first decide whether to set the sale price in euros (EUR) or in USD. A EUR price may be more attractive to a European-based customer, as they have a constant price in their local currency. This means that the value in USD terms will fluctuate, resulting in margin uncertainty. Santander can help you identify currency exposure and assess hedging strategies, which can reduce volatility and lead to more predictable margins.

The above example is relatively straightforward, but there can be more nuanced currency exposures. Imagine that a company's European branch is buying goods from its parent company in the U.S. They have arranged a long-term agreement to purchase a fixed amount of goods each month. The agreement is denominated in euros (EUR). To make things easier, the European branch will exchange EUR for USD and pay the agreement in USD. In this situation, the parent company will hold the risk for the revenue flow in EUR, even if its branch is paying with USD.

Because the agreement is based on a fixed amount of EUR, the U.S. parent company will receive different amounts of USD every month as the EUR/USD exchange rate fluctuates. The extent of the U.S. company's currency risk exposure will be determined by how much those USD payment amounts vary month-to-month, and the currency risk will be reflected in the parent company's books in the U.S.

Now imagine that the same U.S. company is exporting goods to Canada. The company's Canadian clients want to pay in Canadian dollars (CAD), and sales are typically conducted on an "account" basis, which can span between 30 and 90 days. During this period, the U.S. parent company will hold receivables in CAD. Because the CAD exchange rate will differ between the moment that the sale is recorded and the time at which the payment goes through, the extended payment period puts the U.S. company at greater currency risk. A window forward contract could be used to hedge currency here, protecting margins.

In addition to explicit currency risk, companies also may be exposed to implicit currency risk when buying or selling internationally. Following the example above, the same U.S. company is buying goods from China and South America and paying in USD. The foreign suppliers will adjust the prices of their goods according to the extent of the currency risk exposure in their own markets. As a result, the U.S. buyer may be affected by variations in currencies with which it has only indirect exposure, adding implicit costs.

Currency Hedging Solutions

Whether buying or selling, companies may use a number of currency hedging solutions to protect themselves from risk. These solutions allow companies to lock in the exchange rate at the time that a transaction price is agreed upon, therefore avoiding the risk associated with fluctuating exchange rates.

Currency hedging instruments include:

- Forward contracts: A basic arrangement in which all parties set a specific date when they will get the currency they need for a price they agree to today.
- Window forward transactions: These agreements provide more timing flexibility by allowing settlement any time between two dates specified in the contract.
- Foreign currency option contracts: As with other option contracts, companies pay a price for the option, but do not need to exercise it unless it is advantageous to do so.

Determining the best strategy to use and how to implement it will depend on many factors—Santander can help you find the most effective and efficient hedging strategy for your company.

Please contact your Santander relationship manager if you would like to learn more about how FX hedging can help you cover currency risk.

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