IDENTIFYING AND MANAGING HIDDEN EXPOSURES

INDIRECT EXPOSURES ARE LESS EASY TO IDENTIFY AND MITIGATE THAN DIRECT EXPOSURES. ENRIC GIRONES EXAMINES HOW SIGNIFICANT THESE HIDDEN EXPOSURES CAN BE, AND HOW UK TREASURERS CAN UNEARTH AND MANAGE THEM

When corporates have revenues or costs denominated in foreign currency, there is a clear and readily identifiable direct FX exposure. The final value of these revenues or costs can vary in accordance with currency movements, so there is a risk that the company will be adversely impacted by any fluctuations. Treasurers can decide whether or not to hedge their direct exposures, based on the level of risk to their companies and their risk tolerance.

In other cases, UK companies may pay their overseas suppliers in sterling or in a currency other than sterling and the supplier's functional currency (for example, goods imported from emerging markets (EM) may be invoiced in USD). While these arrangements may avoid direct FX risks and exposures to generally more volatile and less liquid EM currency markets, indirect exposures can arise because suppliers may pass on the impact of currency movements, or their own hedged rates, to customers, as Figure 1 (right) shows. These exposures are much less visible than direct exposures, so companies do not always manage them effectively and may not even be aware of them.

Understanding the impact of indirect exposures

While it's easy to overlook, we have seen examples where a company's indirect exposures have been as much as four times the size of its direct exposures.

An overseas supplier that is not hedged may be running the risk that the payment received from its UK customer is not enough to cover its own costs. This may put the supplier's business at risk – and if the supplier fails, the UK customer's supply chain could be disrupted.

It can take time for UK companies to feel the impact of indirect FX risks. While the EU referendum – and resulting GBP depreciation – took place in 2016, some UK companies have only recently started to focus on the indirect risks as existing supplier arrangements or suppliers' hedging programmes reach expiry.

How to manage the risks

It can take time and effort to understand the indirect FX impact of existing supplier arrangements, given that getting information from suppliers may prove difficult. However, managing these exposures better can result in clear benefits.

For companies looking to manage indirect FX risk more proactively, the first step is to understand the inherent exposure. This may be challenging if, as is sometimes the case, the communication between the treasury and procurement teams is limited. In the first instance, it may therefore be necessary to improve communication between treasury and other parts of the business to ensure that goals are aligned.

The next step is for treasurers to find out whether suppliers are hedging their FX exposures, or whether they are adding a margin to the export price to cover FX volatility. The different possible scenarios are outlined below and summarised in Figure 2 (opposite).

If the supplier hedges its FX risk, the UK treasurer could focus on gaining a clearer insight into the supplier's hedging strategy and the extent to which this aligns with the UK company's strategy. Key considerations are the tenor, types of instruments, notional amounts and hedging ratios.

- If the strategies are aligned, it is likely that FX-related price fluctuations will be consistent with the UK company's hedged exposures, although it's worth noting that the

Figure 1: Schematics representing how FX risk may indirectly impact the final price of goods

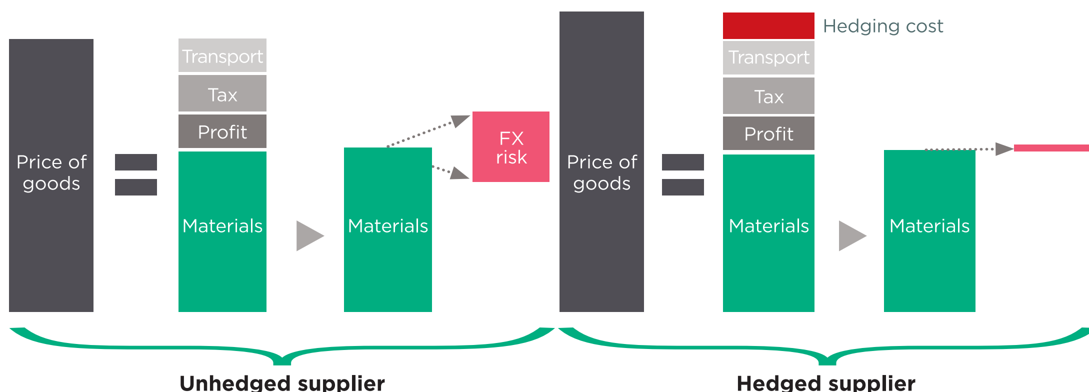
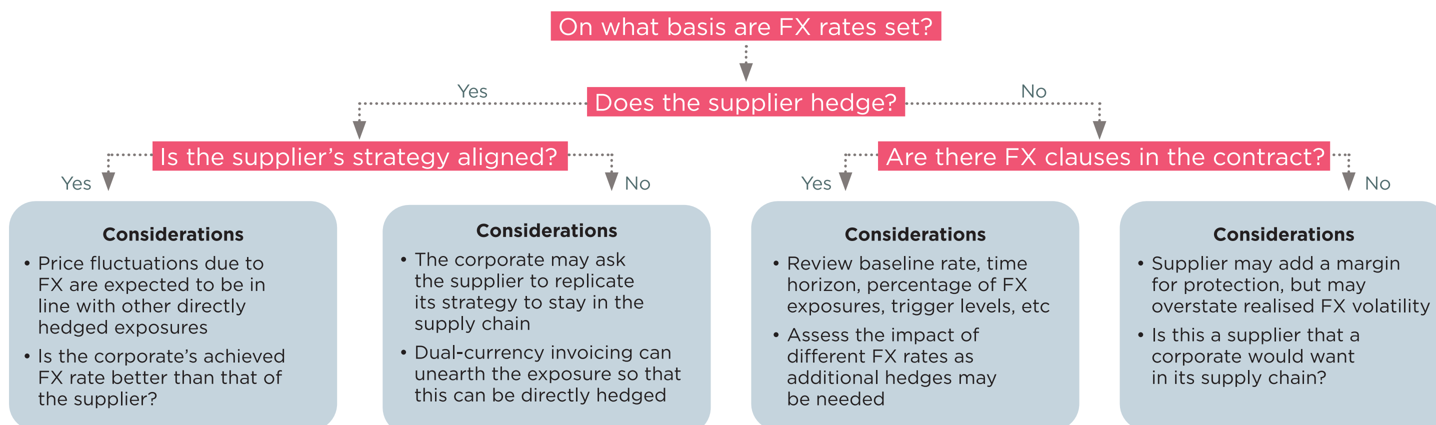


Figure 2: Diagram summarising considerations on how corporates may manage indirect FX risk



achieved rate by the UK corporate may be better than the supplier's rate if the UK company has a natural offset against other exposures, employs a more competitive execution method or a wider banking panel.

- If the strategies are not aligned, the UK company could ask the supplier to replicate the UK company's hedging strategy. This has the advantage of giving the UK company clarity over how FX movements will impact the final cost of goods. Alternatively, the UK company could ask the supplier to invoice in its local currency or in dual currency, so that the exposure becomes part of the company's directly identifiable FX exposure. This may not be accepted by those suppliers with GBP-denominated costs, as a GBP invoice could produce a natural offset.

If the supplier doesn't hedge its FX risk, it may be passing on the impact of FX movements via FX-linked clauses in the contract, which set out how FX movements may affect the final price paid by the UK company.

- If FX-linked clauses are used, such as details of the baseline exchange rate of the initial quote, the percentage of the total cost that is denominated in the local currency, the percentage change in currency that will trigger a pricing adjustment, and the time frame during which the baseline rate and pricing are valid. The corporate can use this information to stress test the impact of different FX scenarios on the final price and decide whether additional hedging is needed.
- If FX-linked clauses are not used, the supplier may be including a margin in the final price to protect itself from the impact of FX movements. The treasurer should compare this margin to the realised volatility of the currency pair in question (for example, GBP/USD) and decide whether the risk is being overestimated. If an extreme FX move could potentially put the supply chain at risk, the UK company could either reconsider working with the relevant supplier, or explore moving to dual-currency invoicing in order to manage the exposure directly.

Achieving clarity

Whatever the chosen approach, it is important for both parties to achieve clarity about the impact of currency movements on the overall price of goods. This requires two-way communication between the UK company and the supplier.

The good news is that, by tackling this area proactively, UK companies can gain greater visibility into their indirect FX risks and make more informed hedging decisions. Similarly, they may be able to increase the stability of their supply chains by managing the risks themselves. It is worth noting that this topic may extend beyond FX risk: it may also be advantageous to look at the implications of exposures relating to commodities and logistics.

The upcoming changes in accounting standards are also to be considered. While the introduction of IFRS 9 will allow hedging of identifiable components in contracts, applying hedge accounting on indirect FX exposures may prove difficult. Alternatively, UK treasurers can consider using economic hedges when mitigating their hidden risks.

In conclusion

Since the 2016 referendum, more UK companies have been taking steps to understand and manage their indirect FX exposures. This is not without its challenges: it can be difficult to gain visibility over this type of risk, with a lack of alignment between treasury and procurement often presenting an obstacle. However, this is not insurmountable – and by communicating efficiently, both with internal procurement and with external suppliers, treasurers can gather the information needed to manage their exposures more effectively.

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