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What is foreign exchange risk hedging?

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WHAT DOES IT MEAN?

Foreign exchange (forex) risk hedging refers to what a company does to reduce its business exposure to forex rate fluctuations.

Hedging practices usually involve the usage of currency contracts such as futures, forward, options and swaps.

These contracts are designed to provide some payoffs conditional on the underlying exchange rate movements.

As a result, the company can be insured from the unexpected adverse currency movements.

But such insurance may also come with a cost. Hence, companies have to decide how much and how long they need to be protected from the forex risk.

WHY IS IT IMPORTANT?

More and more companies have to grapple with supply and demand – both domestically and also from abroad.

The suppliers can be located thousands of kilometres away and demand the payment for their goods or services provided in their home currencies.

Others may prefer to pay or receive payment in US dollars only. More recently, the exponential growth of Chinese companies also brought forth the challenge of dealing with a controlled currency.

To hedge forex risk for the short term – typically a year or so – companies can use standardised currency contracts such as futures and options.

These futures and options are available not only in major currencies such as the US dollar and the euro, but also in many Asian currencies.

The futures contracts denominated in Asian currencies are available for trading offered by the Singapore Exchange (SGX). To meet the surging demand, some yuan options and futures contracts traded on SGX can even last for three years.

If companies want to hedge forex risk that goes for multiple years, they may need to rely on customised contracts, such as currency forward and swaps.

When the need to rely on these contracts arises, financial institutions such as banks are required to find suitable counter-parties and to ensure the proper design and delivery of the contracts when they expire.

The good news is that the hedge can be perfect, where there is a complete removal of the forex risk for the underlying exposure; whereas the disadvantages of these contracts include counter-party risk or opportunity cost if the exchange rate has moved in a favourable direction during the hedging period.

For example, if the Singdollar weakens against the US dollar during the hedging period, the profits earned in US dollars will be more when converted back to the Singdollar. If the company has purchased the currency option, it still has to incur the hedging costs, such as the option's premium.

IF YOU WANT TO USE THE TERM, JUST SAY:

"Forex hedging with well-chosen contracts can be beneficial for companies' bottom lines."

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