FX Payments

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Your Complete Guide To Forex Volatility

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Introduction

Venturing into the global marketplace opens your business up to an endless stream of opportunity and new avenues for growth. Unfortunately, with new opportunities comes new risks. Expanding on an international level increases your exposure to foreign exchange risk, particularly in the face of currency volatility. It's important to gain a firm understanding of your various exposures, where they are coming from, and the applicable risk mitigation strategies.

Every business is unique, as is every venture. Therefore, your exposure and your mitigation strategies must be equally unique and even rather creative at times. While global business and foriegn exchange are certainly not new concepts, they are more widely significant with each passing day. The digital age is breaking down barriers at a rapid pace and in order to adapt and grow to meet demand, you must employ a set of agile solutions to protect your business and your bottom line.

In this guide we break down volatility as it relates to global payments and foreign exchange risk management. Here's what you need to know.

What Is FX Volatility?

Volatility is a term used to describe price fluctuations in relation to an average price over a period of time. Currency volatility, also known as foreign exchange (or forex) volatility, is the near constant change in exchange rates in the global foreign exchange market.

A specific currency's volatility can be considered either high or low. This is measured by how far its value typically deviates from the average. Put more simply, volatility is measured by standard deviation. If a currency is especially volatile, that means there is more risk involved. Though, it also means there is more opportunity to profit from fluctuations if you keep your finger on the pulse and strategize effectively.

International business requires the ability to deal in multiple currencies. This leaves us all at the mercy of the foreign exchange markets, whether you're importing raw materials from China, paying staff in Sydney, or exporting goods to the US.

If you are based in the UK and the pound is strong, your costs for imported goods come down but it's harder to sell abroad. If you are based in the US and the dollar is weak, the opposite is true. The result can be an unpredictable and unstable bottom line. Businesses can adjust their prices as the market shifts as it would not bode well for retaining customers and building brand trust. Though, absorbing losses made while transferring between currencies isn't an attractive option, either. So, how are you to judge if a currency is especially volatile?

Measuring Volatility

As we mentioned, volatility is a measure of standard deviation. While it may sound simple, it can be difficult to track because, in its essence, volatility is unpredictable. There are two types of volatility to be aware of: implied volatility and historical volatility. With historical volatility, you can look back upon past fluctuations to determine if a currency has been volatile in the past. With implied volatility, this is a matter of both extrapolating from past data as well as using foresight into a market's expectations.

Historical volatility is used less commonly as it isn't forward-looking. It is used by looking to past values to identify and calculate price changes. This metric is usually calculated based on a price change from one closing price to the next. By using historical volatility calculations, you can get a picture of relative value fluctuations over specific time changes. For example, you may conclude that the average historical volatility is 15% over a month-long period. You can then understand if a currency is changing at a higher-than-average rate.

In the case of implied volatility, this is a forward-looking metric. It uses things like supply and demand, market shifts, and global events to predict upcoming fluctuations. Both historical and implied volatility are often taken into account together to get the full picture.

It's important to understand the difference between volatility and risk. While volatility may offer the potential for more risk, the two aren't one in the same. Namely, volatility is out of your control while risk is up to you.

You use your understanding of how volatile a currency is to determine your exposure to risk and, in turn, how much risk you are willing to take on. Dealing with volatile currencies carries a great deal of risk, so it is your decision to expose yourself to that risk or not and, furthermore, to determine the degree of your exposure.

What Is The Impact Of Foreign Exchange Volatility?

Now that you have a better understanding of what volatility means, we can explore how it impacts you and why it's an important factor in your international payments and forex decision making.

Currency volatility impacts most facets of life. From the economy itself to the consumer and the business, most members of society feel the shifts to some degree. While the economy takes the brunt of the impact, businesses who operate on an international scale carry the weight, as well. All businesses are affected by currency fluctuations to some degree, but those who export and/or import across borders feel the impact with the most severity. In these cases, a business's bottom line can take a huge hit if they haven't employed an educated risk management strategy.

For example, if a business is headquartered in the US and importing from the UK or paying UK expenses, when the US dollar weakens against the pound, their projected costs or profit margin could increase significantly. On the other hand, if the opposite were to happen, they could see an increase in profit as their currency becomes more valuable in comparison.

These impacts are not only felt in the instance of cross-border import and export. Volatility must be taken into account for any business that ships internationally, sells globally, pays for services abroad, or carries out any type of cross-border transaction.

From sending money directly to purchasing or selling goods, currency fluctuations impact a business's bottom line if there isn't a proactive risk management strategy in place. These risks are even more prevalent in the case of volatile currencies.

What Is Foreign Exchange Risk?

Currency risk or foreign exchange risk refers to the potential loss that an organization may incur as a result of fluctuations in currency exchange rates. Currency exchange risk is an important factor to consider for any international business, no matter how big or small the size of your company.

As an accountant or CFO, it would do you good to assess what impact fluctuations in currency rates could have on your company's profit margin and balance sheets and take steps to mitigate these risks. This is true not just for banks and financial institutions dealing in large sums of international currency transactions, but for any company across a wide range of sectors that deals in foreign exchange directly or indirectly.

Volatility in currency exchange rates could affect your company's bottom line in numerous ways. Banks and financial institutions that process payments and transfers internationally can be vulnerable to sudden fluctuations in currency values caused by unexpected regulatory changes. For a company in the manufacturing sector, foreign exchange fluctuations could impact the price at which you buy raw materials from, say, another country.

Foreign exchange risk could occur in the form of a direct loss which can take place when an international company transfers funds from one country to another as part of regular operations or occur when an investment's value may fall due to fluctuations in currencies that the company is dealing in.

Firms that sell their products overseas can also be affected by forex volatility, as rising or falling currency rates could have a direct impact on their sales forecasts and profit margins, eventually impacting the company's bottom line. Thankfully, there are numerous ways in which you can assess and mitigate foreign exchange risk and protect your company's bottom line.

There are three main types of foreign exchange risk. These are transactional, translational, and economic risks.

Transactional risk

Transactional risk pertains to the volatility experienced by fluctuating rates between different currencies. Transactional risk mainly occurs as a result of currency exchange rate fluctuations between the rate at which a transaction is executed and the rate at which the price is calculated when the transaction is settled.

Translational risk

Translational risk or accounting risk can occur when a company that has offices or subsidiaries in other countries could face unanticipated losses due to currency exchange rate fluctuations. This could happen when the subsidiary's financial statements, which will be denominated in that country's currency, are translated back to the currency of the company's main currency of business. Fluctuations in currency exchange rates at times like this could result in the parent company making lesser returns than it had originally expected.

Economic risk

Economic risk is also known as forecast risk and can occur when a company's market value is impacted by unavoidable exposure to currency fluctuations. Fluctuating currency exchange rates can make it difficult for accounting teams and CFOs to accurately plan budget forecasts for their companies. Fluctuations can also make it difficult for small or mid-sized firms to accurately forecast profits as it is difficult to know the final amount that will ultimately reach your account once the currency has been converted.

Foreign Exchange Risk Management

Any good foreign exchange risk management strategy begins with first identifying where the biggest risks are for your company. A good accountant would then calculate their exposure to foreign exchange risk. A lot of companies use exchange rate risk and hedging techniques to protect their company from unexpected risks in the foreign exchange market.

Numerous banks and financial institutions offer companies the option of hedging their foreign exchange risks. You can also hedge your company's foreign exchange risk by taking advantage of leveraged trading accounts. Numerous brokers offer regulated trading accounts in numerous countries globally. Options contracts, exchange-traded funds (ETFs), and forward contracts are a form of derivatives trading and are just some of the ways in which you can hedge your company's FX risk. Derivatives trading enables you to take a position on the forex markets to offset any potential foreign exchange losses that your company may become exposed to. Other safeguards include devising an effective forex policy that will protect your company's FX exposure during periods of high volatility.

A good risk management strategy is key to managing foreign exchange risk exposure. There are numerous strategies you can use to protect your company against unforeseen foreign exchange risks. The first step is to assess the amount of FX risk your company is exposed to, and then take steps to mitigate these risks.

What Is Hedging?

Hedging is a term that comes up in all areas of life. Though, the most prominent setting is within the world of finance and investments. First and foremost, the word itself simply means to protect oneself from loss on some sort of transaction. Some helpful synonyms include: to protect, guard, cushion, or insure. Generally speaking, to hedge is to take all factors and conditions into account and make a move that reduces the possibility for loss. Essentially, it's when someone tries to reduce risk.

Now when we're talking about making moves or transactions, typically these are in the form of investments. Technically, we all perform hedging in some form in our everyday lives. Paying for life or travel insurance is a helpful example of a hedge.

We purchase travel insurance before going on a trip to gain control in what could be an unpredictable situation. We all hope nothing bad happens when we head off on a trip, but anything from an injury to stolen property can take place and insurance helps you hedge your bets so you incur as little loss as possible in an unfortunate situation.

The concept is a little different when it comes to investments. Hedging is extremely common among investors as it is a key strategy for risk management. There are many ways to go about hedging, but its overall function is to limit risk in one's investment portfolio. Here's the thing, while hedging may reduce your risk, it also reduces your potential reward.

To hedge your investments, you would make offsetting investments which have negative correlations. This means that if one goes up, the other goes down, and vice versa. In the travel insurance example, you're not able to recover the base cost of insurance, even if you have a claim free trip. Leaving the potential reward of not having an accident lessened.

As you've likely come to understand, hedging is not a cash cow, but rather a way to protect yourself from losses.

If your investment makes money, your hedge will reduce the money you could have made. Though, if your investment loses money, your hedge will work to reduce your potential loss.

Foreign Exchange Hedging

A facet of this financial tool is currency hedging, also known as foreign exchange hedging. Currencies are known to be volatile, some more than others, and it's important to protect yourself if you consistently deal with multiple currencies.

The process works in six steps. First, you must identify exposures. Foreign exchange exposure means the risk a business takes when making transactions in other currencies. Moreover, it refers to identifying the vulnerability of a currency in regards to depreciation. Put simply, identifying exposures is analyzing risk.

The next step is formulating a currency risk management policy within your organization. You would then determine your budget rates and goals, formulate a hedging strategy, execute said strategy, and analyze your results and adjust accordingly.

Risk management in the sphere of currency is a strategy-heavy task, particularly if you are working with highly volatile currencies. Though, it can be extremely beneficial when executed mindfully. A key component of the strategy is also a consistent re-analysis of results and re-strategizing as needed.

There is also the ability to utilize Foreign Currency Options which can be imagined as insurance policies. They give the individual a chance to buy or sell a currency at a specific price on or before a date in the future.

Hedging has clear advantages, being risk minimization and support through hard market periods. As for disadvantages, it typically involves costs that can consume the profit.

It is also a difficult strategy for short-term investors. Hedging can also be frustrating when a market is performing especially well, as investors who hedge have negative correlations on their earnings. Lastly, successful hedging requires strategy, knowledge, and experience.

Some types of hedging, currency hedging for example, are far easier for beginners to master.

About OANDA FX Payments

OANDA, a global leader in online multi-asset trading services and currency data, and Currencycloud, the leader in providing B2B cross-border solutions, are working together through their respective partnerships with Shift Connect to deliver cross-border payments functionality to OANDA's North American corporate client base.

OANDA FX Payments helps North America's corporations to manage their global FX payments. Clients benefit from OANDA's international leadership in FX data and trading, coupled with trust in a leading brand and best in class technology partnerships. OANDA FX Payments provides dedicated and personalized customer support, coupled with an easy to use online platform.

The combination of OANDA, Shift Connect and Currencycloud brings together the best of breed payment technology and service solutions to deliver an unrivalled solution to OANDA's corporate clients in North America. OANDA's customers will now be able to make cross-border payments in more than 35 currencies.

To learn more about corporate FX payments, visit:

https://www.shiftconnect.com/oanda/

Or contact us via phone or email:

North America: 1-888-999-7068

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