BRITISH EXPORTERS ASSOCIATION

Tender to Contract Foreign Exchange (FX) cover **February 2021**

UK exporters regularly provide fixed price quotations in foreign currency such as USD or EUR. This brings an additional risk during the period before any export contract is concluded. In this paper, BExA proposes that UKEF extends its product range to provide this FX support to encourage UK companies to export more.

Summary

One of the major reasons[1] UK businesses have stated that they shy away from exporting their goods and services is Foreign Exchange rate risk. This is usually for two reasons, one being that the products available to mitigate FX risks are typically expensive and inflexible, and the second is simply a lack of understanding of the risks and how they can be managed[2].

For exporters, the lack of a credible product for tender to contract FX risk leads many to take the risk themselves or not engage in the first place. A simple, flexible portfolio based approach to tender to contract FX (TTC) could be set up by UKEF to run at no net cost to the taxpayer. This would enable smaller exporters to bid for overseas contracts with certainty of their margins. The bidding process is itself costly and so this product will need to involve minimal up-front cost. An effective TTC product could change the face of UK exports and provide a tangible boost to the UK market.

The Problem for UK exporters

Whilst the UK is proud of the Pound (GBP), and it is a major currency, it is not a currency that is in much demand overseas, therefore the vast majority of export contracts are denominated in foreign currencies. In the main, this is in one of the two major liquid currencies, the US Dollar (USD) and the Euro (EUR), the rest being in other major currencies such as the Japanese Yen (JPY) or Canadian Dollar (CAD) for example. A smaller number of exports are denominated in more exotic local currencies in developing markets.

Buyers will naturally prefer to have contracts denominated in currencies they can easily manage, so this pushes the FX fluctuation risk on to the exporter. During the last 2 years, GBP has ranged from 1.1485 to 1.4141 against the USD and 1.064 to 1.205 against the EUR, ranges of 23% and 13% respectively.

As very few export contracts are denominated in GBP, UK exporters are exposed to risk at various stages of the export contract, both pre- and post-contract. Post-contract FX risks are more easily managed as at this stage payment timings are more certain and are being formalised. Pre-contract

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[1] British Business Bank report: UK SME exporting trends: finance and trade February 2020 - reference to:
Federation of Small Businesses 2016 member survey which found that exchange rates posed the biggest challenge to exporters (35%); and
DIT NSRB 2017 assessed barriers to exporting and found 16% of businesses identified exchange rate fluctuations and 12% increased financial risk as a barrier (Department of International Trade, 2018)

[2] Bibby Financial Services 'Trading Places' report 2017

FX risks arise when a UK exporter is bidding on a contract in a foreign currency, with the risk starting from the time the exporter submits its bid to the point a contract is signed. A small movement in the exchange rate between the two currencies could wipe out the exporter's profit margin leading to at best, the exporter walking away from the deal or, at worst, the exporter taking on the contract at a loss.

The exporter is unable to cover the FX risk pre-contract, because until the contract is signed, there is no guarantee of being able to deliver the foreign currency upon maturity of the hedge. Further, the fluid nature of contract negotiations means that timescales for the tender phase can vary quickly and significantly, which precludes the use of off the shelf FX management: these solutions are more likely to create a risk, not mitigate one.

Available solutions

There are a host of FX products that allow companies of all sizes to manage their FX risks. These are all predominantly designed around certainty so work well where amounts and timings are known and contractually agreed.

The simplest FX product is the FX Forward – this is an obligation to Buy (or Sell) an agreed amount of one currency for an agreed amount in another at an agreed point in the future. This is generally a low cost instrument that is priced at a margin to the relevant Forward Rate (calculated as the difference in the two currencies forward interest rate curves applied to the current day's exchange rate, the SPOT rate). However there is a contractual obligation to fulfil this trade at the forward date whether or not the currency is needed and therefore there are often further security requirements levied on SMEs to ensure that they will perform the trade, i.e. cash collateral or liens over business (or even personal) property. There is no flexibility offered in a FX Forward, it ends on the Forward date regardless of whether the exporter has signed the export contract then or not.

Another FX product suited to providing certainty over future cashflows is the FX Option. This is the right to buy FX at a future time. The FX Option takes a statistical modelling approach to calculating the future FX rate and most importantly calculates the Option premium – the cost to the Exporter of buying the option. Crucially it also offers a degree of flexibility in that the exporter can decide not to use it; however they have paid for this privilege (often 2 or 3 times more than for a FX Forward). The option works by locking in an exchange rate at the option date that the exporter can decide to use at that point or not. There are three scenarios that would usually play out:

1. Exporter wins the contract and exchange rates have moved against them – utilise the option.
2. Exporter wins the contract but exchange rates have moved for them – decline the option and trade at the day's SPOT rate.
3. Exporter loses the contract – decline the option.

This is all good where the contract date and cashflow dates are known in advance and the exporter is awarded the contract and therefore has the cash to pay for the option. However, it is unusual for all this to fall into place and so if there is a delay to the tender process, the exporter is left with the choice of calling the option and then potentially losing the export contract or letting the option lapse and then winning the export contract. Both these scenarios lead to additional FX headaches for the exporter.

Why we need UKEF's help

Although the private market has solutions to hedge FX risks, they are both expensive and inflexible for the exporter. Many exporters therefore trade at spot FX prices and take the risk, whilst others don't export at all.

There is no private market solution for Tender to Contract (or Pre-Contract) risk periods. An FX Forward is more likely to create a risk, and a FX option should only be purchased when the tenderer has a very high probability, typically more than 50%, of winning a tender. We therefore ask UKEF to put in place a tender to contract FX scheme matching the schemes provided by other [3]ECAs.

Specifically we ask UKEF to implement a portfolio based approach to managing this FX risk. This would enable flexibility for the exporter whilst providing a low cost solution both from UKEF and the Exporter's perspective.

This would work as follows:

- Cover provided by UKEF on an internal portfolio basis, i.e. UKEF does not formalise any cover externally until the export contract is won.
- Cover periods for tenders would depend on currency pairs
- Cover to be provided for up to 105% of the contract value (to cover increases in contract scope)
- Provide flexibility to extend cover period in 3 month intervals. Retaining rates where possible. If the market has moved against UKEF in the intervening period then UKEF may increase the rate by up to 1% per month extension.
- Any losses on the FX rate to be borne by UKEF
- Any gains on the FX rate to be retained by UKEF
- Including the small Premium earned by UKEF (i.e. there is always an upside in this respect), over a portfolio, UKEF meets its core requirement to work at no net cost to the Taxpayer. See Appendix for example portfolio approach.
- Upfront Premium as a % of the total premium to limit the cost to the exporter which may lose the tender
- Premium true-up, post any contract win, to be settled within 5 days of export contract signature

The management of such a system, and the pricing of the forward rates, can be achieved with relative ease and automated to a large degree. Such arrangements have been put in place by the Treasury functions of large exporters. The TTC product should not be a resource intensive product for UKEF to manage. BExA would be pleased to assist in setting up the product.

Support the Campaign

To lobby UK Export Finance to implement TTC, BExA is looking for UK exporters who have either been negatively impacted by FX fluctuations or have decided not to bid on export contracts in foreign currencies because of the associated risks and/or the costs of hedging.

Please share your experiences with us by emailing michelle.treasure@bexa.co.uk or call 07498 749002.

BExA would also welcome collaboration with other trade bodies on this issue.

[3] BExA Annual ECA Benchmarking Report 2020

Appendix – Example Portfolio

Consider the following small portfolio of 10 deals for illustration purposes only.

Deal	1	2	3	4	5	6	7	8	9	10			
Currency 1	GBP	GBP	GBP	GBP	GBP	GBP	GBP	GBP	GBP	GBP			
Currency 2	**USD**	**EUR**	**CAD**	**SEK**	**KES**	**USD**	**CAD**	**BRL**	**HKD**	**SGD**			
Tender amount (in CCY 2)	**10,000,000**	**15,000,000**	**5,000,000**	**200,000,000**	**1,500,000,000**	**5,000,000**	**12,000,000**	**66,000,000**	**102,000,000**	**22,000,000**			
Tender start (months from	0	1	0	0	3	1	4	2	0	1			
Tender period (months)	9	6	7	5	4	3	6	6	4	8			
Premium (bps)	**10**	**10**	**12**	**12**	**15**	**10**	**12**	**15**	**12**	**12**			
Forward rate	1.42	1.15	1.81	11.75	155.3	1.39	1.8	7.75	11.25	1.91			
GBP equivalent	7,042,254	13,043,478	2,762,431	17,021,277	9,658,725	3,597,122	6,666,667	8,516,129	9,066,667	11,518,325			
Premium amount	7,042	13,043	3,315	20,426	14,488	3,597	8,000	12,774	10,880	13,822			
Upfront Premium (20%)	1,408	2,609	663	4,085	2,898	719	1,600	2,555	2,176	2,764			
Actual spot rate at contract	1.40	1.18	1.85	11.45	152.00	1.43	1.77	7.83	11.10	1.87			
GBP actual	7,142,857	12,765,957	2,702,703	17,467,249	9,868,421	3,496,503	6,779,661	8,429,119	9,189,189	11,764,706			
FX Gain or (Loss)	**100,604**	**(277,521)**	**(59,728)**	**445,972**	**209,696**	**(100,619)**	**112,994**	**(87,010)**	**122,523**	**246,381**			
Tender status	**Won**	**Won**	**Loss**	**Won**	**Loss**	**Won**	**Won**	**Won**	**Won**	**Won**			
Cashflows													
Month	0	1	2	3	4	5	6	7	8	9	10	11	12
Deal 1	1,408									106,237			
Deal 2		2,609						(267,086)					
Deal 3	663												
Deal 4	4,085					462,313							
Deal 5				2,898									
Deal 6		719			(97,741)								
Deal 7					1,600						119,394		
Deal 8			2,555						(76,791)				
Deal 9	2,176				131,227								
Deal 10		2,764								257,439			
Total	8,333	6,093	2,555	2,898	35,085	462,313	0	(267,086)	(76,791)	363,676	119,394	0	0
Cumulative	**8,333**	**14,425**	**16,980**	**19,878**	**54,963**	**517,276**	**517,276**	**250,190**	**173,399**	**537,075**	**656,469**	**656,469**	**656,469**

The above example portfolio is predominantly successful, in reality the number of unsuccessful tenders is likely to far outstrip successful ones meaning a steady income of premium can be built up to manage the potential shocks of markets moving against UKEF.