DOING BUSINESS WITH THE BRICS:
CURRENCY RISKS AND MITIGATION TACTICS

More and more U.S. companies are engaging with vibrant emerging markets, such as those represented by the so-called BRICS – Brazil, Russia, India, China and South Africa.

Manufacturing capacity, raw materials, labor and even technology make these markets attractive destinations for international expansion.

At the same time, doing business with the BRICS can be a challenge for companies accustomed to the certainties of mainstream currencies.

Although the BRICS proactively promote international business, their governments remain concerned that any sudden inflow or outflow of money could de-stabilize their economies. As a result, they have implemented various restrictions on international transactions. Trade and capital payments are strictly regulated. And certain hedging practices that are routine in other currencies are prohibited.

Let's take Brazil as an example.

MAKING PAYMENTS IN BRAZIL

If you are making a payment, the first question is whether it is a trade payment or a capital payment. Trade payments require your tax ID, an invoice for the item you are paying for and the ultimate beneficiary has to sign documentation with the bank that will receive the foreign currency.

If these requirements aren't fulfilled, the payment may be delayed, cancelled or voided. In the case of capital payments, there is an even stricter set of controls, and the government may require that the payment is executed through a resident onshore bank.

LIQUIDITY AND VOLATILITY CONCERNS

The potential lack of liquidity in emerging market economies and the resulting volatility in their currency also presents a risk. Faced with this unfamiliar environment, U.S. companies are looking for strategies to mitigate future currency risk. But not all of the BRICS permit companies to buy or sell currency for future delivery.

NON-DELIVERABLE FORWARD CONTRACTS

The answer can be a non-deliverable forward contract, or NDF, which allows you to lock in an exchange rate to manage your currency risk exposure.

In this scenario, the foreign currency is never actually delivered, but settled against a government benchmark rate on the specified settlement date with the resulting gains/losses settled in USD.

On the expiry date, the NDF rate is compared to the benchmark rate. If the market spot rate is less favorable than the NDF rate, your bank will pay you the difference between the two rates in U.S. dollars. If the benchmark rate is more favorable than the NDF rate, you must pay your bank the difference between the two rates in U.S. dollars.

When you purchase the currency at the prevailing spot market rate, the gain or loss of the NDF will offset the expense or savings earned since inception of the hedge contract. Similar to a regular deliverable forward, the use of an NDF forgoes the potential to do any better than the forward rate. Since the NDF obliges you to transact at the future date, it is only appropriate as a hedge of firm commitments.

USING AN NDF IN BRAZIL

Taking Brazil as an example once again, you enter into an NDF contract with your bank where you agree to purchase 10 million reales at a fixed rate, say 2.22 for settlement in six months. If the benchmark rate on the fixing date is 2.20, your financial institution will give you the dollar equivalent of that differential on the settlement date.

This dollar gain will offset the additional expense of buying the reales at the current spot rate.

Smart hedging strategies can help you reduce the risks of doing business in emerging markets. For more information, please contact your Treasury Management Officer or visit pnc.com/international.

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