A Foreign Exchange Audit –

Now More Timely Than Ever

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Premise

American companies have been going global at an unprecedented pace. Global manufacturing and sales are no longer the exception but the rule.

For manufacturers, going global has become an important cost-cutting solution to move closer to potential markets and find less costly places to fabricate product.

For services, international has been and will continue to be an even more crucial market with a huge growth curve.

All of this international activity brings with it opportunities. But it also brings with it many challenges – not the least of which is sending or receiving money around the world.

No trade issue is more important than skillful handling of international payments and receipts – international FX. It is an area rife with potential for paying too much in foreign currency conversion mark-ups – with no corresponding benefit in doing so. Naturally, overpayment for foreign exchange often affects new players, but it is also rampant in companies large or small, experienced or inexperienced in currency buying or selling. But how many companies really know what they are paying in foreign exchange mark-ups? How much money can drop straight to the bottom line with proper analysis? *In these times of extraordinary pressure on bank profitability, you need to know how you are being treated on your FX pricing. The temptation to raise fees in this area is almost irresistible.*

This White Paper will examine the need to control FX mark-ups associated with the buying and selling of foreign currencies, and will introduce solutions to effectively lower, and then manage, the large transaction costs often seen in this essential area.

The Challenge of Measuring FX Trading Costs

Everyday, hundreds of billions of dollars' worth of foreign exchange (FX) are traded in the markets. Each purchase and each sale of a currency has a price. **The price of a currency** is the exchange rate a corporation receives from its FX provider, often a bank, for each Pound, Euro, Peso, Yen or other world currency that the corporation may buy or sell in its daily operations**. Or is it? Not exactly.** That price also includes the *mark-ups* paid on each trade. The mark-up on a foreign exchange trade is the amount the FX provider adds to what it itself pays for the currency before passing it on to its corporate client. These mark-ups cost corporations billions and billions of dollars each year.

Do you really know what your FX mark-ups are?

What is the mark-up you are paying on your international currency sales or purchases? How much is it on any given transaction? **Do you know?**

Banks take some profits on FX transaction fees – often a fee for each wire or draft. *However, 99% of their currency-trading profits come from mark-ups that you pay.*, Usually, the bigger the transaction, the smaller the mark-up. *But not always*. There is a huge temptation to take larger and larger mark-ups over time, and occasionally, to take very large mark-ups on all trades. And it works. Why? As clients get into a routine, they spot check only a few trades, if any, (if they can get reliable quotes to compare). Each foreign exchange transaction has two parts - the wholesale price (the cost of the currency itself as purchased on your behalf by your supplier) - and the mark-up (the profit that your supplier adds onto the price before he sells it back to you). Your price is the combination of these two costs. The wholesale price will not vary much among your suppliers. This wholesale, or "interbank" price, is available to them all. The one cost you **can** control in the mix, however, is the *mark-up* – that is the amount you pay your financial institution over and above what it pays wholesale for the currency. The mark-up goes into your supplier's pocket. Mark-ups can range from a few tenths of a percent up to four or five percent, or more, on FX transactions.

Are you certain you know what the rate really is?

The wholesale, (or "interbank") rate, is the rate determined by the last large trade in the market. That's right – the "rate" literally changes with every trade. It is not unusual in actively traded currencies like the Euro and the Dollar to have prices change every few seconds. It is very rare that a typical corporate treasury executive can really know what the rate is, even if he/she would have the *time* to try and figure it out.

The Impact of FX Mark-ups

Very few corporate treasury departments know exactly what they are paying in terms of mark-up for foreign exchange. Regardless how knowledgeable the corporate treasury team is with respect to currency trading, without transparency in pricing, it is very difficult, if not impossible, to KNOW mark-ups charged to your company, to get a handle to effectively reduce currency trading costs. Very, very, few executives have done an analysis of their trading mark-ups, as it is a time-consuming business that is only as effective as the trading archive information he/she has. Many feel under pressure from banks not to question rates! Would they do the same with loan rates, or with analysis fees, or any other bank service? No. Maybe it is because, until now, there has not been an effective way to measure mark-ups. They will not get that information volunteered by their suppliers. The information has been virtually non-existent. Other corporate banking costs are transparent. Now, FX mark-ups can be, too.

How much money do these the mark-ups represent?

Let's look at an example. If your company trades $10 million dollars a year in FX, and pays the bank an average mark-up of two percent over the true cost the bank pays, then you are paying $200,000 per year to your bank (or broker) to handle your foreign exchange payments**. Is this reasonable?** We'll address this later.

FX Price Trends – The Credit Crisis and *You*

Banks continue to look for new sources of income as traditional banking income streams, such as net lending margins, have dropped considerably in a very competitive world.[1] Bank fee income, on the other hand, has risen dramatically in the past five years[2]. *A huge contribution to* bank fee *income* is foreign exchange mark-ups. This increasing pressure on banks to make more fee income profits puts increasing pressure on them to put mark-ups higher on your foreign exchange transactions.

The banking industry is living in extraordinary times. Poor management has led to unprecedented write-downs and losses. FX is a juicy target for banks. They know clients often know little about the topic and even less about the mark-ups they are paying.

Are you giving your bank a blank check in FX trading?

1. Federal Deposit Insurance Corporation: FDIC Outlook – "Does Net Interest Margin Matter to Banks?" June 2, 2004
2. Some Recent Trends in Commercial Banking, Ennis, Huberto – p. 59, Federal Reserve Bank of Richmond, Economic Quarterly, Spring, 2004.

Avoid Traps in FX Pricing

How much are you paying in FX mark-ups?

There really is no single "price of the day" between currencies.

Currency pairs trade within price ranges everyday. These ranges can be large, 1% or more of a currency's value on days when certain currencies are actively traded. Even on 'quiet' days, currencies often range one-half percent or more during the trading day. You cannot judge how well you did on a trade by simply going back and getting the "price of the day". In reality there is no such thing. Prices move every minute, sometimes several times a minute, for popular currency pairs during a trading day. You need to have accurate numbers that show what rates really were at the moment you traded. When you have that information you can make an informed decision about whether or not you might be paying more than you need to pay, and if there are ways to cut costs in this important area.

What is your definition of "Reasonable" as it applies to FX mark-ups?

One obstacle to getting **reasonable** mark-ups in the FX market is the propensity for a corporation to trade with just one partner. That one partner is usually the bank that maintains the closest banking relationship to the corporation. There is certainly no problem *per se* in trading with a bank. They are by far the largest players in the FX market. But problems can lurk there. Often the corporate client is treated as a captive client by its bank or trading institution. They don't expect you to question FX rates. How can you? The result of this is higher prices. There is less competition. Competition in these markets can be harder to come by because it's no simple matter to switch banks or begin trading on a different platform.

The implications of this trading pattern are quite simple. Rates tend to creep up over time. The concept of a **reasonable** mark-up gets blurred. Is an average mark-up of 2% on an annual FX trade of $10 Million ($200,000), **reasonable**; or, would a $100,000 profit for the same few clicks of a mouse be **reasonable** enough. You decide.

Are you intimidated by your bank partner?

Another obstacle can be illustrated as follows. Some corporate executives think they are bound to trade with their major bank partner – that somehow they will be "punished" for not doing so! Let's look at that argument. First, what enlightened treasury executive would accept any pricing he/she is given out of fear? Second, why wouldn't the savvy executive not treat this as an important expense center, and do what he/she could to lower costs? Third, while FX revenue is a large source of income for banks, there are many other profitable areas in corporate finance for them, not to mention the money you pay them just to run your everyday commercial activities. High FX mark-ups should not be a *quid pro quo* for a banking relationship.

How can corporations get the transparency they need to see what their real FX mark-ups are? Now there is a way.

Today's Intelligent Approach to FX Costs

Should you have your mark-ups reviewed?

The answer is an emphatic **"YES"!** Most corporations are trading with just one, or perhaps two trading partners. They become captive to an institution's pricing policies. The temptation for an institution to charge a little more as time passes is often too great, especially when fee income is on everyone's minds at money center and regional banks today. Yet, many corporations do not know what they are really paying.

Today's banking crisis, with its renewed emphasis on increasing fee income begs for you, the client, to look at all costs associated with your banking relationship. A very large exposure to bank fee income and its abuses exists with FX and its mark-ups.

It is not necessary to jeopardize your bank relationships by analyzing FX mark-ups. Expense control is a core competency in your job description. It **is** necessary to include FX mark-ups in your total analysis. If you want to get a handle on all of the costs associated with doing business with your bank, don't leave anything off the table for review.

Companies know there is no sense in paying more than they have to for a particular foreign currency. Foreign exchange is a commodity – you can't buy a better, newer, or cleaner British Pound from one person than you can from somebody else. A Pound is a Pound. You need not pay any surplus or premium on any currency, as it does you absolutely no good.

Foreign currency mark-ups must be considered an expense center.

Now is the time for seasoned treasury executives to come to terms with this, and learn to manage FX mark-ups as an expense center like any other.

But who has the time to look at foreign exchange pricing? More importantly, who has the *expertise, or data,* to do it the right way? Time and money are the two precious commodities that every executive holds dear. It's certainly no different in the treasury area, where many more demands are now made on fewer people. Corporations continually look to analyze and rationalize corporate expenses.

Internet sites and modern technology offer some glimpses, but the time required to monitor these things, the speed of trading, the convenience of bank trading platforms, the delay in getting confirmations, and then the physical time it takes to analyze does not make it a viable process for most treasury departments.

Getting the proper analysis is critical to avoid paying too much.

Getting a proper analysis of your trading patterns can rid your corporation of not only its pricing uncertainties, but also put you in the driver's seat in controlling costs. Excess cost can be eliminated. Savings drop directly to the bottom line. This can result in an amazing amount of money on even $10 million of FX trading annually.

The Outsourced Solution

An outsourced solution is the best course of action for understanding, managing and controlling your company's hidden and mounting FX expenses. It is possible to have your foreign exchange prices analyzed by your current vendor. *However, that is a poor idea if you want* a complete, unbiased, view of mark-ups and other FX costs. It is always prudent to seek an independent third-party for such an analysis. Employing an independent third-party with no product or sales bias will guarantee a true view of your FX expenses. This independent analysis should provide a true "apples to apples" comparison by comparing the prices you paid for currency you purchased, or the amount you received for currency you sold, with the actual prices at the *very minute your trades were executed*.

An independent outsourced analysis will provide the most insightful evaluation of your FX costs.

Treasury Executives need an FX analysis solution that doesn't take a lot of *their* time. An outsourced third-party evaluation of FX costs is the right answer for many corporations. Work should be completed off site at the third party's office, and results can be sent back with comprehensive reports, to make decision making easy. Data can be uploaded in a few minutes and reports can come back that you can study at your convenience.

What to Look For in a Third Party FX Analyst

Let's look at what you should look for from your third party FX analyst.

1. **Non-supplier driven.** Many FX traders will offer to "give" you a complete analysis of your FX trading, with the purpose of making their competition look bad and gaining your trading business. It's important to contract for this service with a disinterested **third party** to get meaningful, non-biased results. At no time should this entity be involved as an active FX broker or trader.

2. **Management.** It is critically important that the outsourced party has broad experience in FX trading and pricing. What sort of foreign exchange experience have they had? How well do they really understand the markets? How can they help you drive down prices? Who do they know in the industry that could be a valuable aid for you?

3. **Historical archive.** The most important criterion for you when selecting a third party analyst is to make sure that the FX data archive they maintain is the best available. The archive should be a mix of *dozens of* rate sources to assure accuracy and reliability. This must include an archive covering any currency pair you trade, and forward as well as spot transactions. It must be able to give you interbank prices as they existed covering **every minute** of any trading day in the past. Only this will give you a complete 'apples to apples' comparison.

4. **Time.** The analysis should take very little of your time. Literally just the time it takes to collect your trading records. You should have no additional involvement in the process until it comes time to analyze the results with the outsourced management team.

5. **Reporting.** What kind of reports will you see? What kind of other reports can be generated at your request? What kind of future reports can you get on any transactions you do? *You should be able to look at your trades versus real-time market cost, but you should also be able to compare various suppliers with which you trade to compare them side-by-side.*

6. **Location of Work.** All work should be done off your premises. You should not hear from the outsourced party until the reports are ready.

7. **Transparency.** The analysis should show you in no uncertain terms what you are paying each supplier for each trade. This will restore clarity and fairness to currency trading.

8. **Contacts.** Your outsourced partner should help you find ways to lower costs and offer solutions, *if you wish it,* such as introductions to other sources for your FX trading.

9. **Monitoring Capabilities.** Perhaps the most important service an FX analyst can provide. Once you have completed your historical analysis, it is critical that you continue to receive satisfactory pricing from your FX providers. Monitoring provides the method to assure the pricing you are expecting day to day is achieved.

A quality FX analysis program will always show what you have paid. You will have no need to oversee each transaction, as that will be done by your third party associate. In addition, a good outsourced partner can provide valuable information relative to where you stand regarding FX costs within your peer group. You will know if you're in the top 10% - and if not – why not.

To conclude, i*n this environment,* you *must review and take charge of your FX mark-up expense, like any other fee based service your bank has to offer you.* **With help, you can do it, and reap the many benefits.**

ABOUT THE AUTHOR

Foreign Exchange White Paper author, Clark Eide, graduated from the University of Notre Dame with a degree in Finance, where he was elected a Notre Dame Scholar. Eide exhibits an auspicious history in the FX market, dating back to 1984, when he founded Eide & Eide Currency Management, a pioneering FX company, which soon grew into a multi-million dollar business, which was later sold to Travelex in 1995. In 1999 he partnered with two payments processing executives to form Trancentrix, Inc., an innovator in the field of corporate electronic funds transfer and Foreign Exchange. This company was honored as an Inc. 500 pick in 2004, before ultimately being sold to Ruesch International in 2005.

His exposure to foreign exchange trading as first a buyer, and later as a supplier (having owned or been associated with many of the major non-bank FX companies), has given him the insider knowledge necessary to combat higher than reasonable mark-ups by providers to their clients – and to give clients an alternative to measure their provider's performance in an industry where mark-up analysis is extraordinarily difficult.

Mr. Eide has also been an innovator in various aspects of Value Added Tax (VAT) recovery for companies worldwide through his firm CEI, with offices in the USA, England, France, India, and Australia. Lincoln Expense Solutions is a natural progression for his global corporate clientele.

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