4 essential factors to consider in managing exchange rates for your international assignments

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The nature of international assignments, where employees are sent to reside/work in another country by their employer for a 'temporary' period only, usually means that they will retain financial commitments in their home country – or at least wish to retain any savings there.

Thus the issue of exchange rates is one that has been familiar to assignees and their employers for many years.

Rates of exchange between the home and host currency (and sometimes a third currency) may be used in setting remuneration at the start of an assignment. As the employee remits funds to and from the assignment country against a constantly changing rate, this will have an effect on his/her perceived '**purchasing power**' during the assignment. The issue, however, has perhaps gained a higher profile in recent years given greater volatility of some major trading currencies.

Unlike with other components, the employer cannot control this aspect of the international assignment package, but **must have a strategy to manage it** and, most importantly, the process must be clearly defined in the company's **international assignment policy**. Everybody is looking for some level of stability against something that changes on a daily basis. There is no perfect solution but a clearly communicated strategy, and robust administrative procedures to support it, will help.

What are the issues to be managed?

There are a number of issues to be 'managed', as follows:

- Maintaining equity with existing assignees in the host country whose remuneration has been set using the same methodology
- Protecting the purchasing power of the assignee while he/she is working in the host country
- Containing the impact of exchange rates on the employer's costs
- Ensuring that the method of salary payment does not have implications for the management of other aspects of the international assignment (for example, tax compliance)
- Taking into account the effect of exchange rates on any cost-of-living allowance paid.

In defining their international assignment remuneration policy many companies still use the 'no worse off ' methodology of the '**balance sheet**' or '**build up**' **calculation**, which seeks to calculate an employee's net income in the home country, and then adjust this for such factors as higher cost of living to derive a protected net income.

These adjustments are typically made in the home country currency, so the effect of exchange rates on the purchasing power of an international assignee is determined more by the **pay method an employer decides to use than by the method of salary calculation itself.** The employer is then responsible for the payment of the tax in the host country.

Organizations typically implement one of the following three methods to pay international assignees:

- Paying solely in the home-country currency
- Paying solely in the host-country currency (or in a third country currency, such as the dollar, if this is not possible)
- Splitting pay between the home and the host countries.

We will now look at each of these methods in turn.

1. Home-Country Currency

By paying all assignees in their home-country currency (and therefore probably also through their existing payrolls), perceived equity is maintained in the calculation of the remuneration, whereas if employees are advised of remuneration in host-country terms, a different exchange rate might apply to someone starting an assignment now as compared with an assignee who has already been at the location for six months and whose salary was converted at a different rate of exchange.

This will probably mean having to **co-ordinate fewer payrolls**, as a multinational company is likely to have a smaller number of expatriate nationalities than assignment countries. With this method, the assignee has flexibility to determine not only how much he/she wishes to remit abroad, but also **the frequency of remittances.**

The home-country currency method is likely to prove popular with the assignee where the host currency is weakening against the home currency (they will be able to use progressively less of their remuneration to meet their spending in the host country).

However, where the converse happens and the rate moves against the expatriate, meaning he/she **has to utilize more of the home-country currency to fund host-currency expenses, dissatisfaction arises.**

Most companies using this method will therefore still monitor the exchange rate in some way and may make retroactive compensation for the assignee if the rate moves by an average of, say, 5-10% against him/her over a defined period (for example, three or six months).

It is important that an **average rate** is used, and some time frame set, so that underlying trends are identified rather than a speculative short-term blip caused by, for example, a **political coup or a natural disaster.**

Alternatively, a guaranteed exchange rate, which is reviewed periodically, may be used to transfer funds. This not only protects the assignee from loss, but also controls his/her '**gain**'.

While the employer has some administrative ease with this method in terms of management of the assignment policy, robust procedures must exist to ensure that these payments are declared for tax in the host country, as tax liability will be determined on where the duties are performed – or on worldwide income – and the location of the payroll is irrelevant.

The nature of the balance-sheet methodology means that this tax liability will **usually fall on the employer**; and thus the employer **cannot avoid the effect of the movement of exchange rates by using this method**, as the rate of conversion will **affect how much the company pays in tax.**

2. Host-Country Currency

The host-country currency method is where the salary is calculated in the home-country currency and, using a specific rate of exchange, is converted into the host-country currency and **then paid in the host country.** This is the most transparent method for the Management in the host country, as it gives them a known cost, which can be matched against the budgeted cost at the start of the assignment.

It makes the administration of tax compliance much easier as, where there is a withholding requirement, the salary can simply be grossed up and tax paid across. However, this simply creates a fresh set of circumstances to be managed.

Firstly, assignees will often start their assignments at different times during the year or will join other assignees who have already been in situ for a number of years.

What rate should be used to convert the desired remuneration into the host currency? There is no right or wrong answer. If the latest rates are used, **this introduces inequities with predecessors, until such time as all salaries are adjusted** (for example, at the next salary review).

A fixed rate (reviewed periodically) may be used, although this may prompt a response from the new assignee that the rate is "**unfair and out of date**". Either approach may be adopted – the key is **consistency of application!**

As with the home-currency method above, the employer may monitor rates and adjust those for existing assignees where **currency movement exceeds certain parameters.**

Secondly, where the host currency is weakening against the home currency, there is a problem for those assignees who have home-country commitments, as they will need more and more host currency to service these commitments.

If the employer monitors this and decides to adjust the exchange rate used, the company is likely to apply any new rate of conversion to the whole of the home-country net income, when in fact only part of that net income is subject to volatility, the rest being paid and spent in the host-country currency.

This is often unpopular with the host management as they may see **increases in expatriate remuneration when there has often been little or no increase in local prices.**

3. Split Pay

The third method – the split-pay approach – is probably the most logical in terms of exchange-rate management. The basic tenet of this method is that net income is split into two: '**spendable income**' and '**non-spendable income**'.

Spendable income (which is spent in the host country on goods and services) is paid in the host currency.

Non-spendable income (for example, that spent on housing or saved) is paid in the home-country currency, as this is the currency in which the assignee will continue to service these commitments. The use of the term 'spendable income' follows the logic that you only adjust what is actually spent in the host country, as with cost-of-living indices (measuring the relative cost of living between two countries).

Many employers using the split-pay approach allow the assignee the flexibility to decide the percentage of salary that will be paid in the host currency. This may or may not match the percentage of net income that will be subject to cost-of living adjustments, as this is usually based on the employer's policy (underpinned by statistical data from third-party vendors).

The employee may be able to change this split, but usually only at defined points. In this way there is still some exchange-rate exposure for both the employer and the employee in the longer term but, if the split is chosen appropriately, there should be no need for large amounts of money to be remitted each month, thus **giving greater stability to an international assignee's cash flow.**

Perceived inequities between assignees themselves caused by the different exchange rates used are also much less visible.

While it does offer the path of least resistance as far as employee complaints about purchasing power are concerned, for the inexperienced the split-pay approach may be the most difficult to administer, as it potentially involves the co-ordination of many payrolls across national boundaries, each country with its own regulations. **Thus the capacity for administrative errors, missed payroll cut-offs, etc. increases.**

Some employers may be able to make payments in various currencies from one central source to avoid such problems, but they must still ensure the timely and correct settlement of tax in each jurisdiction, probably via multiple tax vendors.

4. Exchange Rates and the Cost of Living

Another typical major component of the international assignment package is the cost-of-living allowance. There are a number of different vendors of such data in the market, all using slightly different methods to achieve their results, but common to all is the fact that they will be measuring prices of goods in one location against prices of the same goods in another at a specified point in time.

A specific rate of exchange is used to compare these prices and bring them back to a common base. It is therefore essential that, if the exchange rate used is changed, the index must also be changed, even if the underlying prices in both locations have not moved, as the purchasing power is affected by movements in the exchange rate and the cost-of-living index.

Need for communication and consistency

There is no one solution that meets all needs. The key is **clear communication and consistency so that arrangements are perceived to be at least fair.** The decision is down to which issues the employer wants to manage, and how!

IPM Global Mobility provides support and solutions for all the challenges listed in this guide — and more. So remember: when you need help, we're ready to give you a hand. Let us hear from you! Good luck with your international assignments program.

IPM Global Mobility team.

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Questions? Get in touch!

We are always here to inspire and help, so don't hesitate to contact us if you run into any problems or have any questions along the way of your international assignment programme.

info@ipmglobalmobility.com
+44 (0)845 458 5643 (UK)
+44 (0)1733 364040 (International)

ipmglobalmobility.com