FX Forwards: Brave world for SMEs

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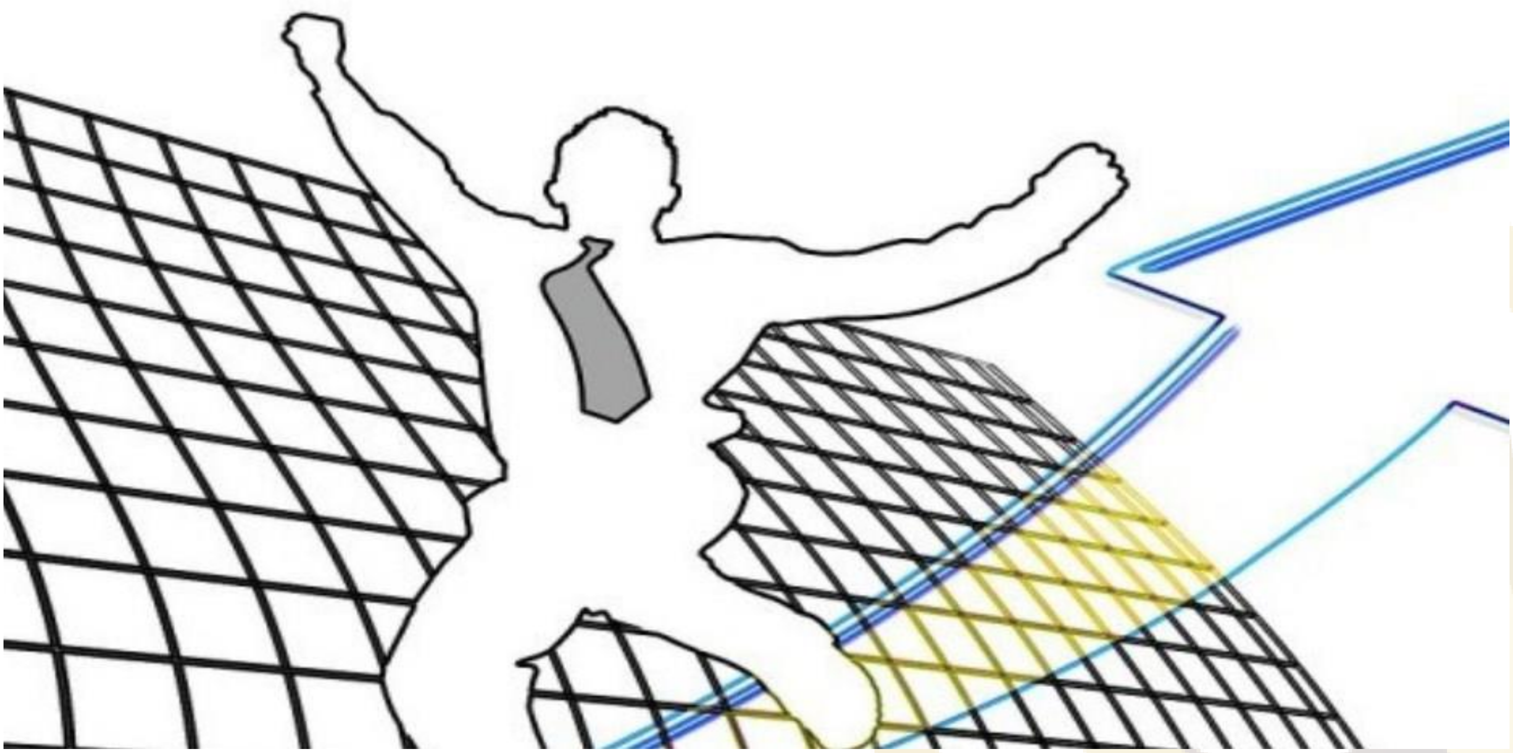

FX Forwards: Brave world for SMEs

It's 2018: a decade since the GFC, yet many SMEs stand significantly exposed to foreign exchange risk.

With proper FX Risk management, firms can enhance their strategic decision-making process by assessing the costs, benefits, and risks associated with currency fluctuations. FX hedging does not have to be complex to be effective, it can just be as simple as a Forward Contract.

The heart of any FX risk management strategy is likely to be the forward contract, which is a contract to buy or sell currencies at an agreed exchange rate on a date in the future.

FX Forwards

A forward contract is a straightforward currency hedging tool, which allows you to lock in a current exchange rate, while delaying the settlement of the contract for a period up to 12 months.

- Minimise Volatility - Forwards are particularly attractive for SMEs that seek a symmetrical payoff profile relative to the spot foreign exchange rate, where the hedge achieves largely equal and offsetting gains and losses related to the underlying foreign exchange exposure. Forwards are by far the most effective way for eliminating FX gains and losses to the greatest extent possible.
- Preserving Cash Flows - Forward contracts don't require a full upfront premium to be paid, unlike an option. However, a forward contract will almost always finish in either an asset or liability position at maturity depending on the ending spot rate, which may require a 10% deposit payment to be made at the beginning of the contract.
- Distinguishing Characteristics - 3 key distinguishing characteristics of forward contracts are their forward point premium or discount, the lack of upfront cost, and the symmetrical payoff profile relative to the spot foreign exchange rate.

A forward contract is no different to a standard currency spot trade, except that the settlement date is pushed forward into the future, and the rate is adjusted slightly to account for the interest rate differentials between the two currencies in question.

FX forwards help investors manage the risk in the currency markets, by locking in the future exchange rate and the date on which they will make a foreign exchange transaction.

By using FX forward contracts, investors can:

- Protect 'costs' on products and services purchased abroad,
- Protect 'profit margins' on products and services sold abroad, and
- 'Lock-in exchange rates' as much as a year in advance.

Risks

The downside of a forward contract is that on the day of settlement you are obligated to settle at the predetermined price. In exchange for this rate certainty, you forgo the ability to participate in the spot market, if the prevailing market rate is more favorable than your predetermined forward rate. Additionally, on occasion you may be required to post margin, if an outstanding forward contract is considered out of the money compared to current market rates.

- Credit risk - as in most financial instruments, one of the major risks associated with an FX forward contract is credit risk. In the case that one of the parties is unable to fulfil its obligation, the other party will have to sign another contract with a third party, thus being exposed to market risk at that time.
- Exchange rate risk - another major risk with FX forwards are potentially unfavorable movement of exchange rates. By locking-in the exchange rate at which the currency will be bought, the party forfeits the opportunity of profiting from a favorable exchange rate movement. Additionally, unfavorable exchange rate movements may take away further opportunity for the party to profit (in the face of opportunity cost!)
- Interest rate risk - since the price of a forward contract is dependent on the differential between the interest rates that can be earned with the two currencies, variations in those rates can change the price of the contract. If the party has already signed a forward contract, it forgoes the opportunity to sign one at a lower rate in the case of favorable change in interest rates.

Conclusion

If you need protection from FX currency markets, Forward Contracts could be the perfect solution. You can lock in an exchange rate for the purchase of currency at a future date,

or over a range of dates, up to a maximum of 12 months. Forward Contracts help protect your business against the risk of market fluctuations, without having to commit cash flow to buying currency in advance. A refundable 10% deposit may be required to set up a Forward Contract, depending on several factors surrounding the risk of the Forward requirement.

Instead of letting the markets determine your financial future, our highly professional FX team can help you manage the markets. Forward Contracts, in the right hands, can provide you with the certainty and protection you need.

Although many businesses prefer to buy most of their foreign currency using Forward Contracts, it is always worth discussing the full range of FX solutions with our FX Team – working together, we can then create the perfect strategy for your business.

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