

FORWARD THINKING



FORWARD CONTRACTS AND FORWARD POINTS

FORWARD FX CONTRACTS ARE AN ESSENTIAL RISK MANAGEMENT TOOL FOR TREASURERS. DOUG WILLIAMSON EXPLAINS THEIR MAIN BENEFITS, AND HOW TO APPLY FORWARD POINTS

Market prices change fast, and unpredictably. Exchange rates are particularly volatile. If treasurers are unprepared, the results can be disastrous. Painful consequences include dwindling assets, ballooning liabilities and consequential problems.

In this article we'll learn about a key tool that treasurers use to manage FX risk, applied to a practical case study.

BritPlant, part 1

You are the treasurer of BritPlant plc, a capital-intensive UK business whose revenues are mainly in GBP (sterling).

BritPlant is about to place an order for a major item of plant. The price is €100m. Payment will be required in euros in 12 months' time.

Explain what will happen to the cost in domestic currency, if an FX payment is due, and the currency in which it is payable strengthens.

Based on a Certificate in Treasury (CertT) 2016 question

Transaction risk

We are due to pay a fixed foreign currency amount of €100m, at a fixed future date. We will need to buy these euros at their market price, in pounds.

If the exchange rate is $\text{€1} = \text{£1.32}$, the cost in pounds will be:

$$\begin{aligned} &100 / 1.32 \\ &= \text{£76m} \text{ (to the nearest whole million)} \end{aligned}$$

If the foreign currency were to strengthen against sterling, buying the €100m would cost us more pounds. This is an example of FX transaction risk.

Do you remember the Brexit vote?

If the euro were to strengthen from $\text{€1} = \text{£1.32}$, to €1.20 , the cost of buying €100m would rise to:

$$\begin{aligned} &100 / 1.20 \\ &= \text{£83m} \end{aligned}$$

Following this change in exchange rates, we would be worse off, paying £83m rather than £76m.

Exchange rates did indeed change by roughly this amount, overnight on 23-24 June 2016, following the Brexit referendum result. Those who were exposed and unprepared lost a lot of money.

Forward contract

Is there anything we can do to protect ourselves against transaction risk? Yes, happily there is. One response is a forward contract.

A forward FX contract is:

- A mutually binding agreement;
- To make an exchange of currencies;
- On a specific future date; and
- At a pre-agreed rate.

BritPlant, part 2

Continuing our BritPlant plc case study, identify the main benefit for the company of using a forward FX contract, compared with taking no action.

Based on CertT 2016

Effective fix

The main benefit for BritPlant is to effectively fix the cost of buying the plant in pounds. The forward FX contract hedges against future exchange-rate volatility.

With the forward contract, this FX risk is transferred to the forward contract counterparty, usually a bank.

How it works

We will need €100m to pay our supplier on the future date, and we don't yet have €100m.

A forward contract fixes the future amount of sterling we will give, in exchange for receiving the €100m we need to pay the supplier. If we hedge forward at the rate of £1 = €1.32, the €100m will cost us £76m.

On the other hand, if we take no hedging action and the rate moves against us, we may suffer a big exchange loss. As we've seen, if the unhedged market rate moves adversely to £1 = €1.20, our sterling cost for the plant will increase substantially, to £83m.

More problems

Sadly, risk transfer using a forward contract isn't entirely free of its own risks and cost. Disadvantages of forward contracts include loss of flexibility, additional complexity and additional cost.

To understand this additional cost better, let's consider the point of view of our bank.

Bank's compensation

A bank quoting market prices takes on risk and work. The bank's compensation is reflected in the difference between its

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buying and selling prices. This difference is known as the bank's 'spread'.

For example, a bank might quote its spot exchange rate as:

GBP/EUR 1.3118-53

35 points spread

The bank's spot spread is 1.3153 less 1.3118 = 0.0035. This is often known as '35 points'. One 'point' here is €0.0001 per £1 exchanged.

In simple terms, the spread in favour of the bank is a cost borne by the customer.

Forward spreads are wider

When a bank quotes a forward FX rate, it takes on more risk. This is because the contract is longer-dated. Accordingly, forward rate spreads are wider, compared with spot rate spreads.

The wider forward spread reflects more benefit for the bank, and more cost for the customer. The wider forward spread is part of the customer's additional cost of hedging forward.

Straight to the point

The differences between spot and forward rates are often expressed as 'forward points'. For example, one-year forward points of '82-99'.

Forward points are applied to the spot rate, to calculate the forward rate.

The detailed meaning of the points depends on the context. If one-year points of 82-99 are quoted for a GBP/EUR spot exchange rate of 1.3118-53, it means the points are €0.0082 and €0.0099, per £1.

But should we add the forward points, or deduct them?

Widen the spread

We always apply the points to the spot rate in such a way as to widen the spread.

Points

82-99	Ascending	Add
99-82	Descending	Deduct

Euro forward rates, part 1

The following table shows quotes for the spot rate and forward points, for GBP/EUR:

Spot	6-month	1-year
1.3118-53	70-80	82-99

Calculate the appropriate rates for a customer buying or selling euros one year forward.

Based on CertT 2016

Add ascending points

The one-year points are ascending, so we add them to the spot rate:

Spot	1.3118	1.3153
+ Points	0.0082	0.0099
= Forward	1.3200	1.3252

Sense check

Notice the forward spread has widened, as expected, compared with the spot spread.

The forward spread is 252 - 200 = 52 points, compared with the 35 points spread for the spot rate.

Your turn now

Euro forward rates, part 2

Using the rates under 'Euro forward rates, part 1', calculate the appropriate rates for a customer buying or selling euros six months forward.

(Check your answer.)*

With many thanks to Jonathan Jeffery for his valued suggestions.

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