MITIGATING FOREX VOLATILITY WITH FORWARD CONTRACTS

By Phillip Silitschanu

NEED FOR FORWARD CONTRACTS

Often in global trade, a company makes a large, important sale to a foreign customer, with payment expected in 60 or 90 days. Or, perhaps the company has made a vital operational purchase for which it has budgeted a sizable supplier payment in the upcoming quarter. Either way, the company's profits and future plans require certainty about the size of that payment. But the relative value of the seller's and buyer's currencies may shift many times in a 60-to-90-day window; a business could find itself receiving significantly less money than expected, or paying significantly more. Forward contracts exist as a widely used solution to counteract the risk of such foreign exchange (forex) volatility.

WHAT IS A FORWARD CONTRACT

A contract that specifies the price and quantity of an asset to be delivered in the future. Forward contracts are not standardized and are not traded on organized exchanges.[1]

What is a Forex Forward Contract?

Currency forward contracts are binding agreements between two parties to trade a specific value of currencies on a certain date at a rate set in advance.[1]

Imagine, for example, a U.S. biotech firm sells $1 million in vaccines to a European buyer that agrees to pay in euros 90 days from now. But the biotech firm's controller recalls that the euro dropped from $1.147 on October 14, 2015 to $1.057 on November 30, 2015 – a decline of more than 8 percent in only 7 weeks.[2,3] Such steep declines don't happen often. But if one were to happen before the vaccine deal closes, the biotech firm's margins might be squeezed – or even wiped out. To avoid this, the firm purchases a forward contract that locks in the current euro/USD forex rate.

Components of a Forward Exchange Rate[4]

- > **Spot Price of Currency**
- > **Bank's transaction fee**
- > **Adjustment for the interest rate differential between the two currencies**

How to Calculate a Forward Contract Price?

When a bank or private currency broker calculates the cost of a forward contract, it considers the current spot price of each currency as well as adjustments based on anticipated differences in interest rates between the pair of currencies involved. These adjustments are expressed as points above or below the spot rate: whichever currency is expected to have the higher interest rate will be discounted; the lower-interest rate currency will earn a premium.[4] The financial institution offering the forex trade also will charge a fee for the transaction.

Currency forward contracts are widely used to protect importers and exporters of equipment, finished goods and raw materials. They are sometimes used to manage a company's internal transactions with foreign subsidiaries, or to mitigate risk in a pending foreign corporate acquisition or real estate transaction. While primarily utilized by large corporations, these forex solutions are also used by small and mid-sized companies as well as wealthy individuals who face currency risks in buying foreign real estate, where transactions may take several weeks or months to close.[5]

Characteristics of Forward Contracts

Companies can benefit from understanding several important characteristics of currency forward contracts.

- **Forward contracts are private legal contracts between two parties.** Both parties are committed to trade the specified currencies at the specified exchange rate on the specified date. If for some reason the international transaction being hedged falls through, the company is still on the hook for the currency trade. Sometimes, companies deal with this by creating a second forward contract that offsets the first. Of course, the financial institution earns fees on both contracts.
- **Unlike the similar but standardized forex future contracts, forward contracts are customized to each party's needs.** Therefore, Forward contracts aren't usually traded and normally conclude with the actual delivery of currency, whereas futures contracts are typically exchange-traded and close out before they mature (so currency is usually not delivered).[6] That said, forward contracts are a sizable market – by one recent estimate, averaging roughly $500 billion per day.[7] So companies that need to trade between common currency pairs should not find it hard to get rate quotes and execute forward contracts. A closely related issue: as private agreements between two parties, forward contracts aren't regulated in the ways standardized instruments are, so companies should therefore be comfortable with their counterparties.[8]

FUTURE CONTRACTS VS FORWARD CONTRACTS

Future contracts are exchange traded and therefore standardized while forward contracts are private agreements and hence flexible.

Settlement occurs at the end of the contract in Forward contract while it is settled day by day for Future contracts.

Forward contracts are used by hedgers where as Future contracts are used by speculators[6]

- Going back to that U.S. biotech firm selling vaccines in Europe, **if the exchange rate moves in a direction that would have been advantageous to the firm, it has foregone that benefit by committing to a forward contract.** That's fine for companies aiming to hedge against volatility in forex markets. But it might be an issue if the company's primary goal is to maximize profits, the company is tolerant of the risk involved and is willing to leverage its insights into future currency exchange rates. When such currency speculation is the goal, however, futures contracts are often the tool of choice.[9]

Forward Contract Variations

In addition to the "mainstream" currency forward contracts described thus far, a few variations exist:

Long Dated Forwards:
Companies seeking to hedge long-term currency risks occasionally use Long Dated Forwards with settlement dates exceeding a year.[10]

Forward Window Contract:
Companies that don't know precisely when a transaction will close can consider a Forward window contract, which may be settled during a short interval (such as a few weeks) rather than on a specific date.[11]

Non-Deliverable Forwards (NDFs):
When a country's currencies aren't legally tradeable or freely convertible, Non-Deliverable Forwards (NDFs) pay the "net" difference on the settlement date between any two currencies – but they pay out in a different tradeable/convertible currency, usually U.S. dollars.[12]

Variations of Forward Contracts

> Long Dated Forwards

> Forward Window Contract

> Non-Deliverable Forwards (NDFs)

Conclusion

Forward contracts are viable tools used by companies of all sizes to mitigate the forex risks that are a natural companion to any global business deal involving multiple currencies. The complexity of hedging forex risk with forward contracts may seem forbidding at first. But with the guidance of qualified forex professionals, forward contracts can be used by any company.

About the Author

Phillip Silitschanu is the founder of Lightship Strategies Consulting LLC, and CustomWhitePapers.com. Phillip has nearly 20 years as a thought leader and strategy consultant in global capital markets and financial services, and has authored numerous market analysis reports, as well as co-authoring Multi-Manager Funds: Long Only Strategies. He has also been quoted in the US Financial Times, The Wall Street Journal, Barron's, BusinessWeek, CNBC, and numerous other publications. Phillip holds a B.S. in finance from Boston University, a J.D. in law from Stetson University College of Law, and an M.B.A. from Babson College.

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