Forward Exchange Contracts

From the world's leading food and agribusiness bank

Flexible exchange rate risk management for exporters, importers and primary producers

Managing exchange rate risk is not an exact science, as there are many variables that impact on currency values. Rabobank offers Forward Exchange Contracts (FEC) to help exporters, importers and primary producers take control over one element of foreign exchange risk associated with exchange rate fluctuations.

How do Forward Exchange Contracts work?

A FEC is a contract where Rabobank and a client agree to exchange one currency for another at a predetermined exchange rate, for settlement on a set future date (longer than two working days). The FEC is calculated by using the spot exchange rate as a base and adjusting it by a forward margin.

A forward exchange rate is not a forecast of what the spot rate will be on a future date. The forward margin is a reflection of the difference in interest rates between the currencies in the contract. You nominate the contract currency, amount and value date, and Rabobank provides the forward exchange rate.

Advantages

You can fix an exchange rate to help you budget for your future income/ expenses. You have a known exchange rate.

The expiry of the FEC can be constructed to match the cash flows of the commercial / physical transaction.

FEC's can be pre-delivered or extended to match any changes in the cash flow dates of the commercial / physical transactions. Extensions are subject to restrictions.

There are no initial transaction costs such as brokerage or GST.

Disadvantages

You cannot take advantage of any favourable exchange rate movements. There can be opportunity losses.

You must be aware that FECs are fixed price obligations. In the event of commercial transaction failures, losses under FEC settlements could significantly affect your financial position.

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EXAMPLE 1

Forward Exchange Contracts

A wine producer has sold produce to an outlet in the USA and will receive USD 250,000 in payment in six months' time.
The current exchange rate meets the producer's budget requirements but they are concerned that the Australian Dollar (AUD) may appreciate in terms of the US Dollar (USD) prior to receiving payment, and therefore reduce income.

The prices and exchange rates used in these examples are for illustrative purposes only and may not reflect actual rates.

Today

Market information

- Spot or current exchange rate is 0.7200.
- Six month forward exchange rate is 0.7050.

Decision:

The wine producer contracts with Rabobank to sell USD 250,000 at 0.7050 and buy AUD 354,609.93 in six months' time.

Six months later

SCENARIO 1

The spot rate is 0.7600

- The wine producer arranges delivery of USD 250,000 to the bank which in turn pays AUD 354,609.93 to the producer. Both parties have satisfied the conditions of the FEC.
- The FEC has proved beneficial as the spot rate of 0.7600 is worse than the FEC rate of 0.7050. Had the producer not entered into an FEC, they would have received a lesser revenue of AUD 328,947.37.

SCENARIO 2

The spot rate is 0.6500

- The wine producer arranges delivery of USD 250,000 to the bank which in turn pays AUD 354,609.93 to the producer. Both parties have satisfied the conditions of the FEC.
- There is an opportunity loss as the spot rate of 0.6500 is better than the FEC rate of 0.7050. Had the producer not entered into an FEC, they would have received a greater revenue of AUD 384,615.38.
- Nevertheless the wine producer was protecting a profit margin and is satisfied.

EXAMPLE 2

Forward Exchange Contracts

An importer has purchased machinery from Europe and is required to pay EUR 100,000 in three months' time.
The current exchange rate meets the importer's budget requirements, but they are concerned that the AUD may depreciate against the EUR before the payment is made, and therefore increase the cost of the machinery.

The prices and exchange rates used in these examples are for illustrative purposes only and may not reflect actual rates.

Today

Market information

- Spot or current exchange rate is 0.6000.
- Three month forward exchange rate is 0.5950.

Decision:

The importer contracts to buy EUR 100,000 at 0.5950 and sells AUD 168,067.23 in three months' time.

Six months later

SCENARIO 1

The spot rate is 0.5500

- Rabobank delivers EUR 100,000 to the importer who in turn arranges payment to the European supplier. The importer pays AUD 168,067.23 to Rabobank. Both parties have satisfied the conditions of the Forward Exchange Contract.
- The Forward Exchange Contract has proved beneficial as the spot rate of 0.5500 is worse than the Forward Exchange Contract rate of 0.5950. Had the importer not entered into a Forward Exchange Contract, they would have had to outlay AUD 181,818.18.

SCENARIO 2

The spot rate is 0.6500

- Rabobank delivers EUR 100,000 to the importer who in turn arranges payment to the European supplier. The importer pays AUD 168,067.23 to Rabobank. Both parties have satisfied the conditions of the Forward Exchange Contract.
- There is an opportunity loss as the spot rate of 0.6500 is better than the Forward Exchange Contract rate of 0.5950. Had the importer not entered into a Forward Exchange Contract, they would have been required to pay the lower amount of AUD 153,846.15.
- Nevertheless, the importer was working with a budget target and is satisfied.

14399 / SEP 2021

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