FX FORWARDS: WHAT CAN GO WRONG?

Foreign Exchange risk is the exposure to changes in exchange rates. Currency markets are volatile and can have implications for businesses that have payments and or receipts in foreign currency.

On conversion, these values can change from one day to the next, depending on the exchange rate at the time.

Forward Exchange Contracts, or hedging, is a tool available to assist customers in managing Foreign Exchange risk. Put simply, a Forward Exchange Contract is the exchange of currencies on a future date, at a pre-determined rate.

They can be used in many instances, such as when a commitment is made to buy or sell a specific amount of currency in the future, and customers are protected regardless of how exchange rates will move.

Let’s look at an example where things can go wrong when it comes to Foreign Exchange risk for an online retailer.

A popular customised clothing business sold clothes online that became insolvent partially due to a lack of currency management. The business offered a wide range of products. Whilst growing rapidly, the business turned over $500,000 per year.

The customised clothes were made in Taiwan and the business invoiced in US dollars. This meant that currency conversion was a factor in the operation of this business.

The business didn’t have any Forward Exchange Contracts in place, meaning they purchased and sold their goods based on the exchange rate of the day.

With a higher Australian to United States Dollar exchange rate, this made the value of imports cheaper. However, when the Aussie dollar falls, this means it costs more to pay for the US dollar denominated invoices, increasing cost of goods sold.

Had the business booked a forward exchange contract and locked in a pre-determined exchange rate, they wouldn’t be at the whim of a constantly changing currency market. This allows the business to budget accordingly and have peace of mind in the operation of their business.

Forward Contracts provide certainty when a currency is declining. However, they do not allow you to participate in appreciating currency.

The proportion of your FX needs that you choose to hedge with a forward contract will be unique to your business. It may be all, some or none. Your forecasted cash flows can assist you in deciding how much you would like to protect using forward contracts.

A Forward Exchange Contract is like any other legally binding contract and can be used in part or in full before its settlement date – this is known as a pre-delivery. They may also be extended if required.

Forwards provide certainty for your business budgeting because:

- you’ll know the exact Aussie dollar cost of your imports because it is fixed

- you’ll be protected if the Aussie dollar moves against you because you have locked in at the higher agreed rate. However, you must use the agreed contract, even if the currency has moved higher. This means regardless of the exchange rate moving against you or in your favour, you have peace of mind and avoid any uncertainty in exchange rates

- you don’t need to pay until you use the contract, so your funds are freed up for the things you need it for.

Forward Exchange Contracts are managed on NAB’s online business platform, NAB Connect. You’re able to create, view, pre-deliver and extend Forwards. As a Foreign Exchange customer, you’ll also have phone access to the Dealing Room to assist in answering any questions you have, or even get information on what’s happening in the market.

To learn more, speak with your banker or Markets specialist.

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