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Derivative Transactions

Foreign exchange risk management

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Use foreign exchange hedging!

Do you do your business with foreign partners and are you exposed to foreign exchange risk? Can foreign exchange rate changes cause you financial losses?

Companies and entrepreneurs who do their business with foreign partners, receive foreign currency or pay in foreign currency for imported goods are exposed to the risk of financial losses through foreign currency fluctuations. Currency changes may result in major or even full loss of operating profit if the currency loss exceeds the profit margin. This may strongly reduce a company's competitiveness or even jeopardise its further business. Foreign exchange hedging tools are a simple solution that eliminates foreign exchange risk.

A simple solution for the elimination of foreign currency risks are foreign exchange hedging tools, which become increasingly popular.

Example: Client exporter

Client made contract in EUR for the sale of machinery due in 6 months. The client charges its costs in CZK (Czech crown) and uses the current rate when calculating the future rate. This means that the client is exposed to the risk of CZK (Czech crown) strengthening against the euro from the moment of setting the price of the product to the transaction due date. If the CZK (Czech crowm) is stronger in 6 months' time, i.e., the rate is lower, the client gets less CZK than expected (originally calculated) for the amount of EUR.

With agreed forward rate, the company gets an effective planning tool (calculation rate) and minimises possible losses. Tools for foreign exchange risk hedging – forward transactions – are used for this purpose.

Forward transaction

A forward transaction is the basic type of currency hedging. It is a contract for the future purchase or sale of a foreign currency at a fixed rate settled at agreed date in future.

The forward rate is based on the spot rate and forward points (called pips). These points depend on the length of the forward contract and the difference between interest rates of exchange rates. With a fixed forward rate, the company gets security and eliminates the risk related to the future negative foreign exchange rate development. On the other hand, it cannot profit from any positive exchange rate development. It is therefore appropriate to consider between 100% hedging or only part of it.

No charges are applied for forward transactions, and they may be made for an unlimited period of time (up to one year as standard, but may also be longer in individual cases). Neither the number of forward transactions nor their amount is limited. The transaction becomes binding at the moment it is arranged.

Example of calculation a forward rate: Client exporter

A company has made a transaction with a foreign partner, which should pay EUR 100,000 for purchased goods in three months' time. The current (market) CZK/EUR rate is CZK 25.30 and the three-month forward rate is CZK 25.38.

EUR/CZK rate on the due date	CZK value without forward	CZK value with forward	Potential gain/loss vs. spot rate when due (in CZK)
25.180	2 518 000	2 538 000	20 000
25.280	2 528 000	2 538 000	10 000
25.380	2 538 000	2 538 000	0
25.480	2 548 000	2 538 000	-10 000
25.580	2 558 000	2 538 000	-20 000

Forward contract with flexible due date

If it is difficult for an importer or exporter to estimate the future due date of collections or liabilities, it may also use hedging through a forward contract with a flexible due date. A forward contract with a flexible due date is based on the same principles as a forward contract, i.e., a precisely defined sum is hedged with a fixed rate, but it has a variable due date instead. The pre-determined forward settlement date is replaced with a three-week interval (1 week before and 2 weeks after the settlement date) during which the exchange can be made on any business day through a single transaction at a pre-agreed rate. This tool also enables companies to make a better use of the fixed rate in calculations in their financial planning.

Example: Client importer

On 30 June, the company bought goods from a German supplier worth EUR 100,000 with delivery in 3 months' time. However, the company does not know exactly when the payment for these goods will be made and wishes to eliminate the risk of exchange rate movements. On 30 June, the company concludes a forward rate with the settlement period falling between 26 September and 14 October and can buy EUR any working day within this period.

Amortization forward contract

An amortisation forward contract is based on the similar terms and conditions as a standard forward contract and may be used in some cases when it is difficult to predetermine the precise settlement date and size of individual transactions. During the agreed period, it is possible to perform the exchange at any time at a pre-agreed rate, but individual conversions do not have to be specified in advance and may be done on any business day during the given period and in any amount up to the amount of the agreed amortisation forward contract.

All withdrawals during the term of an amortization forward until the maturity date is at the originally arranged forward rate and without additional costs. If the whole of the amortization forward is not withdrawn it is possible to perform a swap and thus postpone its withdrawing until a more suitable time

Example: Client exporter

A company is expecting payments from foreign companies that should pay a total of EUR 100,000 for purchased goods within 12 months, i.e., before 31 December. The company concludes an amortisation forward for period until 31st of December with fixed currency rate

Payment receipt date	31.3.	20.5.	30.9.	31.12.
Arranged rate	25,500	25,500	25,500	25,500
Actual rate	25,650	25,550	25,400	25,450
Payment received (in CZK)	100 000	125 000	150 000	125 000
Potential gain/loss vs. spot rate when it is due (in CZK)	-15 000	-6 250	15 000	6 250

Par forward

A par forward is based on the same principles as a standard forward. It differs from standard forwards in that there is a possibility to make a series of multiple forwards with regular maturities. The final rate for all forwards in a given par forward series is determined by the average time weighted forward points for each maturity. In addition to the standard benefits of future exchange rate security, another benefit is the single exchange rate for all maturities. Therefore, the client does not receive a different forward rate for each maturity, as is the case with a series of standard forwards. On the contrary, in case of regular foreign direct debits, the client has the possibility to use one hedging product instead of individual forward trades.

Swap transactions

By making a forward transaction, the company immediately gets certainty of the future foreign exchange rate for which the currency conversion is settled in 3 months time (as at 30 June). It is an ideal solution if the forward rate is in accordance with the expected foreign exchange rate development, and it is an ideal tool in terms of the company's financial plans. In the event that an importer or exporter makes an inaccurate estimate of the due date of the future collections or obligations and at the same time made a forward transaction against collection/payment, there is an option of putting off or shortening the settlement date of the forward transaction made through a swap. The conditions and the principle of the swap price are the same as with a forward trade, i.e., the market and term rate differ in the term (swap) points.

Example: Client exporter Using the currency forward example

According to the initial parameters where the foreign customer should have paid EUR 100,000 as at 30 June, the company has hedged its transaction with a forward contract, i.e., it must deliver EUR 100,000 by 30 June. The customer said the payment for the goods will be 14 days late and so the company concludes a swap to extend the due date of the initially agreed forward contract by 14 days. On 30 June the company buys EUR 100,000 at the current rate, thus settling the forward transaction made, and simultaneously sells the same sum with a new due date of 14 days. The new forward rate value will be based on the current rate adjusted by term points.

Transaction	Agreement	Settlement	Agreement
Date	30.3.	30.6.	30.6.
Transaction type	Forward	Swap/Spot	Swap/Forward
Amount EUR	100,000	100,000	100,000
Party to transaction	Sale	Purchase	Sale
Due date	30.6.	30.6.	14.7.
Rate EUR/CZK	25.380	25.500	25.650

Currency options

This product gives the client the right to buy or sell a currency for another currency for a pre-agreed price on a specified date or during a specified period. The client pays an option premium for this right. A currency option enables you to hedge against negative foreign exchange trends and, unlike forwards, you can profit from an opposite, positive development.

Advantages of derivative transactions

- With derivative transactions you can gain security and fix a margin against losses arising from possible future negative exchange rate trends.
- You can fix the exchange rate within the calculation of your commission.
- There are no fees for completing a derivative trade.

Conditions for acquiring a derivative transaction

- Conclusion of Framework contract on the provision of payment services and Amendment on the Provision of Investment Services
- You are legally obliged to have LEI number
- Deposit of cash collateral or getting a Dealing limit
- Minimum amount per transaction is EUR 10,000 (EUR 30,000 in case of amortization forward) or equivalent in another currency

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* AKCENTA notes that conclusion of the derivative transactions listed in this document involves risks, which the client is required to be familiar with, understand and consider to the greatest extent possible. If necessary, the client must request further information. For more detailed information about the risks associated with the derivative transactions, visit the website https://www.akcenta.com/risks-in-derivates-trading. The information can also be provided by AKCENTA traders.