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Forward Foreign Exchange Information Document

EUR vs GBP

Help for what matters

Ulster Bank

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This document offers you facts and information to help you reach a decision on whether or not to hedge Foreign Exchange (FX) exposure using Forward FX Contracts. It does not constitute advice. If you are in any doubt about any aspect of Forward Foreign Exchange contracts, you should take independent professional advice.

Features

Any business that has a future requirement to buy or sell foreign currency is exposed to potential exchange rate volatility; this can result in price movements either in your favour or against you.

A Forward Foreign Exchange contract allows a business to fix an exchange rate now for the payment or receipt of foreign currency on a future date.

It is legally binding on both the bank and the business.

There are no direct charges for entering a Forward FX contract. All pricing is negotiable and determined by a number of factors not limited to, but including currency liquidity, FX volatility, interest rates in each currency and deal size. A Forward FX limit must be in place prior to entering into a Forward FX Contract.

Forward FX contracts are for fixed maturity dates. Forward FX Time Option contracts allow the business to choose any maturity between two specific dates.

The **advantages** of hedging foreign exchange risk using FX forwards are:

- They provide protection against adverse movements in the exchange rate. Regardless of what happens to the exchange rate between the time the contract is booked and its maturity the business is certain of the amount of EUR that will be required to pay for or be received from the foreign currency.
- They can aid the budgeting process (as the business knows the exact rate and proceeds for a specific transaction in advance and can budget accordingly).

The **disadvantages** of hedging foreign exchange risk using FX forwards are:

- The business cannot benefit from subsequent favourable movements in the exchange rate.
- Should the underlying business transaction be cancelled or delayed, cancelling or extending the contract may involve a cost.

At maturity of the contract one of the following will happen:

- The contract is utilised and settled
- The contract is cancelled and there is a cost or benefit depending on the prevailing exchange rate used to close out the position
- The contract is extended to a future maturity date. There is a cost or benefit for the business depending on the prevailing exchange rate used to mark the contract to market (i.e. valuing the contract at its current price)
- Should the business need to exercise the contract in advance of the maturity date the contract rate will be adjusted to reflect the change in time value

Cancelling, extending or early take up of a forward contract are provided at the Bank's discretion. For further information please refer to the Ulster Bank CBD Markets FX Terms and Conditions.

Appendix 1 – Example of Forward FX Deal for Sterling Payables

An importer of goods priced in Sterling has an exposure to the EUR/GBP exchange rate and specifically to EUR weakness and GBP strength.

The **importer** is due to pay GBP 100,000 to a supplier in six months time and arranges to buy this amount and sell EUR at 0.7300 six months forward.

Thus at maturity the importer will receive GBP 100,000 via the forward contract at a fixed cost of EUR 136,986.30 (£100,000 / 0.7300).

Cancelling the Contract

If the importer needs to cancel the contract for any reason, either on or prior to the maturity date, the contract will be Marked to Market i.e. the rate on the forward contract will be compared with the prevailing spot rate. The EUR difference between the forward contract rate and the prevailing spot rate must be paid or received on the date the contract is cancelled. Please note – if the forward contract is cancelled prior to the maturity date, the contract rate will be adjusted to reflect the change in time value.

If the prevailing rate is 0.6800, the unwanted GBP converts to EUR 147,058.82 and the importer is entitled to compensation of EUR 10,072.52 i.e. the difference between £100,000 at 0.6800 and £100,000 at 0.7300.

If the prevailing rate is 0.7800, the unwanted GBP converts to EUR 128,205.13 and the importer must pay the difference of EUR 8,781.17 i.e. the difference between £100,000 at 0.7800 and £100,000 at 0.7300.

Extending the Contract

If the importer needs to extend the contract for any reason, the contract will be Marked to Market as above with the importer paying or receiving the EUR difference on the original maturity date. The extended or new forward deal will be priced based on the prevailing spot rate i.e. at 0.6800 or 0.7800 in this example, and the appropriate premium or discount* will be applied.

Appendix 2 – Example of Forward FX Deal for Sterling Receivables

An exporter of goods priced in Sterling has an exposure to the EUR/GBP exchange rate and specifically to EUR strength and GBP weakness.

The **exporter** is due to receive GBP 100,000 from a buyer in six months' time and arranges to sell this amount for EUR at 0.7300 six months forward.

Thus at maturity the exporter will sell the GBP 100,000 via the forward contract for EUR 136.986.30 (£100,000 / 0.7300).

Cancelling the Contract

If the exporter needs to cancel the contract for any reason, either on or prior to the maturity date, the contract will be Marked to Market i.e. the rate on the forward contract will be compared with the prevailing spot rate. The EUR difference between the forward contract rate and the prevailing spot rate must be paid or received on the date the contract is cancelled. Please note – if the forward contract is cancelled prior to the maturity date, the contract rate will be adjusted to reflect the change in time value.

If the prevailing rate is 0.6800, the cost of purchasing the replacement GBP is EUR 147,058.82 and the exporter must pay the difference of EUR 10,072.52 i.e. the difference between £100,000 at 0.6800 and £100,000 at 0.7300.

If the prevailing rate is 0.7800, the cost of purchasing the replacement GBP is EUR 128,205.13 and the exporter is entitled to compensation of EUR 8,781.17 i.e. the difference between £100,000 at 0.7800 and £100,000 at 0.7300.

Extending the Contract

If the exporter needs to extend the contract for any reason, the contract will be Marked to Market as above with the exporter paying or receiving the EUR difference on the original maturity date. The extended or new forward deal will be priced based on the prevailing spot rate i.e. 0.6800 or 0.7800 in this example, and the appropriate premium or discount will be applied.

* The terms premium and discount are used in the context of Forward FX points. The Forward FX points are the points by which the spot FX rate is adjusted to determine the forward FX rate. They reflect the calculation of the differential in the interest rates of the two currencies for the time period at the prevailing spot rate. Where the points are "at a discount" to the spot rate they are subtracted from the spot rate and where they are "at a premium" they are added to the spot rate.