Manage risk with a layered approach

What is a forward contract?

A forward contract allows your business to fix an exchange rate for a future overseas payment. You can lock in an exchange rate for typically up to 24 months, and the fixed rate is protected from any future currency movements in the market. This means you know exactly the exchange rate you're getting for a set time, which helps you predict cash flow and forward planning and budgeting.

What is a layered approach?

A layered approach is a method of booking multiple forward contracts across a period to receive a weighted average of multiple exchange rates. This way, instead of booking a single forward contract and committing a certain amount all at once, you can layer contracts over time.

By layering the forward contracts and using this "protection over time", you can reduce the volatility of the rate you're hedging. Through this approach, over periods, the peaks and troughs associated with FX volatility even out.

Example of layered hedging

An importing business needs to buy USD4,000,000.00 over the next 12 months and has budgeted their US dollar buying at 1.25.

Whilst they want to take some risk out of their US dollar buying, they also want some participation on FX movements over the year.

So, the client decides to enter into a layered hedging approach, splitting up their requirements of USD1,000,000.00 every quarter instead of committing to buy all USD4,000,000.00 at a single rate. The layered hedging approach means the client decides to book a portion of the year's requirements at the start of every quarter.

Based on a total amount of USD4,000,000, an example of portions to buy would be:

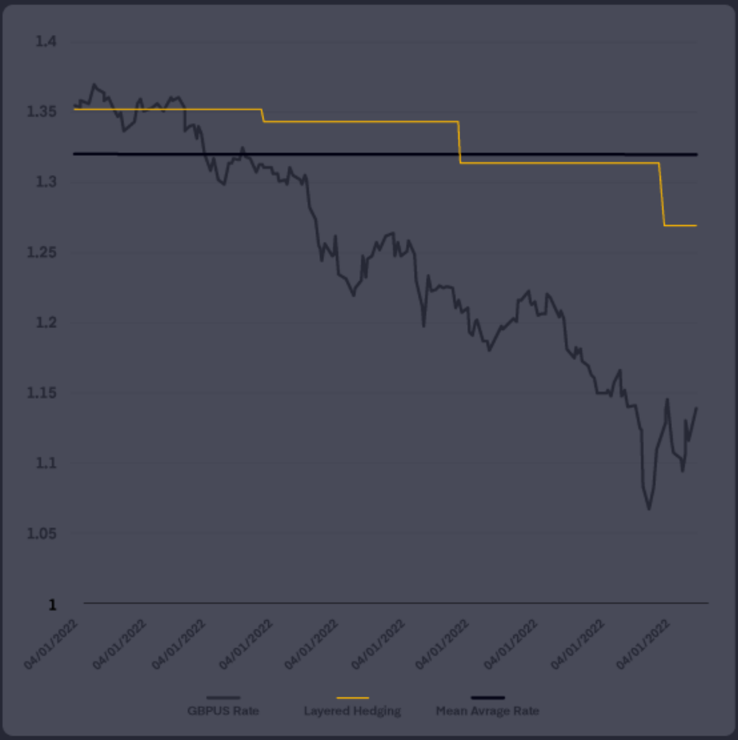
	Settled on 31/3/22 (end of Q1)	Settled on 30/6/22 (end of Q2)	Settled on 30/9/22 (end of Q3)	Settled on 31/12/22 (end of Q4)
Booked on 04/01/22 (2.8 mil)	USD 1,000,000.00	USD 800,000.00	USD 600,000.00	USD 400,000.00
Booked on 01/04/22 (600K)		USD 200,000.00	USD 200,000.00	USD 200,000.00
Booked on 01/07/22 (400K)			USD 200,000.00	USD 200,000.00
Booked on 03/10/22 (200K)				USD 200,000.00
Total to settle each quarter	USD 1,000,000.00	USD 1,000,000.00	USD 1,000,000.00	USD 1,000,000.00

In this example, trades aren't settled in their entirety on the date they're booked to help with cashflow by allowing payments to be spaced. However, you can also settle the full amount on the day you book.

The hedges are then done at the following rates

	Settled on 31/3/22 (end of Q1)	Settled on 20/6/22 (end of Q2)	Settled on 30/9/22 (end of Q3)	Settled on 31/12/22 (end of Q4)
Booked on 04/01/22	1.3530	1.3530	1.3530	1.3530
Booked on 01/04/22		1.3114	1.3114	1.3114
Booked on 01/07/22			1.2095	1.2095
Booked on 03/10/22				1.1323
Weighted Average FX Rate	1.3530	1.3447	1.3160	1.2718
Mean Exchange Rate	**1.321375**			

The rates even out over the period:



The layered approach in this instance smooths out the noise and volatility in the FX rate and allows the exchange rate to average out across the year.

The mean FX rate the client is able to achieve at the end of the year is 1.3214, which is well above their budgeted rate of 1.25.

Why would I want to use a layered approach?

Even though forward contracts are a helpful way to reduce risk and increase certainty, it can get more difficult to plan the further in advance you look.

When speaking with SMEs, we find that the uncertainty of their FX exposure typically increases with time. It's easier to estimate how much cash will be coming in and out of your business and to predict what will happen in the market in the short term than it is to predict these movements well in advance.

Commit without being under or over exposed

By using a layered approach with a forward contract, you can re-evaluate your own turnover and the state of the markets at the beginning of every quarter or whatever time frame you choose.

You can commit to hedging a certain amount of money without worrying about ending up over or under exposed or having too much or not enough currency at the end of the contract.

Considerations

As with all forward contracts, even if the rate moves in your favour by the time it comes to settling the transaction, you'll still receive the same agreed exchange rate. However, many customers find the stability a forward contract offers outweighs this disadvantage, especially when using a layered approach minimises risk even further.

We can only offer forward contracts to facilitate payments for goods and services.

If you're interested in booking a forward contract or implementing a layered approach, get in touch today.

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