Amortising Foreign Exchange Contracts

Background

The large fluctuations in exchange rates during the Global Financial Crisis highlighted the potential for currency hedging to create significant liquidity events. For Australian superannuation funds, and other investors in foreign assets, the need to generate liquidity to settle and maintain currency hedges created significant management difficulties and in some cases created solvency risks.

While un-margined longer-term currency and interest rate swaps have the potential to ameliorate some of these risks, they also have their own associated credit, liquidity and interest rate mismatch risks. An Amortising Foreign Exchange Contract (AFX Contract), which combines aspect of both forward and swap FX contracts, may provide an attractive and effective addition to the currency hedging tools available to holders of foreign currency assets, liabilities and commitments.

Mechanism

An AFX Contract is effectively an initial standard forward FX contract (Initial FX) with a series of contingent contracts attached. A number of parameters determining when the contingent contracts are triggered, and their terms (face value, settlement date, margin relative to forward reference rates, early settlement rights, etc.) are defined and agreed when the initial contract is entered into.

The trigger conditions would typically be related to changes in the Spot FX Rate between the time of entering into the Initial FX leg of the AFX Contract and the exchange rate on the settlement date of the Initial FX. (For operational purposes this would be the Spot Rate 2 days prior to settlement.) Other conditions could also be selected such as a look-back arrangement under which the contingent contract could be triggered if the Spot Rate moves outside pre-defined levels during the life of the Initial FX.

If the trigger condition is not met, then the AFX Contract simply becomes a standard Forward FX contract that settles in the normal way on its settlement date. None of the contingent contracts would be triggered.

If however the trigger conditions are met, (say the AUD has fallen in value by more than 10% versus the USD) then the first contingent contract is entered into. This would involve a partial settlement of the AFX Contract (say 20% of the Initial Face Value), with the remaining 80% rolled forward under the pre-agreed terms, based on the original Spot rate (i.e. an Historical Rate Roll).

The same trigger conditions would then apply for subsequent settlements, with either the remaining Face Vale settling in full at the next settlement date if the trigger conditions are no longer met (i.e. the AUD has risen so that it is no longer down 10% from the original Spot Rate), or alternatively, the trigger condition still applies in which case a further 20% of the original Face Value settles and the remaining 60% is rolled forward at the pre-agreed terms.

Under this arrangement the superannuation fund is not required to meet the full liquidity cost of settling and rolling existing FX contracts as they mature, and instead can realise their gains or losses over a more extended period. (This has the effect of shifting liquidity and credit risks to the Bank counterparty, who would typically be better placed to manage these risks, and who would be compensated by the pre-agreed pricing built into the AFX Contract's terms.)

Note: A special case may apply under which counterparty who would owe a net settlement amount has the option to settle in full if they wish, however counterparties to the AFX Contract would not have the right to demand settlement if this would involve a cash settlement in their favour.

Typical amortisation terms for AFX Contracts might be:

- Quarterly rolls with 20% of initial face value settling at each roll. The full contract would therefore potentially last for 15 months.
- Monthly rolls with 10% settling each month.

AFX Contracts should be documented under standard netting (e.g. ISDA) contracts.

Intellectual Property Rights

To the extent that Intellectual Property Rights exist in respect of Amortising Foreign Exchange Contracts (AFX Contracts), those rights belong to Peterson Research Institute Pty Ltd (PRI: ACN 077 178 208).

Terms of Use

PRI grants "End Users", including entities with assets, liabilities, income or obligations in currencies that they wish to hedge into another currency, free right to use AFX Contracts without limitation or payment.

Counterparties (typically foreign currency dealers and banks) to End User's AFX Contracts, unless otherwise agreed with PRI, by entering into a AFX Contract agreed to pay to PRI, or a charity of PRI's choice, a fee for the use of the AFX Contract concept and intellectual property. This fee shall be 0.002% (twenty in one million) of the initial face value of the AFX Contract between the Counterparty and End User.

AFX Contracts between Counterparties are unrestricted and do not incur any fee.