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Payment purpose exemption foreign exchange forward contracts

A forward exchange contract (FEC) is a binding agreement between two parties, in which they agree on the currencies, amounts and exchange rate at which to transact with each other on a given date (beyond two days) in the future. An FEC is used by importers and exporters to help provide certainty in their cash flows by minimising the impact of adverse currency moves.

Key benefit

The rate of exchange for a future cashflow is locked in and the risk of unfavorable moves in currency markets are protected.

Consideration

There is no ability to benefit from any favourable moves in the exchange rate between transacting and maturity of the FEC.

Two types of forward exchange contracts

Closed

A "closed" forward (fixed date) is where the spot rate is adjusted by the forward points between today and the forward date.

- If the discount or premium is in your favour, the outright forward rate is better than spot.
- If the discount or premium is not in your favour, the outright forward rate is worse than spot.

Open

An "open" forward (window) is where the spot rate is potentially adjusted by the forward points between today and the forward date.

- If the discount or premium is in your favour, the outright forward rate is only improved to the earliest date the contract can be used (window date).
- If the discount or premium is not in your favour, the outright forward rate is calculated to the longest possible date (ie. the same as a closed forward).

How do forward points work?

Outright forward rates are calculated based off the current spot rate and the underlying interest rates of each currency involved in the transaction. The calculation takes into consideration the interest rate differential between currencies from today the date of the forward date. Forward points are then added (if you are selling the currency with the lower interest rate of the two) or subtracted (if you are selling the currency with the higher interest rate) from the current spot rate to give an outward forward rate.

- Forward points are not an indication in which the currency is expected to go.
- Forward points are not a fee charged by Convera.

What is the payment purpose exemption?

FECs are regulated financial instruments, subject to the provisions of the second markets in financial instruments directive (MiFID II) (as incorporated into English law) and other related regulations.

However, not every FEC is regulated by the provisions of MiFID II and EMIR and there is an exclusion available where the FEC is connected to a payment transaction; the so called “payment purpose exemption” or PPE.

When an FEC is entered into in order to facilitate payment for identifiable goods and services, it will not be subject to the requirements of MiFID II or other related regulations e.g. the European Market Infrastructure Regulation. This removes the need for both parties to purchase and maintain a Legal Entity Identifier (LEI) and also the requirement to report all transactions on an ongoing basis to a central repository - something which can be costly in terms of both time and money.

PPE checklist

- At least one of the counterparties is a corporate entity (a non-financial counterparty (as defined in EMIR) e.g. not a bank or an investment firm. Convera is a financial counterparty and as such this exemption will not be available where Convera enters into a FEC with another financial counterparty.
- The FEC must be entered into for the purpose of facilitating payment for identifiable goods or services (for example, entering into a FEC in order to pay an upcoming invoice in a foreign currency, or in preparation of an upcoming purchase in a foreign currency if the approximate value is known).
- FECs are entered into bilaterally and not on a regulated trading venue or exchange (Convera does not offer FECs of this nature).
- The FEC must be settled physically i.e. the parties must exchange the currencies specified in the FEC.

Examples*

FECs that would qualify for PPE

- A SME business enters into FECs to hedge its need for USD/other currency to pay for imports/ exporters from China/another country. In this case, the FEC is likely to qualify for PPE as it is being used to facilitate payment for the purchase of goods.
- A UK business has employees abroad and pays them in local currency. The business enters into FECs with which it will pay its employees. The FEC in this case is likely to qualify for PPE as it is being used to facilitate payment for the purchase of services.

FECs that would not qualify for PPE

- A manufacturer wants to hedge the value of an overseas factory to avoid currency movements or against a currency loan impacting its balance sheet. The FEC would not qualify for PPE because it is not entered into in order to facilitate payment for identifiable goods or services.
- A farmer due to receive payment under the EU basic payment scheme enters into a FEC to fix the sterling amount they will receive. The FEC may not qualify for PPE because the payment may not be linked to any specific goods or services being sold or bought by the farmer.

This guide to PPE Forward Contracts is provided for information only and does not constitute legal advice. It provides a simplified overview of the PPE requirements. Convera does not accept any liability to any person for the information which is provided in this document. We strongly recommend that you seek legal advice in order to fully understand the requirements of PPE.

*More examples are set out in Chapter 13 of the UK FCA’s Perimeter Guidance Manual.

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