

Single Farm Payment (SFP) – Euro rate hedging

The £/€ exchange rate is close to the lowest rate since the launch of the euro in 1999. At the time of writing the rate is 0.93£/€. This means that at today's rates a SFP of €100,000 is worth £93,000 whereas a year ago it was worth £77,500. This is a significant improvement. Under current economic conditions, inflation, interest and exchange rates have fluctuated significantly meaning it is difficult to predict what the rates will be on RPA conversion day (30 September 2009). With this in mind consideration may be given to "locking in" today's exchange rate to give certainty over the value in sterling of your SFP.

You will be familiar with forward contracts in respect of grain trading and the same principle applies to exchange rate forward contracts. There are various different methods, however they effectively achieve the same thing which is to lock into today's rate for a period in the future when foreign currency receipts are expected.

Below are examples of the 2 most popular exchange rate hedges. These should be available at your bank. The bank will require some security, normally around 15% of the amount hedged, however there should be no additional costs.

SFP receipts in GBP

1. Fixed date forward contract

Criteria

- No minimum sum
- Value date 01/10/09
- Farmer transaction – sells euros/buys GBP
- Cost – pre-agreed exchange rate; specific to deal size (example uses a premium of 0.01 or 1%)
- Must have an existing bank account

Application

You enter into a forward contract by *which you are obliged* to sell euros and buy sterling on 01/10/09. On 01/10/09 the bank will close out the trade (by transacting an equal and opposite contract at the prevailing rate in the market because you do not actually have euros to sell). Depending on market movements you will realise either a profit (to make up for any disadvantage after the SFP rate setting) or a loss (to be realised against an advantage you will have after the SFP rate setting).

Illustrative fixed date forward contract rate for value 01/10/09 = 0.93 = £93,000

Worked example

SFP receipts in GBP – protection via forward contract for €100,000

You enter into a forward contract to sell euros and buy sterling on 01/10/09 at the current forward rate of **0.93 = £93,000**.

On 30/09/09 the RPA set the SFP conversion rate at **0.95 (€100,000 = £95,000)**

On 01/10/09 the bank closes out your maturing contract by transacting an equal and opposite contract at **0.96 (€100,000 = £96,000)**, realising a loss of **£3,000 (£96,000 - £93,000)**

However, the SFP conversion rate is in your favour.

Your net position is a receipt of **£92,000 (£95,000 - £3,000)** and therefore your "effective fixed rate" is **0.92**

Or

The SFP set the conversion rate at **0.75 (€100,000 = £75,000)**

On 01/10/09 the bank closes out your maturing contract, by transacting an equal and opposite contract at **0.76 (€100,000 = £76,000)**, realising a profit of **£17,000 (£76,000 - £59,000)**

However, the SFP conversion rate is not in your favour.

Your net position is **£92,000 (£75,000 + £17,000)** and therefore your "effective fixed rate" is **0.92**.

SFP receipts in EUROS

2. Time option forward contract for €100,000

Criteria

- No minimum sum
- Maximum time option window – 3 months
- Recommended time option period – 30/03/10 – 30/06/10
- Farmer transaction – sells euros/buys GBP
- Cost – pre-agreed exchange rate; specific to deal size
- Bank euro account required

Application

You enter into a time option forward contract by *which you are obliged* to sell euros and buy sterling at any time between 30/03/10 and 30/06/10. If euros arrive early they can be placed on deposit until the time option start date. You may set an earlier time period if you can be certain of the SFP receipt date. If euros arrive late then you can extend the contract to a later date but this may lead to a cost.

Illustrative time option forward contract rate for value 30/03/10 to 30/06/10 = 0.9195 = £91,950

All forward contracts require security to be put in place with the bank, prior to any contract being executed. All currency options are regulated by the FSA and you will need to complete mandatory regulatory requirements prior to any option being executed.

All rates are illustrative and subject to change as per market conditions.

Next steps:

If interested you should contact your bank manager to arrange the appropriate exchange rate hedge. If you would like any further information please phone or email your Chavereys contact who will be able to explain further the options above.

It is worth noting that banks are offering forward contracts for the 2010 and 2011 SFP, you should consider whether this is relevant and discuss with your bank manager.

NB

1. It is our understanding that not all the clearing banks are offering this facility.
2. There are numerous hedging options in addition to those set out above; your bank should be able to advise which is most appropriate for your circumstances.
3. Chavereys is not in a position to advise on exchange rate movements and this paper is to illustrate options which are available for those clients who are concerned about fluctuations in exchange rates.