Foreign exchange foward contracts

It is a contract between the bank and its customers in which the exchange/conversion of currencies would take place at future date at a rate of exchange in advance under the contract.

The essential idea of entering into a forward contract is to fix the exchange rate in advance and thereby avoid the exchange rate risk.

Forward Rates = spot rate +/- premium or discount
Forward contract is used for hedging the foreign exchange risk for future settlement.

For example, an exporter having FX contract limit may lock in current exchange rate by entering into forward contract with the bank to avoid adverse rate movement.

Have a look to this video with earing or only subtitles

https://www.nab.com.au/business/international-and-foreign-exchange/financial-markets/foreign-exchange/why-exporters-use-forwards

Just to illustrate: Let's imagine you are a European exporter selling goods to the United States, expecting to receive a payment of 100,000 USD in six months. Currently, the EUR/USD exchange rate is 1.10, meaning 1 EUR is worth 1.10 USD. Without hedging, here's what could happen depending on exchange rate fluctuations.

1. Without hedging (exposed to exchange rate risk):

- Amount to be received: 100,000 USD.
- Current exchange rate today EUR/USD (spot rate): 1.10.
- Amount in euros today (if you could exchange now): 100,000 USD / 1.10 = **90,909 EUR**.

However, in six months, the exchange rate may fluctuate.

- **If the euro appreciates (exchange rate rises to 1.15)**: 100,000 USD / 1.15 = **86,957 EUR**. You lose about 4,000 EUR.
- **If the euro depreciates (exchange rate falls to 1.05)**: 100,000 USD / 1.05 = **95,238 EUR**. You gain about 4,300 EUR.

2. With hedging via a forward contract:

You enter into a forward contract with your bank to lock in an exchange rate of EUR/USD at 1.10 for six months. This means that no matter what the market rate is in six months, you will exchange 100,000 USD at that rate.

- Guaranteed amount in euros: 100,000 USD / 1.10 = **90,909 EUR**.

Comparison:

- **Without hedging**, you are exposed to risk: if the exchange rate becomes unfavorable (e.g., 1.15), you lose money.
- **With hedging**, you lock in a rate and eliminate the risk. This allows you to plan your cash flows with more certainty, even though you give up the chance to benefit from a favorable rate movement.

Hedging through a forward contract protects you against a depreciation of the dollar (or an appreciation of the euro), thereby stabilizing your income in euros.

The cost of a forward contract with a bank depends on several factors

1. Interest rate differential (or forward points):

Banks calculate the price of forward contracts based on the interest rate differential between the two currencies involved. For example, if euro interest rates are lower than dollar rates, the bank will add a premium to the forward exchange rate, as holding dollars is more expensive. This premium or discount is called "swap points" or "forward points."

- If USD interest rates are higher than EUR rates, the forward rate will be higher than the spot rate.
- If EUR interest rates are higher than USD rates, the forward rate will be lower than the spot rate.

2. Transaction fees:

Banks typically add a margin to the forward exchange rate they offer you. This margin is usually a percentage of the amount covered, which can vary depending on the bank and the volume of the transaction. It reflects the risk the bank takes and its cost of managing the transaction.

3. Indirect costs:

There may be administrative fees or hidden costs associated with setting up the contract, but this depends on the bank. These costs are generally less visible.

Example calculation:

- Spot rate EUR/USD: 1.10.
- Interest rate differential: If the USD interest rate is 5% and the EUR interest rate is 3%, the bank may offer a forward rate slightly higher than 1.10 (say 1.12).
- Adding their margin, the forward rate can be EUR/USD: 1,13.