# The Forward Foreign Exchange Market

## What is the Forward Foreign Exchange Market?

Foreign exchange can be bought and sold not solely on a spot basis, but also on a forward basis for delivery on a specified future date. In a forward transaction, the terms of the purchase (buy or sell) are agreed up front but will take place on a date in the future, thus the exchange rate is fixed now for a future exchange of currencies. Forward transactions are commonly known as 'forward exchange contracts'.

## Forward Exchange Contracts (FECs)

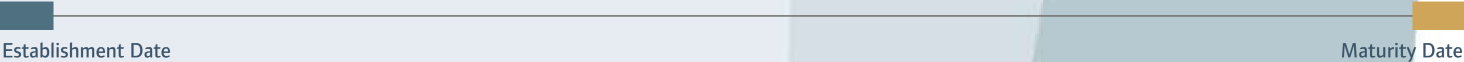
A forward exchange contract, commonly known as a FEC or forward cover, is a contract between a bank and its customer, whereby a rate of exchange is fixed immediately, for the buying and selling of one currency for another, for delivery at an agreed future date. Economic, technical and political factors can cause upheaval in the foreign exchange markets, resulting in volatile exchange rates that can hamper international trade. The forward exchange contract (FEC) is an effective hedging tool tantamount to an insurance policy, in that it protects traders and clients from unfavourable exchange rate fluctuations which might occur between the contract date and the payment date. The exact value of the import and export order can be calculated on the day it is processed and thus, budgeting and costing are accurate. Both parties can make use of forward exchange contracts and this kind of instrument caters for a diverse range of commercial and financial transactions.

## Types of FECs

Customers wishing to arrange forward exchange cover have the choice of three different period types of forward exchange contracts:

1) Fixed contract:

In a fixed contract, the delivery date of the foreign currency takes place on the maturity date and at the exchange rate specified in the contract.



Establishment Date — Maturity Date

These contracts have a "fixed maturity date" and would normally be utilised in full on that date. They occur when the customer knows the exact date of their commitment and they cover forward to that date. Under such a contract, the customer would normally not be able to deliver before the final maturity date shown on the contract. However, there are options available should a customer decide on delivery before the stipulated date.

For example, if a customer knows that he will need to pay for merchandise on 15 December 2008, he will then establish a fixed contract for that date.

2) Partially optional contract

In a partially optional contract, the terms of the contract are fixed during the first period from establishment to option start date, and then fully optionally from option date to maturity date. The delivery of the foreign currency at the exchange rate specified in the contract, can take place at any time during the optional period.

These contracts are a combination of both fixed and fully optional contracts. They have two dates:

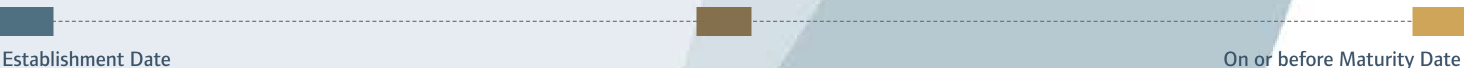
**Option start date:** - indicating the period prior to this date is a fixed contract

Establishment Date — Option Start Date — On or before Maturity Date

A customer would use this contract if they are certain that they will not require it prior to the 'option start date', however, they need flexibility thereafter.

3) Fully optional contract

In a fully optional contract, the delivery of the foreign currency can take place at the contract rate at any time during the existence of the contract.



Establishment Date — On or before Maturity Date

These contracts have an 'on or before maturity' date and may be utilised either in whole or in part, at any time between the establishment date and the maturity date of the contract. These contracts are used when a customer does not know the exact date of his commitment or if he takes out one contract for multiple transactions.

## Pricing

Forward exchange contract rates are based on interest differentials between the countries concerned, and are not predictions of what the rates of exchange will be in the future. The difference between the forward rate and the spot rate reflects the interest rate differential between the two currencies. When the foreign interest rate is higher than the South African interest rate, the foreign currency is said to be at a discount. The forward rate is then lower than the spot rate. A forward exchange contract will therefore benefit the importer, but be at a cost to the exporter. Conversely, when the foreign interest rate is lower than the South African interest rate, the foreign currency

is said to be at a premium. The forward rate is then higher than the spot rate. A forward exchange contract will therefore benefit the exporter, but will be at a cost to the importer. The forward exchange rate may be higher (premium) or lower (discount) than the spot exchange rate, rarely are they the same. If this were not the case, forward contracts would be used to earn risk-free profits through arbitrage.

**Forward exchange rate = Spot rate + Net cost of carry (Interest differential)**

Forward rates as such are not quoted – points are (that is the premium or discount to the spot rate). One point is equivalent to 0.0001 of the currency being quoted. When given direct quotations, the forward rate is obtained by adding the premium to / subtracting the discount from the spot rate (the opposite is true for indirect quotations). For example, if the dollar / rand is R6.4340-6.4350 spot and the 3-month forward premium is 580-590, the forward rate will be R6.4920-6.4940. The calculation can be shown as follows: 6.4340 +(580/10000) and 6.4350 +(590/10000).

## Application of FECs

The bank will give advice and guidance in selecting the appropriate type of forward exchange contract. We are responsible for ensuring that the forward exchange contract is issued, delivered, extended, surrendered or cancelled in accordance with your instructions. (These topics will be covered in next weeks Forex Bulletin). We will ensure that the transaction complies with the relevant exchange control rulings or has a reserve bank approval reference number. To apply for an FEC, the customer would need to obtain the relative credit approval, obtain the exchange control approval where necessary (as described above), Complete a Forward Exchange Contract – General Terms and Conditions and then sign and submit the application at the international Trade Services centre nearest to them.

## Contact Details

For further information on any of our products or services:

**Forex Relationship Centre**
Corporate and Investment Banking Division
Standard Bank
Toll Free Tel: 08000-FOREX
Fax: 011 378 8060
email: Forex@Standardbank.co.za
**www.standardbank.co.za**

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