Forward Contracts

Offset risk from currency market fluctuation

What is a Forward Contract?

In the foreign exchange market, a forward contract is an agreement that allows you to "lock in" an exchange rate today for an agreed-upon date in the future. These contracts are simple and highly effective at locking in profit margins, as well as offsetting risk from currency market fluctuation.

Know Your Costs and Profitability

There are many benefits to "locking in" a rate for a future payment. Chief among them is the ability to more accurately forecast future costs and profitability. Additionally, for finance professionals hoping to safeguard their business against unplanned rate fluctuation, it is the safest bet. If you are hoping to capitalize on net gains when market volatility turns in your favour, however, a forward contract is probably not the best option.

Forward Rate

A forward rate is not a prediction of what the currency rate will be in the future. Rather, it is a rate based on the differential between present day interest rates between the two traded currencies. The forward rate is then calculated by adding or subtracting that interest rate differential from the current spot rate. The currency with a lower interest rate will therefore have points added to the spot rate, while the currency with the higher interest rate would see them deducted from the spot rate.

Use Case Example

A US-based company purchases parts from a Eurozone based company and receives an invoice for €250,000 with "Net 60" terms. In order to hedge the foreign currency risk for 60 days, the US company decides to arrange a forward contract. If the current spot rate is 1.1425 and the difference between the euro and USD interest rates is 37 basis points (or 0.0037), then the forward rate is 1.1462 (1.1425 + 0.0037). In 60 days, the US company will pay $286,550 for €250,000 regardless of how rates have fluctuated in that time.

Deposit Requirements

The typical deposit that is required to secure a forward contract varies from 5 – 10%. In the above example, a 5% deposit would translate to $14,327.50 (5% of $286,550). Keep in mind that the deposit is fully refundable at the end of the contract. Also, depending on your company's financials, the deposit requirement may be reduced or waived.

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