Danske Bank

Information about Forward currency transactions

This fact sheet provides general information about forward currency transaction that can be traded through Danske Bank. A forward currency transaction can be entered into as an OTC transaction with Danske bank as counterparty.

WHAT IS A FORWARD CURRENCY TRANSACTION?

A forward currency transaction is a binding agreement between two parties to buy or sell a specific currency amount at a fixed exchange rate at a fixed future date.

The parties determine the strike rate when entering into the transaction.

USING FORWARD CURRENCY TRANSACTIONS

A forward currency transaction is generally used to hedge receivables or payables in a foreign currency.

A Danish company generating income in US Dollars from exports to the United States may hedge its foreign exchange risk by selling US Dollars forward against Danish Kroner in a forward currency transaction. On the maturity date, the company delivers the agreed amount in US Dollars and receives an amount in Danish Kroner based on the agreed forward rate.

A forward currency transaction can also be used to reschedule loans from Danish Kroner into another currency. For example, a customer wanting to reschedule a loan denominated in Danish Kroner at the upcoming payment date may choose to sell the foreign currency against Danish Kroner. The transaction will then have the same maturity date as the next payment date of the loan.

PRICING A FORWARD CURRENCY TRANSACTION

The price of buying or selling a foreign currency against Danish Kroner in a forward transaction is determined by the following factors:

- The current market rate, *M* (the spot rate)
- Interest rates in the quoted currency DKK on buying or selling US Dollars against Danish Kroner, *R1*
- Interest rates in the base currency, USD on buying or selling US Dollars against Danish Kroner, *R2*
- The interest rate differential between the currencies traded (*R1* less *R2)*
- Maturity of the forward rate transaction, *D*.

If you buy or sell a currency with higher interest rates than Danish Kroner, the forward rate will be lower than the current spot rate. Conversely, a premium is added if the transaction involves buying or selling a currency with lower interest rates than Danish Kroner.

- The current market rate

The current market rate, or the spot rate, is the rate used for exchanging currencies. Normally, the transaction is settled after two business days.

The premium or the discount relative to the spot rate is determined as follows: M * (R1 – R2) * D / (360 *100).

The forward rate, then, is determined as follows:
Spot rate (+/-)forward premium

MATURITY OF FORWARD CURRENCY TRANSACTIONS

Forward currency transactions are settled at the maturity date at the agreed forward rate.
The following events may take place when a forward transaction matures:

- The parties exchange the agreed currency amounts
- The transaction is extended with full or partial exchange rate adjustment and cash settlement of the difference
- The transaction is extended without exchange rate adjustment but with payment of interest compensation.

If a transaction is extended without full exchange rate adjustment, the loss or gain on the transaction will carry interest based on either a lending rate or a deposit rate.

An extension of the maturity of a forward currency transaction generally involves full exchange rate adjustment, meaning that the transaction is adjusted to the current market exchange rate.

In other words, if the transaction is loss-making at the maturity date, exchange rate adjustment means that you will be required to pay the difference between the agreed forward rate and the current market rate.

If the transaction is profitable at the maturity date, exchange rate adjustment means that you will receive the difference between the agreed forward rate and the current market rate.

CALCULATING THE LIQUIDITY PREMIUM

The liquidity premium is calculated on the basis of the following:

- the original forward rate agreed, *T*;
- the market rate at the time of extension, *M*;
- the deposit rate or the lending rate, *R*; and
- The number of days the transaction is extended, *D*

in the following equation:

$$(T-M) \times R \times D / (360 \times 100)$$

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The divisor, shown above as 360, depends on the actual currency in which the gain or loss is expressed.

EARLY TERMINATION	If the basis for the agreement ceases to exist in whole or in part before the transaction matures, the transaction can be settled early. In such case, the rate originally agreed will be adjusted to reflect the forward premium or discount for the remaining period, and interest on the gain/loss on the transaction.
NDF	Some currencies are subject to restrictions and are not traded internationally. Instead, they can be hedged by way of a Non-Deliverable Forward (NDF). The main difference between a traditional forward transaction and an NDF lies mainly in the settlement at maturity. For an NDF, there is no physical exchange of the currencies involved. Instead, cash settlement is used, typically based on the difference between the strike rate and the market rate (spot rate) applying two business days prior to maturity. Cash settlement is generally made USD or EUR, but can also be agreed to settle in any convertible currency in a case by case basis.
SPECIFIC RISKS ASSOCIATED TO NDF SETTLED IN OTHER CURRENCIES THAN USD OR EUR	In case the NDF is settled in a local convertible currency, a conversion from USD to that local convertible currency will be done using a specified fixing source, the same day as USD/NDF fixing takes place. In this case, there is an additional risk embedded, when converting USD settlement to local currency settlement, resulting in a higher/lower local currency settlement amount, unrelated to the USD/NDF settlement.
TERM	When involving the most liquid currencies, forward currency transactions typically have a maximum term of two-three years. For currencies of secondary forward markets, liquidity in excess of 12 months may be limited.
RISK FACTORS	It is important to note that a forward currency transaction may involve substantial risk. A forward currency transaction involves a risk that the forward rate is unfavourable relative to the spot rate at which the transaction will be settled at the settlement date.

Accordingly, if you buy foreign currency in a forward transaction that is to be settled at an exchange rate that is higher than the market rate applying at the settlement date, the transaction will be loss-making. The loss equals the difference between the forward rate and the spot rate. Conversely, the transaction will yield a gain if the spot rate is lower than the spot rate at the settlement date.

If you sell foreign currency in a forward transaction that is to be settled at an exchange rate that is lower than the spot rate applying at the settlement date, the transaction will be loss-making. The loss equals the difference between the spot rate and the forward rate. Conversely, the transaction will yield a gain if the forward rate is higher than the spot rate.

If a forward currency transaction is terminated prior its scheduled maturity, a change in the interest rate difference will trigger a change in the premium or discount in excess of the change triggered by the shorter term to maturity. This could cause you to incur a loss on the transaction.

COLLATERAL

We may require you to provide collateral when you enter into a transaction with us as counterparty.

SPECIAL MARKET CONDITIONS

Under special market conditions, it may be difficult or impossible to liquidate a position. This may occur, for example, at times of rapid price movements if the prices rises or falls to such extent that we are unable to stipulate a price or trading of financial instruments are suspended or restricted under the rules of the regulated market place.

TAXATION

The tax treatment of a gain or a loss on a forward currency transaction depends on whether you are dealing as a private individual or on behalf of a company.

Due to the complex nature of the tax rules, we recommend that you consult an accountant, tax-advisor or other professional adviser to clarify the tax and accounting consequences.