Forward (Outright) Transaction

The Situation

You have ordered goods from a supplier in Canada, there are two payments of CAD500, 000, the first is due immediately which you cover with a spot trade and the other is due in three months time. You want to lock in the USD/CAD exchange rate for the future payment.

The Product: (Forward Outright)

The Forward Outright allows you to buy or sell a specific currency at a specified rate for a specific date in the future. A Forward can have a specific future value date or can be booked on a 'window' basis. The 'window' refers to the time period in which the contract can be exercised or 'drawn down'. For example, a customer may need to pay a bill during the month of June, but does not have an exact date, in this case they can have a 'window' forward from Jun01 – Jun30, allowing them to 'draw down' at any time within that period.

A deal is classified as a "forward" deal if the value date is greater than the spot value date. Forward outright trades are rarely entered into for periods in excess of one year.

The Solution

If you want to guarantee a particular rate for your forward purchase /sale of a specific currency, a forward outright is the 'right' product to choose. In the 'situation' above you need to buy CAD500, 000 in three months time. The current spot rate is USD/CAD 1.5680. This spot rate has to be adjusted by the 'forward points'.

Using the 3-month interest rates specific to each currency, the forward points for the transaction are calculated. These points can either be at a 'discount' or 'premium' to the spot rate. The forward outright rate is arrived at by adjusting the current spot rate by either the discount or premium points.

In this case the spot points are +.0023, therefore the forward outright rate is USD/CAD1.5703. In three months time when the forward matures you will send the bank USD318, 410.49 and the bank will remit CAD500, 000 according to your specified instructions.

In the event that you do not need the currency when the forward contract matures you must either roll over the contract to a new value date or sell the contract back to the bank. In either case, the forward contract is effectively 'marked to market' and the current value of the contract, either positive or negative, is crystallized on the books of the company. You cannot roll over the contract at the "historic rate".

The Benefits and Disadvantages

Simple Product
Known Rate
Agreed Value Date (or 'Window' period)
Opportunity cost - if the rate moves your favor between the deal date and the value date