FOREIGN EXCHANGE TRANSACTIONS: SPOT & FORWARDS EXPLAINED

Here, we take a look at two different types of foreign exchange transactions your business may choose to consider. There are a number of different foreign exchange transactions your business can use to minimize potential losses in the FX market. You've probably come across two of the most common: spot transactions & forward contracts –let's take a look at each one in more detail.

What are spot transactions?

A foreign exchange spot transaction is the quickest foreign exchange transaction, normally settled within two days. Two parties agree to exchange currency at the foreign exchange rate at the time of trade, or 'on the spot'. Typically businesses will either use a bank or a non-bank foreign exchange provider for a spot transaction. To do this, they will either telephone their provider or go online and be given two prices, bid and offer;

1. **Bid price:** In GBPEUR terms, this is the price at which you will buy Euros.
2. **Offer price:** In GBPEUR terms, this is the price at which you will sell Euros.

The prices you see are your rate to buy or sell currency, this differs from the interbank rate which financial institutions buy and sell currency at. The difference between the interbank rate and your rate is known as the spread, this is the profit the bank or broker is making from the transaction excluding associated costs. The interbank FX rate fluctuates throughout the day, and the bank or broker spread applied to a deal can vary depending on a number of factors including:

- **Currency pair:** you are more likely to get a better spread on a commonly traded currency pair, such as GBP/USD, EUR/GBP or USD/JPY. If the currency pair is more exotic, i.e. not as commonly traded, the spread is likely to be higher. Examples of less common currency pairs include GBP/BRL, USD/TRY and USD/MXN.
- **Volume:** as with most tradable commodities, the more you buy the better the price, and foreign exchange is no different. So a business buying $1,000,000 USD from GBP is likely to get a better price than if they bought $10,000 USD from GBP.
- **Customer standing:** businesses are generally assessed on the level of income they bring in, so if you also have other financial products with your provider they may offer you a better price on your foreign exchange transactions as a result.

What are forward contracts?

A forward contract is the agreement to exchange one currency for another at an agreed point in the future, known as the value date.

Instead of using a forward contract, you could exchange one currency for another using a spot transaction then hold the currency on deposit in the corresponding currency account until needed. However, this may impact on cash flow, which is why some businesses prefer to use forward contracts.

- The price of a forward contract is calculated using the spot price and the interest rate differential between the two currencies over the length of term of the contract. The same factors will influence the price a business pays on a forward contract as they do a spot transaction.
- Once the contract has been agreed the business has the FX rate protected for the duration of the contract. Upon the value date, the business is obliged to exchange the agreed sum of currency at the agreed FX rate.
- The business has certainty over the rate it will receive in the future irrespective of where the spot rate moves over the time period.

Deciding on the most appropriate foreign exchange transaction is largely down to understanding your business requirements and your risk appetite, the nature of you foreign exchange exposure (is it contracted or merely forecasted) and then matching all this to the appropriate transaction type.

Global Exchange
Payment Solutions

INFO@GEXCHANGE.COM
GEXCHANGE.COM

a division of Cambridge Global Payments