# What is a forward exchange contract?

A forward contract is a binding contract between you and the bank that ensures that you can buy or sell an asset at a certain future date at an agreed price.

**For which clients are forward contracts relevant?**
A forward contract is relevant for clients who wish to hedge future risks in relation to foreign currencies.

**Possibilities offered by forward contracts**
Trusted Novus Bank offers investors the opportunity to trade forward exchange contracts. In addition to hedging risk, forward contracts can be used for investment in expectations of a future development of a given currency. See the following examples of how the product can be used.

**Forward exchange contract**
If, for instance, you have bought commodities in US dollars, and the payment is due in 60 days, and you wish to know the exact amount you have to pay, you can enter into a forward exchange contract. In such a contract, it is agreed at which rate you can buy US dollars in 60 days. In this way, your payment will not be affected by the development of the exchange rate for US dollars. If, over the 60-day period, the rate goes up above the agreed exchange rate, you obtain an indirect gain. On the other hand, you will suffer an indirect loss if the exchange rate falls, as in this way you pay more for your commodities than you would, had you not entered into the forward contract.

**Pros and cons**

| Forward exchange contract | |
|---|---|
| **Pros** | **Cons** |
| • You will be sure of the price at which you buy/sell in the future.<br>• Forward contract are very flexible as they can be tailored to your individual needs and can be settled on an on-going basis in small portions. | • As forward contracts are over-the-counter products (OTC) and therefore not listed on stock exchanges, there are no clearly defined prices in the market.<br>• If the price of the underlying asset moves in the 'wrong' direction, you may miss out on a possible saving as you have committed yourself to buy or sell at the agreed price and not the market price. |

**What happens in practice?**
A forward contract may stipulate physical delivery or cash settlement. If cash settlement has been agreed, the difference between the agreed price and the market price is to be paid.

A forward contract is binding, so it cannot be cancelled. If you change your mind, you can enter into a closing transaction.

As forward contracts are OTC products (i.e. not listed on the stock exchange), their closing contracts must typically be conducted with the same counterparty. The difference in the exchange rates will then be settled at expiry. The risk on the asset which you originally wanted to hedge, will thus be back with you.

**Forward exchange contract**
The price of a forward exchange contract is the spot rate on the day when the contract is entered plus or minus an adjustment. In connection with forward exchange contracts, this represents the interest-rate differential between the two currencies until expiry of the contract. The contract amount will be exchanged at the spot rate, but since the two amounts are not settled until the agreed future date, you will pay interest for the currency you have sold for later delivery. Correspondingly, you will receive interest for the currency you have bought for later delivery.
If either of the two currencies is Danish kroner, for instance, a premium will be added if the interest rate applicable to the foreign currency is lower than the Danish interest rate. Correspondingly, there will be a deduction if the interest rate applicable to the foreign currency is higher than the Danish interest rate.

**Return**
A forward contract does not generate a return as such. However, as shown in the example above, a forward contract may indirectly generate a return, for instance, due to a difference in yields on the involved assets or opportunity cost as a result of price changes in the market.

**About risk**
By entering a forward contract you accept a counterparty risk, and if the counterparty defaults on his obligations, you may face the risk that the market has developed unfavourably in relation to the contract price.
If a forward contract is subject to cash settlement in another currency (for instance, euro) than your base currency (for instance, the Danish krone), you assume an exchange-rate risk.

We recommend that you seek advice from professional advisers about any accounting and tax consequences before entering into forward contracts.

**What you should know before trading**
Forward contracts are categorised as a complex product and we recommend that your risk profile is reviewed before you engage in transactions. Your relationship manager can help you with that.

To be able to complete transactions, you must be able to provide additional margin, if necessary. In addition, you must be able to meet the counterparty's demands on a daily basis for additional liquidity to cover any unrealised loss on your transactions.

We recommend that you contact your relationship manager if you have any questions in relation to anything described in this fact sheet, or if, generally, you would like to have some points clarified.

**Tax**
We do not give advice on tax issues in connection with specific transactions.
If you wish to learn about the specific importance of the tax rules for you, we recommend that you consult your accountant.