TD Securities

FX Swap

An FX Swap is a simultaneous purchase and sale of usually the same amounts of one currency for another with two different value dates (normally spot to forward). This would allow funding charges designated in another currency without acquiring foreign exchange risk. It is common to trade spot-forward or forward-forward.

An FX swap consists of two legs:

- A spot (or forward) fx transaction (short leg)
- A forward fx transaction (long leg).

Two legs are executed simultaneously for the same quantity and they offset each other.

Commonly used scenarios:

- Covering overnight negative balances in one of the accounts where the other currency account had a positive balance to be transferred from. This would reduce overdraft interest that would be paid if not covered.
- When a company has US$ receivables in the future, however would need US$ to pay (for example) new equipment before it receives US$.

This is not a currency swap (an interest rate swap which involves the exchange of two floating rate financial instruments).

Scenario 1:

Company "A" has US$ 100,000 in their US account that they would not need to use for 30 days and at the same time Company "A" borrows CA$ 100,000 out of CA$ line of credit.

Problem: interest cost.

FX spot rate 1.1100

1) Leg one: Company "A" would sell US$ 100,000 @ 1.1100 and proceeds of CA$ 111,000 would be credited to Canadian account
2) Leg two: Company "A" would buy US$ 100,000 @ 1.1100 (+/-* forward points) and in this case for 30 days forward out would pay rate of 1.1110. The cost of buying US$ 100,000 would be CA$ 111,100.

The difference of CA$ 100 would be the cost for 30 day forward; however overdraft cost would be CA$ 273 (CA$ 111,000 x 3% – using the prime rate for this scenario).

Result:
Company "A" saves CA$ 173 dollars in this scenario.

Scenario 2:

Company "A" has US$ receivables however would need to buy US$ for the equipment purchased.

Problem: timing.

1) Leg one: Company "A" would buy US$ @ 1.1100 and pay CA$ 111,000 for a spot purchase
2) Leg two: At the same time Company "A" would sell US$ 100,000 for 30 days @ 1.1100(+/-* forward points) – for this scenario at 1.1110.

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Result:
Company "A" would have a credit of CA$ 100 in CA$ account 30 days from now and wouldn't have fx risk (two different rates when buying US$ and selling US$ once payables are received).

Variations:
a) Amounts on both legs of a swap could be the same or different
b) Long leg doesn't need to be a single dated instead could be a time option.

* Forward points are based on interest rate differentials between the two countries. In the forward market, the currency of a country with lower interest rate than Canada will trade at a "premium". The currency of a country with higher interest rates than Canada will trade at a "discount".

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