FX derivatives
Information sheet

Financial instruments are all types of instruments that are intended to be traded on the securities market. They can be divided into complex and non-complex instruments. Before you trade in a financial instrument, we are required to ascertain whether you have sufficient knowledge and experience to understand the properties and risks involved in trading in financial instruments. Below is some information about the most important qualities and risks associated with a type of instrument in which you have shown an interest. If you do not have sufficient knowledge and experience, we recommend that you do not trade in this instrument.

Introduction

FX derivatives are a collective term for instruments such as forwards, options and swaps relating to currency. They are classed as complex financial instruments. FX derivatives are generally used to manage currency risk when trading in a foreign currency.

Derivative instruments vary in regard to their risk level and the factors that affect the financial outcome. It is therefore important that you understand what applies to the specific derivative you intend to trade in.

How FX derivatives work

One characteristic of derivatives is that they are linked to events or conditions at a specific time or period in the future.

The value of the derivative is based on the underlying asset, i.e. the various currencies. The price is affected by factors such as the interest rate level (the difference in interest rate between the various currencies), the remaining investment term and the volatility of the underlying asset.

Transactions in some FX derivatives require you to pledge collateral. The collateral requirement may also change in line with changes in the price of the underlying asset.

For whom are FX derivatives suitable?

FX derivatives are primarily used by companies with incoming and outgoing payments in currencies other than SEK, who need to hedge a future payment or receivable in a foreign currency. They can also be used as protection from currency risk in an investment.

Trading in FX derivatives

FX derivatives are generally unlisted instruments that are not traded on an exchange. An FX derivative is tailored to the customer's needs in regard to term, level, amount and so on, and is traded OTC (Over The Counter), i.e. directly between the customer and the bank.

In order to trade in FX derivatives with SEB you must have payment instructions for the relevant currencies (accounts with SEB or another bank) and a limit. Companies that are authorised for the currency trading service may trade on their own in FX derivatives.

Types of FX derivatives

There are various different types of FX derivatives. The most common variants available for trading at SEB are reviewed below.

FX Spot

Spot refers to the settlement day of the transaction in question; the spot day will typically be two banking days forward for the currency pair traded. If the exchange is to take place on a different date, this is referred to as a forward transaction. Spot exchanges are not inherently financial instruments, but since this is a common way to trade in currency, and as the spot rate is used to calculate the forward rate, we are providing information about it here.

FX forwards

An FX forward is a binding agreement between two parties (e.g. you and the bank) in which the parties have an obligation to buy or sell one currency against another at a predetermined price on a predetermined date. The difference between a forward and a spot is that the forward is a contract for a future transaction.

FX forwards are generally used to hedge the currency rate on future revenues or costs associated with import and export, for example. The FX forward locks the rate of a future currency exchange, thereby offering protection from negative price movements. A forward also means that the holder cannot benefit from positive price movements.

The forward rate is determined using the daily (spot) rate and the difference in interest rate between the currencies for the relevant term. The difference in interest rate is recalculated as rate points, known as forward points. The forward rate does not include any expectation or assessment of future price movements.

It is possible to use all or parts of a forward hedge prematurely. This is known as unwinding. Depending on how long is left until the due date, the rate is adjusted based on the difference in interest rate between the currencies.

FX swaps

An FX swap is an agreement between two parties to exchange payment flows with each other on two different dates in two different currencies. The purpose may be to change currency exposure over a specified time, for example, if you want to postpone an expiring FX forward transaction.

An FX swap consists of both a purchase and a sale of the same pair of currencies, on two different value dates. The amount is usually the same on both dates, expressed in one currency. However, the amount in the other currency will differ between the dates due to the difference in interest rate between the two currencies and between the two dates.

The rate of the FX swap consists of the difference in interest rate between the two currencies for the relevant term. The difference in interest rate between the currencies may be either negative or positive, and can therefore be regarded as either a cost or a revenue.

FX options

Depending if you buy or sell an FX option you are given the right or obligation to buy or sell a currency at a predetermined price (redemption price) at a set time.

The buyer of the option is entitled to buy (call option) or sell (put option) the currency at the set rate at a set time. The seller of an option is obliged to buy (put option) or sell (call option) the currency at the set rate at a set time. The buyer of the option pays a premium to the seller for this right.

An option solution is more flexible than a traditional forward, since as the buyer you can choose whether or not to exercise the option. Depending on the market rate, you can use the option if the agreed rate is advantageous, let it lapse or sell it back to the bank and switch to the prevailing market rate.

There are many ways to hedge currency using options. The various strategies can be tailored according to the individual's needs and belief in the market.

Risk

In the context of FX derivatives, the term "risk" denotes the probability that the value of your instrument will decline. A higher risk often means a greater opportunity for a high return, but at the same time the risk of losing money increases.

Risk varies substantially from one derivative to the next. Derivatives can be used to avoid the risk associated with future exchange rate changes, but also to speculate in order to increase the value of an investment. Using FX derivatives for speculative purposes is associated with greater risk, as there is no underlying asset, i.e. the other currency. There is a risk that you will be forced to change the transaction back, thereby making a loss.

Trading in FX derivatives always carries a counterparty risk, i.e. the risk that the counterparty will not fulfil its commitments.

Forwards

An FX forward involves an obligation for both parties to exchange a certain amount at a set rate on an agreed date. If the purpose of the forward transaction being entered into does not come off, a counter-transaction in the form of a new FX forward may be necessary. The risk then is that the exchange rate has moved in an unfavourable direction.

Swaps

The risks in an FX swap include counterparty risk, flow risk and interest rate risk. Flow risk is the risk that the payment flows will have changed between entering into the FX swap and delivery of the FX swap.

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Interest rate risk is the risk that the interest rates on which the FX swap was based will differ negatively from the prevailing interest rates at a later date.

Options

If you buy an option, the maximum you can lose is the premium you paid. If you sell an option, on the other hand, the loss can be unlimited. The change in value may be greater for the option than for the underlying asset.

More information

Companies or sole proprietors trading in financial instruments are covered by the European Market Infrastructure Regulation (EMIR). Among other things, this means that you must sign the contract named "Agreement regarding portfolio settlement" in order to trade in these instruments at SEB.

As a company or sole proprietor, you are also obliged to report your transactions to a transaction register, which requires you to have a LEI-code (Legal Entity Identifier). This can be obtained from various issuers, such as Nordlei (www.nordlei .org) and GMEI Utility (www.gmeiutility.org). You must have a LEI-code in order to trade in these instruments at SEB. You can also transfer the task of reporting your transactions to SEB. We will do this on your behalf.

Things to remember:

- The historical return of a financial instrument is not a guarantee of future return. The value of financial instruments can rise or fall, and it is not certain that you will get back all the capital you have invested.
- In order to trade in these instruments, you must familiarise yourself with the terms and conditions that apply to trading in financial instruments. The contracts that apply depend on the instrument you are trading in.
- Certain instruments require you to be liable to make payments in future. It is important that you are prepared to comply with your undertaking.
- Check the information on the statement and other reporting relating to your holdings, and inform us immediately of any errors.
- Regularly monitor changes in the value of your holdings and positions.
- You are responsible for taking any action necessary to reduce the risk of losses.
- Always ask for supplementary marketing material or further information with more details about the financial instrument you are interested in.

Check your experience

How long have you invested in this type of instrument?	What is the average amount of money you have invested in this type of instrument?	How many times per year have you traded in this type of instrument?
☐ No experience	☐ Up to 50 000	☐ Up to 2
☐ Less than one year	☐ Up to 100 000	☐ Up to 5
☐ 1 to 5 years	☐ Up to 250 000	☐ Up to 10
☐ More than 5 years	☐ Up to 500 000	☐ More than 10
	☐ More than 500 000	

Check your knowledge

1. What is characteristic of an FX derivative?

A) ☐ It is a tailored instrument that is traded OTC
B) ☐ It is a standardised contract that is traded directly with the bank
C) ☐ It is a standardised contract that is traded via a stock exchange

2. As the buyer of a FX forward, what have you undertaken to do on the due date?

A) ☐ Nothing, but you have the option of buying the currency on the due date
B) ☐ Buy the currency on the due date, whatever the exchange rate is then
C) ☐ It depends on what has been agreed

3. Which of the following alternatives affects the forward rate?

A) ☐ The securities you pledged
B) ☐ The difference in interest rate between the two currencies
C) ☐ Where the bank judges that the rate will be in the future

4. What is characteristic of a FX swap?

A) ☐ A package consisting of two FX transactions with delivery of the currencies in two banking days
B) ☐ A right, but not an obligation, to buy and sell a pair of currencies on different value dates
C) ☐ A purchase and a sale of the same pair of currencies, but on different value dates

5. What does buying a call option mean?

A) ☐ You are entitled to buy the underlying currency at a predetermined rate
B) ☐ You are entitled to sell the underlying currency at a predetermined rate
C) ☐ You are obliged to sell the underlying currency at a predetermined rate

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6. What does selling a call option mean?

A) ☐ You are entitled to sell the underlying currency at a predetermined rate
B) ☐ You are obliged to sell the underlying currency at a predetermined rate
C) ☐ You are entitled to buy the underlying currency at a predetermined rate

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7. What risk are you taking if you buy a put option?

A) ☐ In principle, the loss could potentially be unlimited
B) ☐ You are taking no risk at all
C) ☐ The maximum you can lose is the premium you paid

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