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Forward Points

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What are Forward Points?

In currency trading, forward points are the number of basis points added to or subtracted from the current spot rate of a currency pair to determine the forward rate for delivery on a specific value date. When points are added to the spot rate this is called a forward premium; when points are subtracted from the spot rate it is a forward discount. The forward rate is based on the difference between the interest rates of the two currencies (currency deals always involve two currencies) and the time until the maturity of the deal.

Forward points are also known as the forward spread.

Basis points can be either added or taken away from the spot rate. If they are added, they are forward points. If subtracted, they are discount points.

The Basics of Forward Points

Forward points are used to calculate the price for both an outright forward contract and a foreign currency swap. Points can be calculated and transactions executed for any date that is a valid business day in both currencies. The most commonly traded forward currencies are the U.S. dollar, the euro, Japanese yen, British pound and Swiss franc.

Forwards are most commonly done for periods of up to one year. Prices for further out dates are available, but liquidity is generally lower. In an outright forward foreign exchange contract, one currency is bought against another for delivery on any date beyond spot. The price is the spot rate plus or minus the forward points to the value date. No money changes hands until the value date.

date. The rate for the forward leg of the swap is the near date rate plus or minus the forward points to the far date. Money changes hands on both value dates.

Discount Spreads

In contrast to the forward spread, a discount spread is the currency forward points that are subtracted from the spot rate, to obtain a forward rate for a currency. In the currency markets, forward spreads, or points, are presented as two-way quotes; that is, they have a bid price and an offer price. In a discount spread, the bid price will be higher than the offer price, while in a premium spread, the bid price will be lower than the offer price.

KEY TAKEAWAYS

- In currency trading, forward points are the number of basis points added to or subtracted from the current spot rate of a currency pair to determine the forward rate for delivery on a specific value date.
- A discount spread is the currency forward points that are subtracted from the spot rate, to obtain a forward rate for a currency.
- When points are added to the spot rate this is called a forward premium; when points are subtracted from the spot rate it is a forward discount.

Examples of Forward Points

Forward points are often quoted in numbers, such as +13.2 or minus -270.68. These represent 1/10,000, so +13.2 means 0.00132 when added to a currency spot price.

For example, if the euro can be bought versus the dollar at the rate of 1.1350 for spot, and the forward points are +13.2, the forward rate is 1.13632 (or 1.1350 + 0.00132).

Just based on this information we can determine that the interest rate in the US is higher than in the Eurozone. The positive forward points when buying the EUR/USD tell us that the rate goes up the further out into the future we go. This is because the forward points compensate for the difference in interest rates between the two currencies.

Thinking of it a different way if the euro interest rate is 1% and the U.S. interest rate is 2%, you could make the 1% difference by holding U.S. dollars instead of euros. So when exchanging or locking in currency exchange rates for the future (forward rate) this needs to be factored in.

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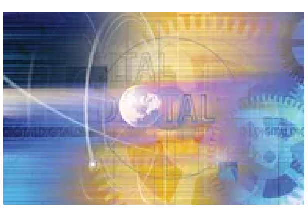

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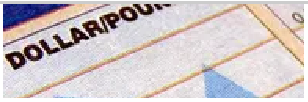

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