

Information about Currency Swap transactions

This fact sheet provides general information about currency swap transaction that can be traded through Danske Bank. A swap transaction can be entered into as an OTC transaction with Danske bank as counterparty.

WHAT IS A CURRENCY SWAP TRANSACTION?

A currency swap transaction is a binding agreement between two parties to exchange a specific currency amount at a fixed exchange rate at a near date and to reverse the transaction at another fixed exchange rate at the maturity date of the swap.

USING CURRENCY SWAP TRANSACTIONS

A currency swap transaction is generally used to manage liquidity in connection with cash flows in foreign currency.

A Danish company has excess USD liquidity for a period of time, but payables in USD in general. The company can use a currency swap to exchange the USD liquidity into DKK to cover any negative balance in his DKK account in the period. When the swap transaction matures, the USD amount is returned to the company against paying DKK. The company is able to pay his invoice in US Dollars without being exposed to exchange rate fluctuations in the period, which would have been the case if the USD was exchanged to DKK in the start and exchanged back, when invoice should be paid.

A currency swap transaction can essentially be broken down into two opposite forward currency transactions simultaneously; one near leg against one far leg.

PRICING A CURRENCY SWAP TRANSACTION

The price of a currency swap in US Dollars against Danish Kroner is determined by the following factors:

- The current market rate, M (the spot rate)
- Interest rates in the quoted currency DKK on buying or selling US Dollars against Danish Kroner, R1
- Interest rates in the base currency, USD on buying or selling US Dollars against Danish Kroner, R2
- The interest rate differential between the currencies traded (R1 less R2)
- Maturity of the swap transaction, D.

If you buy near and sell far a currency with higher interest rates than Danish Kroner, the swap rate will be negative, such that the far leg DKK exchange rate is lower, compared to the near leg DKK exchange rate. Conversely, a premium is added if the transaction involves buying or selling a currency with lower interest rates than Danish Kroner.

The swap premium or discount relative to the spot rate is determined as follows: $M * (R1 - R2) * D / (360 * 100)$.

The swap rates, then, is determined as follows:

Near leg: Spot rate

Far leg: Spot rate (+/-)swap premium

MATURITY OF CURRENCY SWAP TRANSACTIONS

Currency swap transactions are settled at both maturity dates, using the agreed near leg spot rate and the far leg forward rate.

The following events may take place when the far leg of the swap matures:

- The parties exchange the agreed currency amounts
- The transaction is extended with full exchange rate adjustment and cash settlement of the difference

An extension of the maturity of a currency swap transaction generally involves full exchange rate adjustment, meaning that the transaction is adjusted to the current market exchange rate.

In other words, if the transaction is loss-making at the maturity date, exchange rate adjustment means that you will be required to pay the difference between the agreed forward rate and the current market rate.

If the transaction is profitable at the maturity date, exchange rate adjustment means that you will receive the difference between the agreed forward rate and the current market rate.

CALCULATING THE LIQUIDITY PREMIUM

The liquidity premium is calculated on the basis of the following:

- The original forward rate agreed, T ;
- The market rate at the time of extension, M ;
- The deposit rate or the lending rate, R ; and
- The number of days the transaction is extended, D

in the following equation:

$$(T-M) \times R \times D / (360 \times 100)$$

The divisor, shown above as 360, depends on the actual currency in which the gain or loss is expressed.

EARLY TERMINATION

If the basis for the agreement ceases to exist in whole or in part before the transaction matures, the transaction can be settled early. In such case, the rate originally agreed will be adjusted to reflect the forward premium or discount for the remaining period, and interest on the gain/loss on the transaction.

TERM

When involving the most liquid currencies, currency swap transactions typically have a maximum term of two-three years. For currencies of secondary forward markets, liquidity in excess of 12 months may be limited.

RISK FACTORS

It is important to note that a currency swap transaction may involve substantial risk.

A currency swap transaction involves a risk that the forward rate is unfavourable relative to the spot rate at which the transaction will be settled at the settlement date.

Accordingly, if you buy foreign currency in a forward transaction that is to be settled at an exchange rate that is higher than the market rate applying at the settlement date, the transaction will be loss-making. The loss equals the difference between the forward rate and the spot rate. Conversely, the transaction will yield a gain if the spot rate is lower than the spot rate at the settlement date.

If you sell foreign currency in a forward transaction that is to be settled at an exchange rate that is lower than the spot rate applying at the settlement date, the transaction will be loss-making. The loss equals the difference between the spot rate and the forward rate. Conversely, the transaction will yield a gain if the forward rate is higher than the spot rate.

If a currency swap transaction is terminated prior its scheduled maturity, a change in the interest rate difference will trigger a change in the premium or discount in excess of the change triggered by the shorter term to maturity. This could cause you to incur a loss on the transaction.

COLLERATERAL

We may require you to provide collateral when you enter into a transaction with us as counterparty.

SPECIAL MARKET CONDITIONS

Under special market conditions, it may be difficult or impossible to liquidate a position. This may occur, for example, at times of rapid price movements if the prices rises or falls to such extent that we are unable to stipulate a price or trading of financial instruments are suspended or restricted under the rules of the regulated market place.

TAXATION

The tax treatment of a gain or a loss on a currency swap transaction depends on whether you are dealing as a private individual or on behalf of a company.
