Contemporary Issues in Finance
FRAs and Futures

V/O:
Forward Rate Agreements, known as FRA's, and Short Futures, are financial derivative instruments that can be used to hedge interest rate risks, usually those arising over periods of up to one year ahead. Typical of such risks are the re-fixings of interest rates paid on floating rate debt, or received on floating rate investments. FRA's and Short Futures can hedge such risks by enabling the interest rate to be received or paid on a future date, to be fixed or locked in ahead of that date, since the two instruments are alternatives for hedging short term interest rate risks, which should organisations opt for when executing their hedging strategies. FRA's have the advantage of being able to be customised to fit exactly the size and relevant interest dates of the items to be hedged. So, for example, if the floating rate on a €2.7 million loan, that it is to be re-fixed to six month Euribor in two months' time needs to be hedged, an FRA can be bought from a bank that will match these precise requirements. With Futures the hedging contracts are standardised, both in terms of their notional principle amounts, and the forward dates, so hedging a precise requirement is operationally more difficult. Indeed, it may require entering into a series of Futures transactions which collectively provide the required hedge. FRA's also have the benefit of being easy to administer. One deal will secure the FRA transaction and on its maturity, one cash flow will move from one party to the contract, to the other. Compare this with Futures where, during the life of the contract, margin money has to be paid to, or received from, the Futures clearing house. Indeed, setting up and running such margining operations represents an additional business expense for a treasury department. So why would an organisation opt to use Futures when hedging with FRA's looks to be more precise and operationally simpler? There are three reasons to opt for Futures. Firstly, because the contracts are not customised, the hedge rate of interest achieved is typically a little better than when using FRA's. Indeed, the banks providing FRA's often use the Futures market to hedge their own positions, taking a small profit margin in the process. Secondly, the margining operations ensure that the credit risk arising from using Futures contracts is minimal. This compares with FRA's where you are potentially exposed if your counter party defaults. Thirdly, Futures contracts typically have more liquidity than FRA's, so if you want to cancel or alter your hedged position, it is easier to do so with Futures. A general observation is that FRA's tend to suit non-financial institutions that have only periodic and specific requirements to hedge short term interest rate risks. Futures are more suited to those organisations, like financial institutions, that regularly engage in large volumes of hedging transactions.