

## Forward Rate Agreement

A forward rate agreement can be used to hedge future interest rate or exchange rate exposure. The buyer hedges against the risk of rising interest rate whereas the seller hedges against the risk of falling interest rates. In other words, the buyer locks in the interest rate to protect against the increase of interest rates while the seller protects against the possible decrease of interest rates.

A forward rate agreement is a forward contract between two parties in which one party will pay a fixed rate while the other party will pay a reference interest rate for a set future period. Similar to a swap,

A forward rate agreement has two legs: a fixed leg and a floating leg. But each leg only has one cash flow. The party paying the fixed rate is usually referred to as the borrower, while the party receiving the floating rate is referred to as the lender.

Some people believe that a forward rate agreement is equivalent to a one-period vanilla swap. That is not completely true from valuation perspective. A forward rate agreement is usually settled and paid at the end of a forwarding period, called settle in arrear, while a regular swaplet is settled at the beginning of the forward period and paid at the end. Strictly speaking, FORWARD RATE AGREEMENTs need convexity adjustment. However, given forward rate agreement is such a simple product, the adjustment is very simple as well.

Forward rate agreements are over-the-counter (OTC) derivatives. They are cash-settled with the payment based on the net difference between the floating interest rate and the fixed (reference) rate in the contract.

Similar to a swap, a forward rate agreement has two legs associating with each party: a fixed leg and a floating leg. But each leg only has one cash flow. The party paying the fixed rate is usually referred to as the buyer, while the party receiving the floating rate is referred to as the seller.

A speculator can also use FORWARD RATE AGREEMENTs to make bets on future directional changes in interest rates. Market participants can also take advantage of price differences between a FORWARD RATE AGREEMENT and other interest rate instruments. FORWARD RATE AGREEMENTs are money market instruments that are liquid in all major currencies.

Reference:

<https://finpricing.com/lib/EqLookback.html>