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FMA FINANCIAL MARKETS AUTHORITY

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Your guide to foreign exchange (forex/FX) trading

Online foreign exchange (forex) trading is used by some people to try to make a quick profit by betting on the changing value of foreign currencies. Like gambling, you are just as likely to lose money as make it. The risk is increased if you trade with borrowed money, as this increases any gains or losses you make. Forex trading is also used to lock in an exchange rate for future foreign currency payments.

What is foreign exchange (forex) trading?

The value of currencies changes constantly. Foreign exchange (forex) trading is the buying and selling of foreign currencies to try to make a profit, or to lock in a rate to provide certainty about the cost of future foreign currency payments.

Forex trading for profit is when you bet that the value of one currency will change favourably against the value of another. You can trade in forex by:

- Purchasing foreign money (that will need to be held in a foreign currency bank account) with the hope that the currency will increase in value against the NZ dollar, or
- Buying and selling contracts linked to 'currency pairs' from a licensed derivatives issuer. A currency pair values one currency against another, for example NZ$1 = AUD$0.92.

Forex trading to provide certainty about an exchange rate is called 'hedging'. An example of hedging is when you lock in an exchange rate today, for a payment that you need to make in that foreign currency next month.

Forex trading for profit is very risky

For every person who gains a dollar from forex trading, someone else loses a dollar. And that's before taking into account costs and fees, which can be significant. Forex trading is not appropriate for most investors because trying to make a profit from predicting exchange rate changes is extremely risky.

Changes in foreign exchange rates are difficult to predict and are often influenced by unexpected events, so even highly experienced traders using specialist tools regularly get it wrong.

We recommend you talk to a financial adviser before deciding to start forex trading. Ask them whether it is a sensible strategy for you, and have them help you to understand what level of loss you can afford. If you do choose to get into forex trading you will need plenty of spare money to cover losses incurred when exchange rates move against you.

Borrowing to trade is even riskier

'Leverage' or 'margin' trading are terms used to describe ways of trading with borrowed money. Borrowing to trade in forex is like borrowing to place a bet. You may only pay a small portion of the value of your trade up-front, but if you lose you will still need to repay the full amount. This means that even small movements in currency values can have a big impact on any gains or losses you make through forex trading.

For example: You purchased a forex contract worth NZ$100,000 for an upfront NZ$500 payment or 'margin' of 0.5%, or 200 times leverage. At the time of purchase the NZD/AUD currency was at NZ$1 = AUD$ 0.92. If the exchange rate then dropped to 0.88, the value of your NZ$100,000 trade would fall by NZ$4,545. You would have to pay the forex trading service an extra NZ$4,045 in addition to the $500 you paid up front.

Forex trading risk is hard to manage

Forex traders can use risk management techniques such as 'stop loss' orders to try to limit trading losses. In the example above, you may have been able to agree a stop loss order to automatically close your trade when the exchange rate reached AUD$0.90. In theory this would have capped the potential loss at NZ$1,800, but it would not be guaranteed as stop orders may not work at all when there are extreme movements in the markets. You might also have to pay additional fees or costs to have a stop loss order in place.

Beware of forex trading 'training' and 'tools'

You should be wary of anyone who tells you that a particular product or technique can give you access to better exchange rates or easy money. While there are software programs and training courses that claim they can teach you when to make profitable forex trades, the fact is that no person or program can ever accurately predict movement in foreign currencies.

Use a licensed provider

Forex trading using contracts linked to 'currency pairs' is classed as trading a 'derivative' financial product. A derivative product involves trading in the changing value of an underlying asset such as shares, bonds, commodities, currencies and interest rates. In New Zealand, individuals or businesses offering these contracts must hold a 'derivatives issuer licence' from the FMA. You can find a list of all licensed derivatives issuers on the FMA website.

We recommend you avoid overseas forex trading services not licenced by the FMA, even if they appear to be regulated by an overseas authority. Anyone selling derivatives products to the New Zealand public must have a derivatives issuer licence from the FMA. You can check our warnings, alerts and scams information to read about steps you can take to check you are dealing with a licensed provider, and to see the latest warnings about forex dealers.

Read the product disclosure statement

Licensed derivatives providers must give you a product disclosure statement (a PDS) before you trade with them. Different types of forex trading products involve different risks, so you should read the PDS carefully. In particular you should look for information on:

- How the particular product you're looking at works
- 'Counterparty' risks - the risk that the forex provider won't be able to fulfil its obligations to you if something goes wrong. For example, if your provider became insolvent, you may be an unsecured creditor and have difficulty getting your money back
- How they handle market risks such as lack of liquidity in the market, and trading delays. You may not be able to make trades when you'd like to
- Fees and other charges.

  Note: the provider may advertise low or even zero fees and commissions, but there is usually a profit margin or 'spread' built into the exchange rates you'll trade at.

Be wary of promotional offers for 'free' or 'no loss' trades. These often have strings attached so examine their terms and conditions closely before committing your money.

For more information on different ways to invest and different types of investment see the consumer section of our website, www.fma.govt.nz.