

## Lesson №5

### Margin Trading on the Forex Market

What makes Forex attractive not only for heavy speculators but for private investors as well? It is the mechanism of margin trading. Margin trading is used for providing access to the market for clients who administer small funds. The standard lot in SuperForex is 10 000 USD, which you can trade with a minimal deposit of 1 USD.

The underlying principle of margin trading is that for the deal execution it is necessary to have just a small percentage of the total contract sum. To buy or sell a currency a client should pay a bank or a brokerage organization a guaranteed deposit. After this, leverage is provided to the trader (**leverage** – the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment.) This borrowed money is used for the purchase of currency, shares or other assets. With the help of leverage an investor gets the opportunity to execute deals with a volume that exceeds the initial investment 50-100 times.

In other words, the purchase of a currency with margin is a contract conclusion with payment by means of credit provided by the broker. That is how leverage helps both the investor and the firm to invest or operate. However, it comes with greater risk. If an investor uses leverage to make an investment and the investment moves against the investor, his or her loss is much greater than it would have been otherwise. Leverage magnifies both gains *and* losses.

There are two types of margin: **fixed margin** and **margin of interest**. Working with a fixed margin, the trader must have a certain sum which ensures security requirements according to a provided leverage. For example, at leverage 1:100 the standard lot is 10000 of the trading currency units. This means that it is necessary to ensure a deal by the margin of 100 units of the deposit currency in order to open a position with 1 lot.  $10000/100=100$ , and in this case it does not matter which currency a deal is executed with.

The situation is different when we speak about the margin of interest. We need to ensure a deal by a margin of a certain percentage (according to the conditions of the leverage) of the amount of the trading currency. This sum is counted in accordance with the current rate, which takes into account the currency of the deposit and the currency of the trading asset.

Suppose that the currency of the deposit is USD and the margin of interest is 1% from a deal's volume. A trader decides to execute a deal with EUR/USD, the volume is 1 lot (10000 EUR), and the rate at the moment of the deal execution:

	bid	ask
EUR/USD	1.2050	1.2053

Let's count the needed margin:

1% from the sum of 1 lot =  $10\ 000\ \text{EURO} * 1/100 = 100\ \text{EURO}$ .

The required margin is 100 EURO, but due to the fact that the insurance deposit is in USD it is necessary to count the sum in USD – the equivalent of 100 EUR.  $100\ \text{EURO} = 100\ \text{EURO} * 1.2053\ \text{USD (ask rate)} = 120.53\ \text{USD} = 120.6\ \text{USD (round up)}$ .

Let's take the following example:

- EUR/USD rate is 1.2505/1.2508. Suppose you have made an analysis of the currency market and think that the EUR/USD rate will rise (at least up to 1.2600). You buy 1 lot EUR/USD at 1.2508 (ask). The size of our deal is 10000 EUR (1 lot for EUR/USD)

equals 10000 EUR). You have bought 10000 EUR and have to pay  $10000 \times 1.2508 = 12508$  USD. But it is not necessary to have all 12508 USD. It is enough to have 100 USD. The matter is that the sum 12508 USD will be paid by a broker as credit. For instance your forecast was correct and the EUR/USD rate reached 1.2599/1.2602. You make a profit by closing the open position through the opposite deal – in our example you close a deal by selling euro. You sell EUR at 1.2599 (bid). So you sell 10000 EUR and get 12599 USD, fixing a profit of 91 USD. You needn't invest 10000 EUR (12509 USD) but 100 times less – 100 USD. The profit is 90 pips. Pip is the minimal value of the price change. You earned  $1.2599 - 1.2509 = 0.0090$ , 90 pips.

The scheme of the deal balance:

+10000 EUR	-12508 USD
-10000 EUR	+12599 USD
0	+91 USD

Executing the opposite (offset) deal you not only fix your profit which will be added to you margin, but also return the credit lent by the broker.

- b) In case your forecast appears to be incorrect and the price goes down and the EUR/USD rate is 1.2419-1.2422 and you have decided to limit your losses, make an offset deal and fix losses.

The scheme of the deal balance

+10000 eur	-12508 usd
-10000 eur	+12419 usd
0	-89 usd

In this case a loss of 89 USD will be deducted from your margin. That is why it is obligatory to have a margin. As you understand a broker does not want to suffer losses from deals and that is why margin is an obligatory condition.

Margin trading does not presuppose any physical supply of the funds and the basis of this calculation method in netting. Netting is a method of calculations on executed deals which does not foresee the transaction of all assets' volume but only the result of the executed deals when a sum of the bought and sold base currencies between all the counterparties is the same. The mutual compensation of the liabilities and assets is balanced by the bank between the bank's branches or several banks. This operation allows one to save the bank's fee and decreases currency risks. This method of calculations is widely used in inter-bank trading.

Here is an example:

Bank A bought 1000000 EUR from bank B at a rate of 1.2050. During the day Bank A needs USD and it sold 1000000 EUR at rate 1.2060 to the same bank B. After the purchase, bank A owes bank B 1205000 USD, while in its turn bank B owes Bank A 1000000 EURO after the inverse operation is made. So Bank A sold Bank B 1000000 EURO at 1206000 USD, an opportunity to offset the main sum of the deal and make a final calculation by sending the difference of 1000 USD by Bank B to Bank A occurred.

As it is seen from the above example a calculation among a broker and a client is a calculation with the help of netting. In order to limit risks, different brokerage companies set

a certain level of the margin fall and when this level is reached the client's position is closed automatically. This means that offset deals are executed without the client's participation in the process. In our company this limit is 30% of the initial margin sum. This means that the client's losses may be 70% of the sum deposited to the trading account. Suppose a client has deposited 1000 USD. The initial margin, non-implemented profit/loss (the current result of the open positions) constitutes 700 USD. This means that the current balance (deposit sum decreases or increases in the sum of non-implemented profit/loss) equals  $1000 \text{ USD} - 700 \text{ USD} = 300 \text{ USD}$ , 30 % of the initial sum. According to the rules, a company compulsory closes the client's open positions fixing a loss. In case several positions are opened, for example 3 positions with 1 lot, then these positions are closed one by one beginning with the position which has maximum loss. For instance, 3000 USD were deposited to open 3 positions each with 1 lot (30000). The initial margin will be 3000 USD. If all positions appeared to be incorrect, a loss is already 2100 USD. This means that your current balance is 900 USD or 30 % of the initial margin (30% of the sum 3000), so in this situation a compulsory closing of the positions will take place. A broker will close the position with the maximum "floating" loss.

This mechanism permits you to avoid the full loss of the deposit and the accrual of a debt to the company or other parties in the market. During a position shift a commission is charged. The position shift happens when executed deals are not closed at the end of the day by 00:00, and positions are shifting to the next trading sessions. The main reason why a commission is charged lies in the credit resources that are received by a client during the deal's execution, and after 00:00 it is considered that a client uses a credit for 24 hours. SuperForex provides an opportunity to open accounts without a commission charge. This type of account is very popular in the Islamic countries, which is why this account type is often called Islamic.

The sum of the deposit is reflected in the field "balance" in the trading SFX trading platform. This sum will be changing depending on the result of the executed deals and fixing in the field "profit/loss." In case the result is positive, the sum of the balance will increase; it will decrease if the result is negative.

The field "free margin" determines how much money you may use for trading. So leverage is a serious instrument which increases the potential profit as well as the risk levels.

### Test Questions

1. What is a margin?
2. What does it mean to have a leverage of 1:50? Count the necessary margin with such leverage for opening a position in 1 lot (10 000 units).
3. Determine the sum of the free margin, if
  - deposit = 3000;
  - non-implemented profit/loss = 300;
  - fixed profit/loss = 250;
  - initial margin = 1000;
  - commission = 20.