



Forward exchange contracts (FEC)

Forward exchange contracts are used to secure a rate today for settlement at some time in future, usually longer than two business days. In this document we will take a look at the different types of cover, factors to consider when selecting a contract type, as well as the various methods of delivery that can take place with a FEC. These are: early delivery, extension and cancellations or surrenders.

Types of cover

There are two distinct 'legs' (transactions) in any rand / foreign currency deal. The importer / exporter can cover either one of the two legs of the transaction, or both of them, depending on the client's view of the currency market. The client can opt for:

- Foreign currency / dollar cover (thereby leaving the rand / dollar leg uncovered)
- Rand / dollar cover (thereby leaving the foreign currency / dollar leg uncovered) or
- Rand / foreign currency cover (thereby eliminating the entire currency risk)

A customer wanting to enter into a forward exchange contract must state what type of contract is required and what type of cover is needed.

Considerations when selecting the type of contract:

- Is the payment / accrual date of the underlying commitment determinable, or is there some uncertainty?
- What are the terms and conditions of the underlying contract of sale and is there any uncertainty regarding the adherence to manufacturing / delivery dates which in turn will have a bearing on payment / accrual dates?
- Is the currency quoted at a premium or discount?
- Is it likely that the premium / discount will increase / decrease during the life of the contract?

Forward exchange contracts – Early delivery

An early delivery is when a forward exchange contract is used before the maturity date of a fixed contract OR during the fixed period of a partially optional contract. Delivery will take place on a "swap" basis.

To understand a "swap" transaction, consider the following example: A person invests money on fixed deposit with the bank for six months. After three months, that person needs the money on fixed deposit. But, the bank cannot release the money under a fixed deposit, so it then arranges for a loan for three months to help that client. On maturity of the fixed deposit, the proceeds are used to offset the three-month loan. The client will either have to pay or receive the difference in the interest between the overdraft rate and the fixed deposit rate.

Swap contracts operate on a similar basis. The importer needs to make a payment but is unable to use the contract because of the fixed period. To assist the client, the bank provides the foreign currency converted at the current ruling rate of exchange. The forward contract therefore remains unused and is surplus to requirements. To eliminate the surplus funds, the bank enters into a contra (swap) contract to buy back (offset) the amount on the maturity date of the original contract.

Forward exchange contracts – Extension

On occasions, payment is delayed owing to late arrival of documents or other mishaps. When payment or receipt of funds is deferred for any reason, the maturity date of the forward contract has to be extended. This is also done by means of a swap.

The **importer** must fulfil his obligation under the existing contract, that is he will receive the foreign currency against the settlement in rand at the forward contract rate. As the importer has no foreign currency commitment at this time, he must sell the foreign currency to the bank at the spot (current) rate of exchange. At the same time, and based on the same spot rate, the bank will provide a fresh forward contract to the new maturity date.

The **exporter** must fulfil his obligation under the existing contract by selling the foreign currency to the bank against settlement in rand at the forward contract rate. He will buy the foreign currency from the bank at the spot (current) rate of exchange, as there is no foreign currency accrual. He will obtain a fresh forward contract, to the new maturity date, based on the same spot buying exchange rate.

Please note (using the case of the importer as an example):

- The difference in exchange between buying the foreign currency at the forward contract rate and selling the currency at the spot rate of exchange is not a profit or loss in exchange, but is merely a prepayment to or an advance by the bank.
- The importer does not lose the benefit of the rate of exchange on which the original contract is based.

Forward exchange contracts

- Cancellations or Surrenders In the event of an importer being unable to use the forward exchange contract, in whole or in part, the outstanding balance is surrendered by settlement for the difference in exchange between:
 - The forward contract rate, and
 - The current day's spot telegraphic buying rate of exchange

If an order is cancelled, the forward exchange contract must be cancelled at the prevailing spot exchange rate, which can result in financial loss.

Forward exchange contracts – Advantages

Forward exchange contracts offer the following advantages:

- They cater for a diverse type of commercial and financial transactions and both importers and exporters can make use of it.
- The company is protected against unfavourable exchange rate fluctuations.
- The exact value of the export and import order can be calculated on the day it is processed.
- Budgeting and costing are accurate.

Forward exchange contracts – Disadvantages

- Once a company has covered a transaction with a forward foreign exchange contract, it cannot take advantage of preferential exchange rate movements.
- If an order is cancelled or there is any surplus amount outstanding on a forward exchange, it must be surrendered at the prevailing spot exchange rate, which can result in a financial loss.
- Early deliveries, extensions, surrenders and cancellations during the fixed period of a forward exchange contract are done on a swap basis causing additional administration.

Forward exchange contracts – Exchange control requirements

The South African exchange control authorities allow banks to enter into FECs subject to the following conditions:

- A firm and ascertainable foreign exchange commitment must exist. For example, a commitment to pay for imports
- The transaction is permitted in terms of the exchange control rulings or a specific authority has been granted by the authorities for the transaction
- The period of cover does not exceed 12 months at a time
- The commitment is not already covered
- Documentary evidence of the commitment is presented to the bank within 14 days of establishment of the FEC.

Contact details

For further information on any of our products or services:

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