Cancellation/Extension of forward contract

The customer is having the right to cancel a forward contract at any time during the currency of the contract. The cancellation is governed by Rule 8 of the FEDAI. The difference between the contracted rate and the rate at which the cancellation is done shall be recovered or paid to the customer, if the cancellation is at the request of the customer. Exchange difference not exceeding Rs.50 shall be ignored. The spot rate is to be applied for cancellation of the forward contract on due date. The forward rate is to be applied for cancellation before due date. In the absence of any instruction from the customer, contracts which have matured shall on the 15th day from the date of maturity be automatically cancelled. If the 15th day falls on a holiday or Saturday the cancellation will be done on the next succeeding working day. The customer is liable for recovery of cancellation charges and in no case the gain is passed on to the customer since the cancellation is done on account of customer‘s default.
The customer may approach the bank for cancellation when the underlying transaction becomes infractions, or for any other reason he wishes not to execute the forward contract. If the underlying transaction is likely to take place on a day subsequent to the maturity of the forward contract already booked, he may seek extension in the due date of the contract. Such requests for cancellations or extension can be made by the customer on or before the maturity of the forward contract.

Cancellation of Forward Contract on Due date

When a forward purchase contract is cancelled on the due date it is taken that the bank purchases at the rate originally agreed and sells the same back to the customer at the ready TT rate. The difference between these two rates is recovered from/paid to the customer. If the purchase rate under the original forward contract is higher than the ready T.T selling rate the difference is payable to the customer. If it is lower, the difference is recoverable from the customer. The amounts involved in purchase and sale of foreign currency are not passed through the customer‘s account. Only the difference is recovered/paid by way of debit/credit to the customer‘s account.
In the same way when a forward sale contract is cancelled it is treated as if the bank sells at the rate originally agreed and buys back at the ready T.T buying rate. The difference between these two rates is recovered from/paid to the customer.

Example: A forward sale contract for French francs 2,50,000 for an import customer on 15th March for delivery on 15th April at Rs.7.0450. The customer requests for cancellation of the contract on the due date. The following information are available. French francs were quoted in London foreign exchange market as under.
Spot USD 1 = FRF 6.0200/0300
1 month 305/325
2 months 710/760
The U.S dollars were quoted in the local inter bank exchange market on the date of cancellation is as follows.
Spot USD 1 = Rs. 42.2900/2975
Spot/May 3000/3100

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Spot/June 6000/6100
Exchange margin required is 0.10%. What will be the cancellation charges payable by the customer?
Solution: The sale contract will be cancelled at the ready T.T buying rate. Dollars/rupee market buying rate = Rs. 42.2900
Less exchange margin at 0.10% = Re 0.0423
Rs.42.2477
Dollar/Franc markets spot selling rate = FRF 6.0300
TT buying rate for Franc (42.2477 / 6.0300) = Rs. 7.0062
Rounded off the applicable rate is Rs. 7.0050
Franc sold to customer at = Rs. 7.0450
Now bought from him at Rs. 7.0050
Net amount payable by customer per franc Re 0.0400
Therefore, at Re.0.0400 per franc, the customer has to pay Rs. 10,000 for FRF 2, 50,000 by including flat charge of Rs.100, on cancellation Rs. 10,100 will be recovered from the customer.

Early Cancellation of a Forward Contract:

Sometimes the request for cancellation of a forward purchase contract may come from a customer before the due date. When such requests come from the customer, it would be cancelled at the forward selling rate prevailing on the date of cancellation, the due date of this sale contract to synchronize with the due date of the original forward purchase contract. On the other hand if a forward sale contract is cancelled earlier than the due date, cancellation would be done at the forward purchase rate prevailing on that day with due date of the original forward sale contract.

Extension on Due date

An exporter finds that he is not able to export on the due date but expects to do so in about two months. An importer is unable to pay on the due date but is confident of making payment a month later. In both these cases they may approach their bank with whom they have entered into forward contracts to postpone the due date of the contract. Such postponement of the date of delivery under a forward contract is known as the extension of forward contract.

The earlier practice was to extend the contract at the original rate quoted to the customer and recover from him charges for extension. The reserve bank has directed that, with effect from16.1.95 when a forward contract is sought to be extended, it shall be cancelled and rebooked for the new delivery period at the prevailing exchange rates.

FEDAI has clarified that it would not be necessary to load exchange margins when both the cancellation and re-booking of forwards contracts are undertaken simultaneously. However it is observed that banks do include margin for cancellation and rebooking as in any other case.

Further only a flat charge of Rs.100 (minimum) should be recovered and not Rs.250 as in the case of booking a new contract.

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Overdue Forward Contracts

As we have already seen, the customer has the right to utilize or cancel or extend the forward contract on or before its due date. No such right exists after the expiry of the contract.

FEDAI Rule 8 provides that a forward contract which remains overdue with any instructions from the customer concerned on or before its due date shall on the 15th day from the date of maturity be automatically cancelled by the bank. The customer remains liable for the exchange difference arising there from but if it results in profit it need not be passed on to the customer. In case of delivery subsequent to automatic cancellation the appropriate current rate prevailing on such delivery shall be applied.

Roll over Forward Contracts

When deferred payment transactions of imports/exports takes place, the repayment of the installment and interests on foreign currency loans by the customer requires long term forward cover where the period extends beyond six

months. The bank may enter into forward contract for long terms provided there is suitable cover is available in the market. However the cover is made available on roll over basis in which cases the initial contract may be made for a period of six months and subsequently each deferred installments for the outstanding balance of forward contract by extending for further periods of six months each. For these transactions the rules and charges for cancellation / extension of long term forward contracts are similar to those of other forward contracts.

Inter bank Deals

Foreign exchange transactions involves transaction by a customer with the bank while inter bank deals refer to purchase and sale of foreign exchange between banks. In other words, it refers to the foreign exchange dealings of a bank in inter bank market.

Cover Deals

The banks deal with foreign exchange on behalf of its customers. Purchase and sale of foreign currency in the market undertaken to acquire or dispose of foreign exchange required or acquired as a consequence of its dealings with its customers is known as the _cover deal'. In this way that is through cover deal the bank gets insured against any fluctuation in the exchange rates.

While quoting a rate to the customer the bank is guided by inter bank rate to which it adds or deducts its margin, and arrives at the rate it quotes to the customer. For example, if its is buying dollar from the customer special it takes inter bank buying rate, deducts its exchange margin and quotes the rate. This exercise is done on the assumption that immediately on purchase from customer the bank would sell the foreign exchange to inter bank market at market buying rate.

Foreign currency is considered as peculiar commodity with wide fluctuations price, the bank would like to sell immediately whatever it purchases and whenever it sells, it immediately tries to purchase so that it meets it is commitment. The main reason for this is that the bank wants to reduce exchange risk it faces to the minimum. Otherwise, any adverse change in the rate would affect its profits.

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In the case of spot deals the transaction is quite simple. If the bank purchased any foreign exchange, it would try to find another customer to whom it can sell this and thus books profit. In this process the profit would be the maximum because both buying and selling rates are determined by the bank and the margin between the rates is the maximum. If it cannot find another customer its sells in inter bank market where the rate is determined by the market conditions and the margin is narrower here.

Example: Your dealer in the _Dealing Room' sells through an exchange broker in the local market USD 5, 00,000 delivery spot in cover of a telegraphic transfer from abroad.Calculate the rupee amount receivable from this sale assuming that US dollar / Rupees rates are quoted in the local market as under:

Spot USD 1 = Rs. 42.8000/8500

Brokerage 0.01%

Solution: The bank sells at the market buying rate of Rs. 42.8000.

Rupee amount received on sale of USD 5,00,0000

At Rs. 42.8000 = Rs. 2,14,00,000

Brokerage payable at 0.01% - Rs. 2,140

Net amount receivable on the deal = Rs. 2,13,97,860

Example: A customer sold French Francs 10,00,000 value spot to another customer at Rs. 6.5200 and covered himself in London market on the same day when the exchange rates were as under:

Spot USD 1 = FRF 6.5880/5920

Local inter bank market rates for US dollars were:

Spot USD 1 = Rs. 42.7…/8500

Calculate the cover rate and ascertain the profit or loss in the transaction. Ignore brokerage on the inter bank transaction.

Solution: The bank covers itself by buying Francs (or selling dollars) from the London market at market buying rates for dollar. The requisite dollar is acquired in the local inter bank market at the market selling rate for dollar against rupee.

Dollar/Rupee selling rate = Rs. 42.8500

Dollar/Franc buying rate = FRF 6.5880

Franc/Rupee cross rate (42.8500 + 6.5880) = Rs. 6.5042

Franc is sold to customer at Rs. 6.5200

The sale is covered at Rs. 6.5042

Profit per Franc sold = Rs. 0.0158

Profit on FRF 10,00,000 at Re. 0.0158 per Franc = Rs. 15,800.

Note : This rate has not been rounded off because no transaction is done at this rate but is calculated only to arrive at the profit.

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