CONTRACTS TO PURCHASE OR SELL EXCHANGE DUTIES/GAMBIA

Bureau for Private Enterprise
U.S. Agency for International Development

Prepared by: *E. Bjelke*

Sponsored by: *Financial Markets Project*
Project Number 940-2005
Prime Contractor; Arthur Young

April, 1987

Arthur Young
A MEMBER OF ARTHUR YOUNG INTERNATIONAL

5/31/87

(exchcont.doc)

CONTRACTS TO PURCHASE OR SELL EXCHANGE
DUTIES AND SAFEGUARDS

Foreign exchange is, in all respects, a commodity, and trades as such. A contract to purchase or sell exchange between two banks, or between a bank and a commercial client has the same force and effect in law as any other contract of sale and is subject to the law of contracts in effect in the country of domicile of the parties thereto.

The form shown below sets forth details of a forward trade and can be considered as typical:

```
 -------------------------------------------------------------
¦       COMMERCIAL BANK OF BANJUL                             ¦
¦-------------------------------------------------------------¦
¦                                                             ¦
¦ TO: Ground Nut Commercial Company   DATE: 29 May 1987       ¦
¦     PO Box 3333                                             ¦
¦     Serekunda                                               ¦
¦     The Gambia                                              ¦
¦                                                             ¦
```

We confirm our sale to yourselves as follows:

Currency: U.S. Dollars Amount: US$50,000

Rate: D7.516 Value (Delivery) 29 June 1987

Against payment by yourselves same value:

Currency: Dalasi	Amount:	D375,800
	Plus commission	D 70
	Cable charges	D 100
	Total amount due	D375,970

Settlement: U.S. Dollars paid to account DuPont Fertilizer Acct No. 333-5671 at Chase Manhattan Bank, New York. Dalasi by debit to your Account with ourselves.

Signed ______________ Manager

The document above is the confirmation of a forward contract of sale. The actual contract is usually executed by telephone or in a meeting at the Bank. The spot sale differs only in the dates entered. All contracts to purchase or sell are confirmed through the use of similar documents by both parties concerned, and are carefully matched against accounting records to insure that there is no misunderstanding as to amount, value date, rate, and settlement terms. When dealing with a commercial firm, many banks will require that the counterparty acknowledge receipt of the confirmation by signing and returning a copy. In bank to bank trades, the usual practice is to require that both parties confirm on their respective confirmation forms. Confirmations received, after checking, are maintained in a live tickler file by maturity date for reference at the value (or delivery) date. Routine accounting proofs of outstanding commitments to purchase or sell exchange are usually performed by comparing totals in the confirmation file against foreign currency accounting ledgers.

It has been suggested that some form of penalty should be imposed as part of the trading process for failure by either party to deliver foreign currency or local payment as agreed in contract terms. This suggestion was reportedly advanced as a means of discouraging speculation in the forward markets, and to insure that contracts are issued only to cover transactions supported by a genuine commercial purpose. Market experience indicates that such penalty is not a viable means of accomplishing either purpose. If a penalty of say 10% of Dalasi value were imposed, and spot rates at or close to settlement date had moved in excess of 10%, then default is commercially advantageous and should be expected. In this sense, it can be said that the penalty, which fixes a cost of default, may provide an added opportunity for speculation.

Compensated contracts are quite common in a volatile market. Compensation occurs when rate movements permit a commercial client to purchase or dispose of exchange at a more favorable rate than that stated in a existing forward contract. The situation is usually identified in advance of contract maturity. The client could accomplish the same purpose by entering into the reverse of the original contract with his bank. The more reasonable and usual method is to reach agreement with the bank to compensate (or cancel) the contract by payment of a differential related to the current price or cost to obtain cover. This technique avoids the duplicate settlement which would be necessary if the reverse contract procedure were utilized.

With respect to the desire to insure that all contracts represent cover for commercial transactions, this is a duty usually imposed upon the commercial bank. In assessment of the credit risks the bank must be aware of the purpose of cover requested. While in large operations it is not usual to require that a contract of purchase or sale of actual merchandise be offered as evidence of cover requirements, the financing bank is certainly familiar with client inventory and receivable patterns. Standard credit questioning should reveal situations where a client is requesting more in the way of forward cover than indicated by his operating patterns. In addition, a requirement that an underlying commercial movement of goods exist would preclude the use of the compensation technique outlined above, and unduly restrict normal market operations.

In situations where a client is marginal, it is a common practice to require margin deposits as a percentage of the value of a forward contract to protect against the risk of fluctuation and non-delivery. This adds a true commercial cost to the transaction and should be imposed only when conditions dictate. If conditions of this type were imposed on all forward contracts, then the delivered price of merchandise to the ultimate consumer would be likely to increase. This procedure would be an additional complicating factor and discourage development of this fledgling market.

Conventions in forward exchange markets are highly developed and widely observed. Because the contract is recognized under existing law of contracts, to develop a body of regulation or law to insure that exchange contracts are completed seems unnecessary. Parties damaged by such failure have adequate remedies.

Speculation is better controlled by application of usual credit factors by the commercial banks involved and by intervention by the Central Bank either directly or through the Commercial Banks.