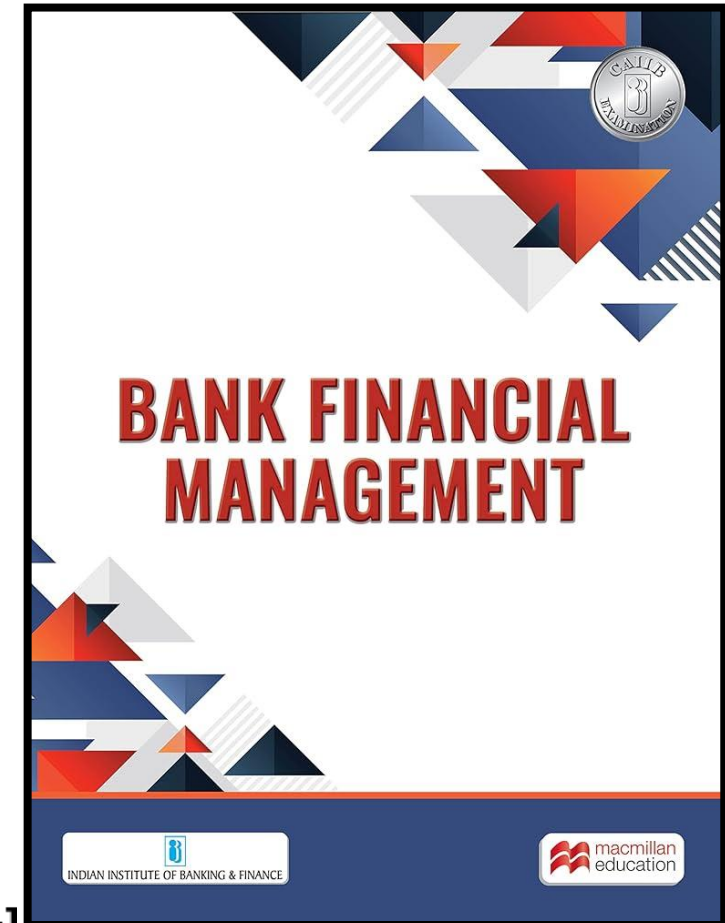


CAIIB Examination

Bank Financial Management Module A Chapter 1 – Exchange Rates & Forex Business - Part 4



EXCHANGE RATES & FOREX BUSINESS



EduTap

1. Exchange Rates - 1. Meaning of Forex, 2. Forex markets, 3. Factors determining Exchange Rates, 4. Exchange Rate Mechanism, 5. Exchange Arithmetic

2. Forex Business - 1. Forex Dealing Room, 2. Derivative Products, 3. RBI/FEDAI Guidelines, 4. Forex Arithmetic

1. FOREX

1. Meaning

1. Exchange Rates

FEMA

Foreign Exchange Management Act

1. Foreign Exchange

2. Forex Markets

1. Payable & Drawn in Foreign Currency – Deposits, credits and balances payable & drafts, letters of credit and bills of exchange drawn

2. Transactions – In Foreign Currency

1. Features – 1. 24x7, 2. Not brick and mortar marketplace, 3. OTC, Highly liquid

2. Facts – 1. **Daily turnover of global forex** = USD 6.60 tn. In 2020, 2. **Indian** – OTC turnover = USD 34 bn. & Exchange traded derivatives = USD 12.2 bn (2019-20), 3. **Exchange rate fluctuation time** = every 3 to 4 seconds, 4. **Operation** – Mon to Fri

1. Exchange Rates

1. CENTRAL BANKS

Manage Forex Reserves and Currency value

4. FOREX BROKERS

Middlemen

2. Forex Markets effected by

1. TIME ZONE

1. Participants of Forex Markets

2. COMMERCIAL BANKS

3. INVESTMENT FUND/BANKS

1. Act as Authorised Dealers

1. Moving Funds – Between countries for clients

2. Invest – Hedge and Speculate

2. Invest – Hedge and Speculate

5. CORPORATIONS

6. INDIVIDUALS

1. Moving Funds – Between countries for self

1. Invest – Hedge, Speculate, Trade, Travel

2. GOVERNMENT POLICIES & CONTROLS

सत्यमेव जयते

EXCHANGE RATES & FOREX BUSINESS

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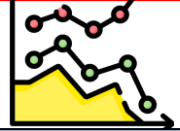
3. Factors determining Exchange Rates

1. Fundamental Reasons



- 1. Government controls & Freedom of capital movement** – Volatile Exchange Rates
- 2. Huge Foreign Investments** – 1. Huge surplus - In oil-exporting countries etc.

3. Speculation



- 1. Effects** – Long-term Exchange Rates
- 2. Factors** – 1. **Balance of payment (BOP)** – Surplus BoP = Stronger home currency & Vice versa, 2. **High Economic growth rate** = Stronger home currency, 3. **Fiscal policy** – Expansionary = Economic growth, 4. **Monetary policy** – High IR = Home currency appreciates in short run while weakens in long run, 5. Political issues = Economic stability

2. Technical Reasons



- 1. Disrupt market** – Expect depreciation in Rupee against \$ and buy at (1\$ = Rs. 80) while sell at 1\$ = Rs. 80.20 + Others expect & buy \$
- 2. Positives** - Provide depth and liquidity to the market and act as cushion.

4. Exchange Rate Mechanism – Based on types of delivery

1. Ready or Cash



Same day Delivery

2. Tom



Tomorrow Next day Delivery (T+1)

3. Spot



Delivery 2 days from deal – T+2

4. Forward



Delivery on a future date

1. Terms included

1. E.g. of USD/INR Quote

1 USD = 74.9500/74.9600



3. Direct/Indirect Quotes

- 1. Direct quotes** = Local currency is variable, 1 USD = Rs. 74.9500/74.9600
- 2. Indirect Quotes** = Local currency fixed, Rs. 100 = USD 1.3342/1.3340, Used in case of GBP (Great Britain Pound/British Pound), Euro etc.

6. Bid & Offered Rates

1. Exchange Rate USD/INR = 74.9500 / 9600

5. Exchange Arithmetic

2. Forward Margins

- 1. Forward Rate** derived from Spot Rates
- 2. Forward rate = Spot rate + Premium (or - Discount)**
- 3. Determination of Premium or Discount** – 1. Interest rate differentials of the two currencies, 2. Demand & Supply

4. Criss Rates

- 1. Exchange Rate USD/INR** 74.9500 / 9600
- 2. GBP/USD** is 1.3670/80
- 3. GBP/INR rate** as Rs. 102.4567/102.5453

7. Chain Rule

- 1. Fixing rate of exchange** between 2 currencies through another currency
- 2. For Non-US Dollar Currencies**

5. Fixed vs. Floating Rate

- 1. Fixed** = Pegged to currency
- 2. Floating** = Depends on Supply & Demand and inflation differential

8. Other terms

- 1. Percent (=per 100) & Permille (= per 1000)**
- 2. Value Date** = Date when payment of funds or an entry to an account becomes actually effective
- 3. Arbitrage** = Simultaneous Buying & Selling currency in 2 (simple or direct) or more markets (Compound)



EXCHANGE RATES & FOREX BUSINESS

1. Exchange Rates

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1. Meaning



1. Internal Control Guidelines of RBI

1. Forex Dealing Room

1. Service branch – To meet the needs of customers of other branches to buy or sell forex, manage foreign currency assets and/or liabilities, fund and manage NOSTRO accounts, trading in forex & Treasury Management Operations.

2. Treasury Management – The following is to be put in compliance:



2. FEDAI Regulations



3. Internal guidelines of Bank

2. Integrated Treasury Operations of Banks

Front Office = dealing room

Mid Office = Risk management department

Back Office = settlements, accounting and reconciliation department

2. Forex Business - 1. Forex Dealing Room, 2. Derivative Products, 3. RBI/FEDAI Guidelines, 4. Forex Arithmetic

2. Dealers in ITO



1. Involved in – buying and selling of currencies, or undertaking market activities, are the most critical manpower

2. To maintain 2 positions – **1. Funds position** reflects the inflow and outflow of funds that are ready in nature and also forwards etc. thus also gap positions, **2. Currency position** - currency overbought or oversold positions

3. Need for ITO



1. Interest rate de-regulation



2. Liberalization of exchange control



3. Devp. Of forex markets



4. Advancement in settlements system



5. Dealin g Env.

4. Functions of ITO

- (i) Meeting CRR and SLR requirements and having an optimum mix of investment portfolio
- (ii) Liquidity and funds management-analysis of major cash flows, funding mix and yields expected in credit and investments.
- (iii) Asset liability management, growth rate of the balance sheet, pricing of assets and liabilities in accordance with the prescribed guidelines
- (iv) Risk management-market risk associated with bank's assets & liabilities, credit risk on treasury products, operation risk on payments and settlements
- (v) Transfer pricing-bench mark rates to various business groups, ensuring that the funds are deployed optimally
- (vi) Derivative products-developing of IRS and other derivative products to hedge bank's exposure and also selling such products to customers
- (vii) Arbitrage - simultaneous buying and selling of same type of assets in two different markets in order to make risk less profits
- (viii) Capital adequacy - focussing on quality of assets and return on investments and evaluating the efficiency of deployed funds
- (ix) Minimizing the level of provision requirements due to build up of NPA



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5.1 Internal Control Guidelines of RBI



1. Forex Dealing Room

- (i) The **data processing systems** used must be appropriated to the nature and volume of activities in order to ensure functional separation
- (ii) **Access rules** for performing distinct functions should be defined in detail and drawn up for persons unconnected with the dealing activities.
- (iii) **Confidentiality of data** in the systems may be ensured in case of outsourcing of IT services to the external agencies
- (iv) **Global limits for Inter-Bank deals** (both domestic & overseas) to be put in place consistent with the overall risk management processes
- (v) **Adequacy of capital** to undertake aggressive dealing activities bearing in mind the Bank's capital and earnings performance.
- (vi) **Appropriate VAR models** for quantifying the extent of market risk for a given level of confidence
- (vii) **Periodic review and validation** of existing models to test the robustness of such models
- (viii) Every **dealer** should be advised of the **limits** (including the stop loss limits) allocated and work within the limits
- (ix) All deals done have to be **within the corresponding limits** fixed viz, the counterparty exposure limits, stop loss limits, country-wise exposure limits (in respect of foreign exchange dealings) and within the Net Overnight Open Position Limits (NOOPL), Individual GAP Limits (IGL), Aggregate GAP Limits (AGL), etc, as approved by the Bank's Board
- (x) **Evaluation of foreign exchange profits & losses** at the closing rates of every month as announced by FEDAI.

5.2 Role of Mid and Back office

Mid Office = Risk management + Compliance of guidelines

Back Office = Processing of deals, accounts, reconciliation etc., Any lax = Dealers efforts to generate profits is negated or dealers misreport and exploit; Supportive + Checking role

2. Forex Business -
 1. Forex Dealing Room, 2. Derivative Products, 3. RBI/FEDAI Guidelines, 4. Forex Arithmetic

5.3 Profit & Loss Evaluation



Approved

Uniform Accounting Procedure for evaluation of forex profits and losses by Authorised Dealers issued by **FEDAI**

Banks to assess forex profit & loss every month + report quarterly → Some report daily



Front Office	Mid Office	Back Office
Fund Management Nostro Accounts	Market Risk	Confirmation of deals
Foreign Exchange Advisory Management	Liquidity Risk	Settlement of deals
ALM & Maturity Mismatches	Country Risk	Accounting of deals
Dealing in the Inter-Bank Market	ALCO Committee	Reconciliation
Trading in the Inter-Bank Market	Reporting to the Top Management	Audit facilitation & reporting
Compliance	Compliance	Compliance

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Q. 1

As per Uniform Standard Accounting Procedure for Authorised Dealers as issued by Foreign Exchange Dealers Association of India (FEDAI), banks need to undertake profit/loss valuation of forex positions every _____.

(Select the most appropriate answer from the option given below)

- a) Day
- b) Month
- c) Quarter
- d) Year

Answer: Option B

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HW

Reporting to the Top Management is a function of which among the following of Foreign Exchange Dealing Room? (Select the most appropriate answer from the option given below)

- a) Front Office
- b) Mid Office
- c) Back Office
- d) None of the above

Thank You

For More Info Contact us:



+91 8146207241



hello@edutap.co.in



www.edutap.co.in

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Answer: Option B

