7.MODERN FOREIGN EXCHANGE MARKETS:

Unit Structure:

7.1 Learning Objectives

7.2 Introduction

7.3 To modern Foreign Exchange markets,

7.4 Structure of Indian Forex Market

Authorised Dealer

Money Changer

Dealing Room operations

7.5 Role of FEDAI

7.1 LEARNING OBJECTIVES:

After studying this lesson you are able to:

- Understand modern Foreign Exchange markets Understand , Structure of Indian Forex Market
- Understand Authorised Dealer
- Understand Money Changer
- Understand Dealing Room operations
- Understand Role of FEDAI

7.2. INTRODUCTION:

The foreign exchange market (Forex, FX, or currency market) is a global decentralized market for the trading of currencies. In terms of volume of trading, it is by far the largest market in the world. The main participants in this market are the larger international banks. Financial centres around the world function as anchors of trading between a wide range of multiple types of buyers and sellers around the clock, with the exception of weekends.

The foreign exchange market determines the relative values of different currencies. The foreign exchange market works through financial institutions, and it operates on several levels. Behind the scenes banks turn to a smaller number of financial firms known as “dealers,” who are actively involved in large quantities of foreign exchange trading. Most foreign exchange dealers are banks, so this behind-the-scenes market is sometimes called the “interbank market”, although a few insurance companies and other kinds of financial firms are involved.

In this current chapter we will learn in details about various types of dealers and various types of deals.

7.3 FEMA AND THE INDIAN FOREIGN EXCHANGE MARKET:

Sections 41, 46 and 47 of the Foreign Exchange Management Act,1999 (FEMA) collectively provide the Reserve Bank of India with the powers ' as well as the responsibility to administer foreign exchange business in the country. However, the RBI does not transact with private entities and therefore has delegated this function as provided in the act.

-AUTHORIZED PERSONS:

Although the Reserve Bank of India has the sole authority to administer foreign exchange business in India, it does not deal with individuals and : other private entities and therefore cannot undertake this function by itself.

Foreign exchange is received or required by a large number of individuals, exporters and importers in the country spread over a vast geographical area. It is not possible for the Reserve Bank of India to deal with them individually. Section 10 of the act permits the Reserve Bank of India to delegate this activity. The Reserve Bank provides licenses to three categories of persons called Authorized Dealers, Money Changers and Offshore Banking Units (OBU's) to transact with the public at different levels. All such transactions, with end-users are governed by the Exchange Control Regulations provided by the Reserve Bank of India.

Authorized persons are mandatorily required to comply with the directions or orders of the Reserve bank in all the foreign exchange dealings undertaken by them. Before undertaking any transactions in foreign exchange, necessary declarations and information should be obtained from the customer so as to ensure that the provisions of the Act are not violated.

-AUTHORIZED DEALERS:

The bulk of the foreign exchange transactions undertaken in the country twelve end-users and banks. Banks and selected entities licensed by the Reserve Bank to undertake these transactions are called 'Authorised Dealers' (AD's), They are permitted to undertake all Categories of' transaction pertaining to ’both the Current and Capital accounts of the Balance of Payments.

An authorized dealer is required to comply with. The directions and instructions of the Reserve Bank of India. Such instructions are collectively called 'Exchange Control Regulations' and are. Contained in the 'Exchange Control Manual'. All amendments to the Exchange Control Manual are intimated to Authorized Dealers by the Reserve Bank in the form of its AD (MA Series) circulars. Further, directions pertaining to general procedure are given in the form of its AD (GP Series) circulars.

With regard to the operational aspects of foreign exchange transactions such as charging of commission, methods of quotation of rates etc., the authorized dealer is required to comply with the rules of The Foreign Exchange Dealers Association of India (FEDAI).

-AUTHORIZED MONEY CHANGERS:

Money changers are licenced entities permitted to provide facilities for encashment of foreign currency denominated travel related instruments such as foreign currency notes and traveller's cheques. Licences to operate as money changers are normally provided to hotels, travel agencies, etc. Authorised money changers are sub-classified as full-fledged money changers and restricted money changers. A full-fledged money changer is permitted to undertake both purchase and sale transactions with the public eg: Travel agencies. A restricted money changer is permitted only to purchase foreign currency notes and traveller's cheques e.g. 5 star hotels. All collections need to be surrendered to an authorized dealer in foreign exchange through a back-to-back arrangement.

-DEALING ROOM OPERATIONS TREASURY OPERATIONS:

The Treasury of a commercial bank or financial institution can be described as an independent profit centre within the organization; which deals specifically with optimizing returns on surplus resources or arranging resources at the lowest cost. In a commercial bank the treasury operations are normally divided into four activities:

***Call Money Operations** involve management of short term financial resources so that the bank meets its obligations as per the Cash Reserve Ratio (CRR) stipulated by the RBI at a given time.

***Securities operations** involve management of medium and long term financial resources and requirements, thereby ensuring compliance of the Statutory Liquidity Ratio (SLR) specified by RBI from time to time. Debt instrument values have an inverse relationship with nominal interest rates and it is the prime objective of this group to protect the bank from interest J rate risk, on investments in debt securities.

***Commodity operations** involve buying and selling of commodities for clients as well as on proprietary basis. Therefore this group operates as both a service delivery channel to customers and generating trading profits for the bank.

***Foreign Currency operations** involve buying and selling of foreign currencies and providing all international trade related services to the banks customers. This group also undertakes speculative and arbitrage transactions on behalf of the bank. All such activities are collectively called Foreign Exchange Dealing Room Operations.

-FOREIGN EXCHANGE DEALING ROOM OPERATIONS:

It is a profit centre for the bank and functions as a centralized service branch to meet the needs of all other branches to buy/sell foreign currencies. It is manned by specially trained personnel called 'dealers or traders', who undertake all foreign currency treasury operations:

***Card Rates** at the start of every trading day the market first establishes the vehicle currency quotation. The dealers then prepare cross rates for currencies normally used by their customers. Profit margins are loaded for different categories of transactions and tabulated under eight heads: TT Buying, Bills Buying, TC Buying, CN Buying, TT Selling, Bills Selling, TC Selling and CN Selling. These rates collectively called Card Rates are conveyed to all branches. All transactions undertaken at branches involving amounts less than USD 5000 or equivalent during the day are put through at the Card Rates. These rates generally remain constant for the given day. (TC=travellers cheque, CN=currency banknote, TT = telegraphic transfer, Bills = Documentary transactions)

***Ready Rates -** when branches receive transactions involving amounts in excess of USD 5000 or equivalent, a transaction specific rate is provided, by the Dealing Room in each case based on the on-going market rate. Thus, while Card Rates are standardized, Ready Rates are customized; these rates are finer than Card Rates in terms of profit margins.

Transactions reported throughout the day are segregated currency wise and separate dealers consolidate the exposure of the bank in each currency on an on-going basis. Depending on the view of the dealer the exposures are covered in the inter-bank market. (Ref: CH 8 and 9) The Dealing Room therefore represents the point of interface between the Retail and Wholesale components of the foreign exchange market.

Currency exposures are called 'positions'. A 'position' can therefore be described as an uncovered transaction in which the bank has assumed exchange rate risk by providing a committed rate to the opposite party. A dealer has to maintain two positions- funds position and currency position The funds position reflects inflows and outflows of funds i.e. receivables and payables. A mismatch in funds position will expose the bank to interest rate risks in the form of overdraft interest in the Nostro a/c, loss of interest income on credit balances, etc. Currency position deals with overbought and oversold positions, arrived after taking various merchant and/or inter-bank transactions. The overall net currency position exposes the dealer to exchange risks from market rate movements. Transactions undertaken in the inter-bank market to eliminate merchant exposures are called 'Cover Transactions'.

Customers of the bank require derivatives for hedging their currency risks. Forward Contracts and Swaps being OTC derivatives, they are provided by banks. Providing rates for such transactions and covering the same is also the function of the dealers.

An important feature of a dealer's job is to keep abreast of market developments, international events and news items which would have an impact on exchange rates. This helps them to take informed decisions, regarding open positions to be maintained.

Dealers are required to comply with the Code of Conduct specified by RBI, and operational guidelines provided by the Foreign Exchange Dealers Association of India (FEDAI).

-STRUCTURE OF THE DEALING ROOM:

A standard structure of the dealing operations in a commercial involves three compartments:

***Front Office**: It is manned by dealers who represent the bank in market operations at both retail and wholesale levels. They therefore fund as the 'face' of the bank in the market. All dealing operations take place this compartment.

***Mid office:** This section deals with the risk management function the parameters for evaluating and controlling risks are established by this section. Every transaction undertaken by a dealer is recorded in a 'Deal Slip' which provides alt particulars of the transaction. Each deal slips processed in this section to ensure adherence to all risk control limits specified by the management. These control limits include:

- Limits on intra-day open position in each currency called Daylight limits'. (Exposure control)
- Limits on overnight open positions in each currency (lower than intra-day) called 'Overnight limits'. (Exposure control)
- Limits on aggregate open position for all currencies. (Exposure control)
- Stop-loss limits. (For each currency) (Control over loss)
- A turnover limit on daily transaction volume for all currencies. (Control of overtrading)
- Deal Size limits. (Distribution of Risk)
- Country-wise exposure limits. (Control of Market Risk) Brokerwise business limits. (Control of Operational Risk)
- Counterparty limits. (Control of Credit Risk)
- Forward settlement date-wise limits. (Control of Settlement risk)
- Currency-wise Individual Gap Limits (IGL's)- (Control of Maturity Risk / Interest Rate Risk)
- Currency-wise Aggregate Gap Limits (AGL’s)- (Control of Maturity Risk / Interest Rate Risk)

The Mid Office therefore represents the Risk Management hub of all dealing operations. It provides a constant flow of market information to the dealers.

***Back office**: Takes care of processing deals, maintaining mirror accounts for nostro accounts reconciliation, recording of utilization of forward contracts by customers, recovering overdue interest, preparing returns to be submitted to RBI, etc. It represents the administrative hub of all dealing operations.

-DEALING ROOM TRANSACTIONS:

The transaction flow in the dealing room is as follows:

All transactions in the dealing room can be classified as either.

- Merchant transactions entered into with customers of the bank and
- Interbank transactions undertaken with other banks or institutions.

***Merchant Transactions:** Customers of the bank continuously approach the bank for rates for various types of transactions. Either Card or Ready rates are applied depending on the volume of each transaction. Every deal is reported to the dealing room where it is recorded into the respective currency position. The impact of the deal on the funds position and forward gaps is also recorded separately. The evolving open* currency position is offset through opposite transactions in the interbank market. These are called 'Cover transactions'. All merchant deals are customized in nature.

***Inter bank transactions**: Such transactions are undertaken either to 'Cover' merchant transactions to lock the profit margins or represent proprietary trading or speculative transactions done in keeping with the view of the dealers regarding anticipated rate movements. All such transactions are conducted at interbank rates and are standardized in nature. Interbank deals are classified in terms of their settlement maturity i.e.: Cash, Tom, Spot or Forward.

Irrespective of the nature of the transaction, they are each recorded in 'Deal Slips' providing full particulars and forwarded to the Mid - Office. This section processes each deal slip against all control parameters specified by the management. The deal slip then gets forwarded to the Back - Office.

In addition to verification of adherence to the control limits the midoffice also maintains a 'Rate Scan System'. Market rates are recorded at fixed intervals to cross check that deals have been done at reasonable rates and that there are no wide variations from the market rates at the corresponding deal timings.

Dealing Rooms in India are now required to maintain 'Voice Recording Systems'. Most deals are concluded verbally on 'Over-thephone' (OTP) basis and are therefore subject to mis-understandings, misinterpretations and disputes. Therefore all conversations in the dealing room between banks, bank and brokers, with customers, branches and between dealing staff are recorded and stored for minimum six months.

These records are kept to verify the stand taken by market participants in the case of disputes, litigations etc.

The back-office is the administrative section where the deal is actually processed. Each deal is recorded in term of maturity, confirmed with counterparties, settled through receipt / payment of respective currencies etc. All statistical and regulatory returns are compiled by this section.