EXCHANGE RATES AND FOREX BUSINESS

CH – 1 MODULE A PART 3 BFM By Ashish Jain

ARBITRAGE IN FOREIGN EXCHANGE ♻️

Arbitrage involves the **simultaneous buying and selling** of a commodity or currency in two or more markets, aiming to profit from **temporary price discrepancies**. In the context of foreign exchange:

1. Basic Idea

- **Buy** one currency in a certain market (or center).
- **Immediately sell** the same currency in a **different market** (or multiple markets).
- Exploit any **price differentials** that exist at that moment.

2. Types of Arbitrage

- **Simple (Direct) Arbitrage:**
  - Conducted **between two centers** only.
  - Example: Buying USD in **Mumbai** and simultaneously selling USD in **Delhi** if there is a momentary price difference.
- **Compound (Three or More Point) Arbitrage:**
  - Involves **three or more centers** or **several currencies**.
  - Example: Purchasing USD in Mumbai, converting it to EUR in London, and selling the EUR in New York—if prices across these centers/currencies are favorable.

3. Key Considerations

- **Speed** ⚡ : Any profit opportunity can disappear quickly as markets adjust to price imbalances.
- **Technical Skill** 🎯 : Executing arbitrage deals with minimal delay requires **rapid decision-making** and **precise communication** among different centers.

RETAIL AND MERCHANT RATES 💱

When dealing with merchants or retail customers, **transaction-specific rates** often apply. For instance:

- **TT (Telegraphic Transfer) Rates**
- **Bill Transaction Rates**
- **Foreign Currency Note Rates**
- **Travelers Cheques (TC) Rates**
- **Personal Checks Buying Rates**

> Different **margins** are added over the **interbank rate** depending on the **transaction type**—whether it's a **buying** or **selling** operation and the nature of the underlying deal.

🔎 Key Point	⚙️ Explanation
Nature of Transaction	TT, bills, currency notes, TCs, checks, etc. Each form can incur different service costs or risks.
Buy/ Sell Rates	Banks quote **buy** and **sell** rates differently, adding **margins** for transaction costs or risks.

Interbank Rate	Baseline market rate used among banks. **Retail** or **merchant** quotes include extra spreads or margins.

FOREIGN EXCHANGE DEALING ROOM OPERATIONS 💱

The **FOREX dealing room** in a bank functions like a **service branch**, handling:

1. **Customer Requirements**: Buying or selling foreign currencies for branches or business divisions.
2. **Managing Foreign Currency Assets/Liabilities**: Ensuring balances remain within set limits.
3. **Funding and Managing NOSTRO Accounts**: Maintaining adequate balances in overseas accounts to avoid overdrafts or idle surpluses.
4. **Proprietary Trading**: Engaging in currency trades to generate profit.

Key Point: A **Dealing Room** often operates as a **profit center** for the bank or institution.

Regulatory Compliance ⚖️

While conducting **treasury management** for foreign exchange, the **treasurer** must ensure adherence to:

1. **Internal Control Guidelines** from the Reserve Bank of India (RBI)

2. **FEDAI** (Foreign Exchange Dealers' Association of India) regulations
3. **Bank's Internal Guidelines**

Functional Segregation 🏦

A **cardinal principle** in **Dealing Room operations** is clear segregation of **Front Office**, **Mid Office**, and **Back Office** functions. In an **integrated treasury**, these are:

1. **Front Office (Dealing Room)**
   - Carries out **active buying** and **selling** of currencies, money market instruments, etc.
2. **Mid Office (Risk Management Department)**
   - Monitors **risks**, sets limits, and ensures compliance.
3. **Back Office (Settlements, Accounting & Reconciliation)**
   - Handles **record-keeping**, **confirmations**, settlement of deals, and **account reconciliation**.

Role of Dealers 🧑‍💻 👩‍💻

Dealers are **critical** to dealing room profitability:

- **Market Awareness**: Must understand changing market conditions and **currency trends**.
- **Quick Decision-Making**: A single second's delay can **wipe out** potential profits.

- **Psychological Traits**: Work under **stress**, accept **responsibility**, be **aggressive** yet ready to **admit mistakes**.

Indian Context Example: A dealer at an Indian bank (e.g., in **Mumbai**) might need to **buy USD** quickly if an exporter client in **Chennai** expects a better dollar rate. The dealer's swift action can yield immediate profits, but any misjudgment could cause a **loss** instead.

Funds Position vs. Currency Position 💰

1. Funds Position

- Reflects **inflows (receivables)** and **outflows (payables)** of actual money.
- **Mismatches** in timing or amount can lead to:
  - **Overdraft interest** in NOSTRO accounts if short on funds.
  - **Loss of interest** on surplus balances if funds remain idle without investment.

Tip: Proper **calculation of funds position** helps avoid unnecessary interest costs or missed opportunities.

2. Currency Position

- Reflects being **overbought** or **oversold** in various currencies.
- Any net position exposes the bank to **exchange rate risk**.
- The dealer must remain within **permissible limits** set by management (or regulators).

Example: Suppose the bank's net position is **+ USD 2 million**. If the **USD/INR** rate falls significantly, the bank can incur an **exchange loss** on that USD surplus unless it's hedged or brought back into balance.

Integrated Treasury – Why? 🔗

Traditionally, **FX markets** and **domestic currency markets** were managed separately. However, the following developments led to the concept of an **Integrated Treasury**:

1. **Interest Rate Deregulation**
2. **Liberalization of Exchange Control**
3. **Growth and Sophistication of Forex Markets**
4. **Advances in Settlement Systems**
5. **Evolving Dealing Environments**

Together, these changes allow banks to **optimize** currency and money market activities under a **unified strategy**, improving **risk management** and **profit opportunities**.

SUMMARY TABLE 📊

Section	Key Points
Dealing Room Operations 💱	- Service branch for currency buys/sells- Maintains NOSTRO a/cs - Handles proprietary trading
Regulatory Compliance ⚖️	- Follow RBI Internal Guidelines - Adhere to FEDAI norms - Observe Bank's internal policies

Functional Segregation 🏦	- **Front Office**: Trading - **Mid Office**: Risk Management - **Back Office**: Settlements & Accounts
Dealers 👨‍💻 👩‍💻	- Critical for profit generation - Stressful environment, rapid decisions, willingness to be wrong
Funds vs. Currency Positions 💰	- **Funds**: Cash inflows/outflows - **Currency**: Overbought/oversold in FX, risk from rate movements
Integrated Treasury 🔗	- Needed due to deregulation, market evolution, advanced settlements, and modern dealing practices

FUNCTIONS OF INTEGRATED TREASURY 🏦

An **Integrated Treasury** performs several critical tasks within a bank. Key functions include:

1. **Statutory Requirements** ⚖️
   - **CRR (Cash Reserve Ratio)** and **SLR (Statutory Liquidity Ratio)** compliance.
   - Maintaining an **optimal investment portfolio mix** to meet these requirements.
2. **Liquidity & Funds Management** 💰
   - Analyzing **major cash flows**, determining **funding mix**, and managing **yields** in credit and investments.
   - Ensuring liquidity without incurring excessive costs.
3. **Asset-Liability Management (ALM)** ⚖️
   - Managing the **growth rate** of the balance sheet.

- Pricing assets and liabilities in line with **regulatory guidelines**.
- Controlling mismatches in maturities to maintain **financial stability**.

4. **Risk Management** ⚠️
   - Monitoring **market risk** associated with assets and liabilities.
   - Handling **credit risk** in treasury products.
   - Managing **operational risk** in payments and settlements.
5. **Transfer Pricing** 🔄
   - Establishing **benchmark rates** (e.g., internal cost of funds) for various business groups.
   - Ensuring **optimal deployment** of funds across different units in the bank.
6. **Derivatives & Hedging** 🔀
   - Developing **Interest Rate Swaps (IRS)** and other **derivative products** to hedge the bank's exposures.
   - Offering such products to customers for **risk mitigation**.
7. **Arbitrage** ♻️
   - Engaging in simultaneous **buying and selling** of identical assets in different markets to **earn risk-free profits**.
   - Capitalizing on **price discrepancies** across locations.
8. **Capital Adequacy** 🏦

- Focusing on **asset quality** and **return on investments**.
- Evaluating how effectively the bank deploys funds to **sustain capital requirements**.

9. **Minimizing Provisions for NPAs** ⚙️
   - Keeping **Non-Performing Assets (NPAs)** in check.
   - Reducing the **level of provisioning** needed by **improving asset quality**.

🌐 Indian Context Note
For a bank in Mumbai, ensuring CRR/SLR compliance with RBI while also finding profitable investments (e.g., G-Secs, T-bills) is a core aspect of Integrated Treasury.