EXCHANGE RATES AND FOREX BUSINESS

CH – 1 MODULE A PART 4 BFM By Ashish Jain

INTERNAL CONTROL GUIDELINES OF RBI ⚖️

The **Reserve Bank of India (RBI)** prescribes **internal control guidelines** for banks to ensure **safe and compliant** dealing room operations. Some important guidelines include:

1. **Appropriate Data Processing Systems** 💻

- Systems must match the **nature and volume** of activities.
- Helps maintain clear **functional separation** among front, mid, and back offices.

2. **Defined Access Rules** ✅

- Detailed protocols for **who** can perform **which functions**.
- Prevent unauthorized individuals from accessing **dealing activities**.

3. **Confidentiality in Outsourcing** 🔓

- Ensure **secure handling** of data if IT services are outsourced.
- Safeguard sensitive **deal and customer information**.

4. **Global Limits for Inter-Bank Deals** 🌏

- Align global dealing limits with the **bank's overall risk management** framework.
- Covers both domestic and international transactions.

5. **Capital Adequacy for Dealing Activities** 🏦

- The bank's **capital and earnings** should support **aggressive dealing** if undertaken.
- **Avoid overextending positions** without **adequate capital** backing.

6. **Value-at-Risk (VaR) Models**

- Use **appropriate VaR** methods to quantify **market risk** with a certain **confidence level**.
- Regularly **review and validate** these models to ensure reliability.

7. **Limits for Each Dealer**

- Communicate **stop-loss limits** and other **exposure limits** to every dealer.
- Strictly monitor **compliance** within these boundaries.

8. **Adherence to Counterparty & Exposure Limits**

- Deals must stay within:
    - **Counterparty exposure** limits
    - **Stop-loss** thresholds
    - **Country-wise exposure** limits (for FX deals)
    - **Net Overnight Open Position Limits (NOOPL)**
    - **Individual GAP Limits (IGL)** and **Aggregate GAP Limits (AGL)**
- All these limits are approved by the **Bank's Board**.

9. **Monthly Profit/Loss Evaluation**

- Foreign exchange P&L must be calculated at **closing rates** each month, as per **FEDAI announcements**.

- Ensures **accurate reflection** of market positions on **financial statements**.

SUMMARY TABLE 📊

Section	Key Points
Integrated Treasury Functions 🏦	- CRR/ SLR & Investment Mix- Liquidity & Funds Mgmt- ALM & Pricing- Risk Mgmt (Market/Credit/Operational)- Transfer Pricing- Derivatives & Hedging- Arbitrage- Capital Adequacy & NPA Provisions
RBI Internal Controls ⚖️	- Data Processing Systems - Access & Confidentiality - Global Exposure Limits - VaR Models & Ongoing Validation - Dealer & Counterparty Limits - Monthly FX P&L at FEDAI Rates

OTHER PARTS OF THE DEALING ROOM ⚙️

Back Office 🏛️

The **Back Office** oversees **deal processing**, **accounting**, **reconciliation**, and related functions. While often working behind the scenes, its role is **equally critical**:

- **Support Function**: Ensures that dealers' trades are accurately recorded, confirmed, and settled.
- **Checking Role**: Detects misreporting or potential wrongdoing. Any laxity here can **negate dealer profits** or enable **unnoticed errors**.

Key Point: A **strong Back Office** prevents **operational risks**, ensuring the bank's integrity and compliance with regulations.

Mid Office 🔍

The **Mid Office** is responsible for **risk management** and the **parameterization of risks** affecting the dealing room operations, including **FOREX transactions**:

- **Risk Monitoring**: Tracks **market**, **liquidity**, and **credit** risks.
- **Risk Control**: Ensures dealers abide by **limits** (e.g., stop-loss, overnight exposure).
- **Market Information**: Provides up-to-date intelligence, supporting informed trading decisions.
- **Compliance**: Verifies adherence to **treasury guidelines** and maintains **independence** from front-office activities.

MANAGEMENT CONTROL & PROFIT/ LOSS VALUATION ⚖️

With growing **international trade**, **cross-border cash flows**, and **FX trading** by authorized dealers, **managing** and **controlling** foreign exchange operations is essential.

1. **FEDAI & RBI Guidelines**

- The **Foreign Exchange Dealers' Association of India (FEDAI)**, with **RBI** approval, issues guidelines for **uniform accounting** of foreign exchange profits/losses.
- Banks must **value** their FOREX positions at **month-end** (minimum) using **FEDAI's** rates, even if actual accounting entries occur quarterly.

- Many banks now **automate** this process, doing **daily** or **more frequent** valuations.

2. **Revaluation Scope**

- **All foreign currency positions** must be revalued, including:
    - **Mirror accounts** of each currency
    - **Foreign currency notes** on hand
    - **Import suspense accounts**
    - **Spot & forward positions** (e.g., export bills, sight/usance bills)
    - **Overdue contracts** (if any)
    - **Merchant & inter-bank** contracts
    - **Other FX assets and liabilities**
- **FEDAI** prescribes the **valuation rates** based on market quotes at **month-end**, enabling authorized dealers to revalue positions accurately.

COMBINED ROLES: FRONT, MID, AND BACK OFFICE 🏦

Front Office 🚀	Mid Office 🔍	Back Office 🏦
Fund Management (NOSTRO Account)	**Market Risk** Assessment	**Confirmation** of Deals
Foreign Exchange Advisory & Management	**Liquidity Risk** Control	**Settlement** of Deals
ALM & Maturity Mismatches	**Country Risk** Monitoring	**Accounting** of Deals

Dealing in Inter-Bank Market	**ALCO Committee** Participation	**Reconciliation** of Transactions
Trading in Inter-Bank Market	**Reporting** to Top Management	**Audit** Facilitation & Reporting
Compliance with Limits	**Compliance** (Guidelines)	**Compliance** (Documentation)

MANAGEMENT & CONTROL OF A DEALING ROOM 🏦

The **Reserve Bank of India (RBI)** advises that a bank's **Board of Directors** should frame suitable **policies** and set **limits** for FOREX dealing operations. Effective **management** of dealing room operations must consider the **risks** arising from:

- **Complex FX Markets**: Rapidly changing rates and global interconnections.
- **Volatile Exchange Movements**: Major currency fluctuations can impact positions quickly.

Key Point: Policies must **mitigate** these risks, focusing on compliance, real-time monitoring, and robust **Front–Mid–Back Office** coordination.

SUMMARY TABLE 📊

Section	Key Points
Back Office 🏦	- Processes and settles deals - Maintains accounts and reconciliation - Acts as a check against fraud
Mid Office 🔍	- Manages and monitors risks - Ensures compliance with treasury limits - Provides market intelligence
Management & P/L Valuation ⚖️	- FEDAI & RBI guidelines for monthly (or more frequent) revaluation - All currency positions are included
Front–Mid–Back Office Table 🏦🔄	- Outlines respective roles in fund mgmt, market risk, settlements, accounting, compliance, etc.
RBI Advice on Dealing Room Management 📃	- Board sets policies and exposure limits - Focuses on complexity and volatility of FX markets

RISKS IN FOREIGN EXCHANGE DEALING ⚠️

1. Operational Risk ⚙️

Definition: The risk of loss due to **human errors**, **technical faults**, **infrastructure breakdowns**, **faulty systems/procedures**, or **lack of internal controls**.

In Short: **"Risk of loss resulting from inadequate or failed internal processes, people, systems, or external events."**

2. Exchange Risk (Currency Risk) 💱

Definition: The possibility of losses due to **fluctuations in exchange rates** or **mismatches** in currency assets/liabilities or receivables/payables.

3. Credit Risk 🤝

Definition: The risk of loss when a **counterparty** fails to meet its payment obligations (principal/interest).

- **Pre-Settlement Risk**: Counterparty fails **before maturity** of the contract.
- **Settlement Risk**: Counterparty fails **on the settlement date** itself (see more below).
- **Lending/Borrowing Context**: Could arise if a **borrower** or **issuer** defaults on loans, bonds, or other debt instruments.

4. Settlement Risk ⚠️

Definition: Occurs when parties exchange currencies at **different times** or across **different time zones**, leading to potential loss if one party pays out but the other **fails** before reciprocating.

- **Classic Case**: **Herstatt Risk** (1974) in Germany, where Bankhaus Herstatt's failure during the day led to losses for counterparties expecting USD payments after delivering Deutsche Marks.

Example:

- **Bank A (Frankfurt)** buys EUR 1,000,000 from **Bank B (New York)** for USD 1,550,000, value spot (e.g., 5th Nov).
- Due to time zone differences, **Bank B** might send EUR first, but if **Bank A** fails before sending USD, **Bank B** loses out on the USD and has already parted with EUR.

5. Liquidity Risk 💧

Definition: The risk that a bank **cannot meet** its obligations as they become due because it **lacks sufficient cash** or **easily salable assets**, despite being well-capitalized on paper.

- **Arises** when there are significant **maturity mismatches** in assets/liabilities.
- **Positive Liquidity Gap**: More cash inflows than outflows (less risk, but limited investment scope).
- **Negative Liquidity Gap**: Outflows exceed inflows (greater risk, potential shortfall).

6. Gap Risk / Interest Rate Risk

Definition: A **gap** occurs if a bank's **forward purchases** and **sales** of currency are for different value dates, causing mismatches in **assets vs. liabilities** at future points.

- **Forward Differentials** depend on **interest rate** movements.
- If **interest rates** move adversely, **forward differentials** can also move adversely, affecting the **cash flows** on any open gap.