EXCHANGE RATES AND FOREX BUSINESS

CH – 1 MODULE A BFM By Ashish Jain

FX GLOBAL CODE 🌐

The **FX Global Committee**, in a global meeting in **London**, endorsed the publication of the **FX Global Code**—a **uniform code** for **wholesale foreign exchange markets** worldwide. Its aims include:

1. **Principles of Good Practices**
2. **Active Engagement** of local participants
3. **Promoting Healthy & Disciplined** dealing room trading

Key financial authorities—**HKMA (Hong Kong)**, **MAS (Singapore)**, **RBA (Australia)**, **Bank of Korea**, **RBI (India)**, and the **Federal Reserve Bank (USA)**—have already endorsed this code.

In **India**, the **revised FEDAI Code of Conduct** for the Indian FX market became effective from **1 September 2021**.

RBI GUIDELINES FOR AUTHORIZED PERSONS ⚖

1. **AD Category I – Banks**

- **Open/ Close Rupee Accounts**: Non–interest-bearing accounts in the name of overseas branches/correspondents (except for Pakistani banks outside Pakistan) without prior RBI approval.
- **Rupee Accounts for Exchange Houses**: Require **RBI** approval.

- **Foreign Currency Accounts**: May be opened abroad in the bank's own name for routing FX transactions; balances may be maintained as per the Board's guidelines.
- **Investments Overseas**: Allowed in money market or debt instruments (under one-year residual maturity) if rated as per guidelines.
- **Use of Surplus in NOSTRO Accounts**: Can grant loans to resident constituents for FX or INR needs, extend credit to Indian company subsidiaries/joint ventures abroad, subject to conditions.

2. **Borrowings/ Overdrafts**: **All borrowings** (incl. ECBs, short overdrafts not settled in 5 days) must not exceed **50% of unimpaired Tier 1 capital** or **USD 10 million**, whichever is higher. Certain exceptions apply (e.g., overseas borrowings for export credit, Tier II capital from foreign HQ, etc.).
3. **Forward Exchange Contracts**

- **Banks** can allow residents to book forwards if the underlying FX transaction is **permissible** under FEMA 1999.
- Must verify **underlying documentary evidence**; ensure **maturity** does not exceed underlying's tenor.
- May allow forward booking on **past performance basis** for importers/exporters up to certain turnover limits.
- **SMEs** can book forwards up to credit facility limits.
- **Resident individuals** can book forwards up to **USD 100,000** (deliverable basis; one-year max tenor).

4. Other Derivatives

- **AD Category I – Banks** may offer **Interest Rate Swaps (IRS), Coupon Swaps, FX Options, FRA, Caps/Collars** to hedge foreign currency borrowings (FEMA-compliant).
- **FX-Rupee Swap** allowed for residents with FX or rupee liability to hedge long-term exposure.
- **Cross-currency options** on a back-to-back basis (or, subject to RBI permission, run an options book).

FOREIGN EXCHANGE ARITHMETIC – CONCEPTS & EXAMPLES ➗

Foreign exchange (FX) is treated like a **commodity**, but with a unique twist:

- **Purchase** (Bank's viewpoint): The bank **buys** foreign currency from a customer (inflow to the country).
- **Sale** (Bank's viewpoint): The bank **sells** foreign currency to a customer (outflow from the country).

Purchase Rate (BID)

- The rate at which the bank **purchases** FX from the customer.

Sale Rate (ASK)

- The rate at which the bank **sells** FX to the customer.

Inward Remittances (Purchase Transactions) ⬅

- **Bank receives** foreign currency (via **Nostro** or as **FC notes / TCs**).
- Customer's account is credited in **INR** at the **applicable purchase rate** (e.g., TT Buying Rate, Currency Buying Rate, or TC Buying Rate).

Outward Remittances (Sale Transactions) ➡

- **Bank pays out** foreign currency on the customer's behalf (e.g., to overseas suppliers or for travel).
- Bank **debits** the customer's **INR** account and converts INR into FX at the **applicable selling rate** (TT Selling Rate, Currency Notes Selling Rate, or TC Selling Rate).

COMMON PURPOSES FOR FX TRANSACTIONS

Inward Remittances – Examples

1. Family maintenance, education, medical, or gifts from overseas relatives.
2. **Donations** under **FCRA** guidelines.
3. NRIs/ PIOs/ OCIs **remitting savings** to Indian accounts.
4. Export proceeds (goods, software, services).
5. FDI/FPI/FVCI, equity investments by overseas investors.
6. ECB/FCCB disbursements to Indian companies.

Outward Remittances – Examples

1. Family maintenance, education, medical, or gifts to overseas relatives (under **LRS**).
2. Repatriation of NRE/FCNR(B) balances.
3. Import bills (sight/usance), advance remittances for imports.
4. Overseas Direct Investment (ODI) into JVs/WOS abroad.
5. ECB loan repayments (principal/interest).
6. Misc. commercial or licensing fees (patents, trademarks, etc.).

SELECT EXAMPLES OF FX ARITHMETIC 🏦

Example 1

Inter-Bank Spot Rate: USD/INR = 75.0050 / 75.0075

Margin: 10 paise

1. **Inward Remittance** Rate
    - **Bank** buys USD at the lower inter-bank rate **minus** margin.
    - 75.0050 – 0.1000 = **74.9050** (Customer TT Buying Rate)
2. **Outward Remittance** Rate
    - **Bank** sells USD at the higher inter-bank rate **plus** margin.
    - 75.0075 + 0.1000 = **75.1075** (Customer TT Selling Rate)

Example 2

USD/INR (Market Quote): 76.09 / 76.11

Customer has **Inflow** of USD 100,000 (via TT for exports).

- Bank sees it as a **purchase** of USD from the customer.

- Market **buys** USD at **76.09**, so the bank's **customer rate** = 76.09 **minus margin**.

Example 3

Export Bill for USD 500,000, 120 days from shipment (3-Oct to 1-Feb).

- **Spot** = 75.14 / 75.15
- **Forward Premium** (Spot–Jan) = 0.45 / 0.46
- **Margin** = 0.15%
- **Interest** = 8.50% for 120 days
- **Commission** = 0.0625%

Bill Buying Rate Calculation Steps:

1. Spot Rate = 75.14
2. Add Premium → 75.14 + 0.45 → 75.59
3. Less margin (0.15%): 75.59 – (0.15% of 75.59) → 75.4766
4. ~75.477
5. Round to 75.4770

Example 4

Retirement of Import Bill: GBP 100,000.

- **GBP/USD** = 1.2175 / 1.2185
- **USD/INR** = 75.4770 / 75.4870
- **Margin** = 0.20%

Bank must **buy GBP** in the market:

1. Market buys GBP at 1.2185 USD/GBP.
2. Market sells USD to the bank at 75.4870 INR/USD.
3. Implied GBP/INR = 1.2185 × 75.4870 = 91.9809.
4. Add margin 0.20% → ~92.1648 (rounded to 92.1650).

Example 5

Forward Contract for **export** of USD 150,000 in **December**.

- **Spot** = 75.45 / 75.50
- **Forward Premium (Nov)** = 0.30 paise
- **Margin** = 0.05 paise

Rate = (75.45 + 0.30) – 0.05 = **75.70** (Forward TT Buying Rate)

Example 6

Forward Contract for **import**: USD 100,000 due **15 Sept**.

- **Spot** = 75.27 / 75.29
- **Forward Premium (Aug)** = 0.32 / 0.34
- **Margin** = 0.20% on spot

Bank sells USD forward, so the rate might be calculated by adding the **full premium** to the higher spot side, plus margin.

Example 7

Foreign Correspondent wants to **fund** their INR account by purchasing Rs. 30 million vs. USD.

- **Inter-Bank**: 75.2550 / 75.2650

- Transaction is **inward** from India's perspective, bank uses **lower rate** (75.2550)
- USD received in **NOSTRO** = 30,000,000 ÷ 75.2550 ~ USD 398,644.60

Example 8

Remit JPY 100 million by TT for import payment.

- **USD/INR** = 75.2500 / 75.2600
- **USD/JPY** = 116.50 / 116.60
- **Margin** = 0.15%

Cross Rate Logic → JPY/INR = (USD/INR SELL) ÷ (USD/JPY BUY). Then add margin.

1 USD = 75.2600 INR

1 USD = 116.50 JPY

JPY/ INR = (75.2600/116.50) x 100 = 64.60

ADD Margin → 64.60 + 0.15% = 64.6977

Example 9

Forward Purchase Contract: USD 500,000 at 75.2500, due in 2 days.

- Payment delayed by 1 month; contract must be **cancelled** and **rebooked**.
- **Cancellation**: Done at TT selling rate (opposite side), adding margin.

- **Re-booking**: Subtract margin from the lower side, adjust for forward premium, etc.

SUMMARY TABLE: KEY POINTS

Section	Highlights
FX Global Code	Common global code endorsed by multiple central banks, including RBI, for uniform best practices in wholesale FX markets.
RBI Guidelines	Scope of AD Cat I banks, NOSTRO account usage, borrowings limit, permissible derivative offerings (for hedging, etc.).
FX Arithmetic	- **Inward** = Bank **buys** FX → Use **TT buying** or relevant buying rate. - **Outward** = Bank **sells** FX → Use **TT selling** or relevant selling rate.
Margin Application	- **Deduct** margin from **buying** side. - **Add** margin to **selling** side.
Forward Contracts	- Must align with underlying exposures. - Maturity ≤ exposure tenor. - Profit/Loss upon cancellations or early deliveries.