



# Module-A Unit-1

## CAIIB PAPER-2

### **BANK Financial Management(BFM)**



## CAIIB Paper 2 (BFM) Module A Unit 1 Exchange Rates and Forex Business

### Foreign Exchange - Definition and Markets

Foreign Exchange Management Act (FEMA), 1999, (Section 2) defines foreign exchange as:

*Foreign Exchange means foreign currency, and includes:*

- All deposits, credits and balances payable in foreign currency, and any drafts, traveller's cheques, letters of credit and bills of exchange, expressed or drawn in Indian currency and payable in any foreign currency,
- Any instrument payable at the option of the drawee or holder, thereof or any other party thereto, either in Indian currency or in foreign currency, or partly in one and partly in the other." Thus, broadly speaking, foreign exchange is all claims payable abroad, whether consisting of funds held in foreign currency with banks abroad or bills, checks payable abroad.

### **Foreign Exchange Markets**

Foreign exchange markets comprise a large spectrum of market participants, which include individuals, business entities, commercial and investment banks, central banks, cross border investors, arbitrageurs and speculators across the globe, who buy or sell currencies for their needs.

The world currency market is a very large market, with a large number of participants.

*Major participants of FOREX markets are:*

- **Central Banks** – managing their forex reserves and using currency markets strives to reduce the volatility and smoothen out the value of their home currency.
- **Commercial Banks** - offering exchange of currencies to their big and retail clients and hedging and investing their own assets and liabilities, as also on behalf of their clients, and also speculate on the exchange rate movements in the markets.
- **Investment Funds/Banks** - moving funds from one country to another using exchange markets as a vehicle for investments as also hedging their investments in various countries/currencies.

- **FOREX Brokers** - acting as middleman, between other participants, and at times taking positions on their books.
- **Corporations** – moving funds between different countries and currencies for investment or trade transactions or even speculation in currency markets.

*Thus, the characteristics of foreign exchange market can be listed as under:*

- A 24-hour market
- An over the counter market as well exchange driven market
- A global market with no barriers/no specific location
- A market that supports large capital and trade flows
- Highly liquid markets
- High fluctuations in currency rates. (every seconds)
- Settlements affected by time zone factor
- Markets affected by governmental policies and controls

### **Factors Determining Exchange Rates**

The quotations in the FOREX markets depend on the delivery type of the foreign currencies, i.e., exchange of streams of the two currencies being dealt with. The spot rates, being the base quotes in the FOREX markets are more dynamic and are effected by varied reasons, a few of which are fundamental and other technical.

**The main factors, which influence movement of exchange rates, can be summarized as under:**

#### **Fundamental Reasons**

These include all those causes or events, which affect the basic economic and monetary policies of the concerned government. The causes normally affect the long-term exchange rates, while in the short-run, many of these are found ineffective.

*In a long run, exchange rates of all currencies are linked to fundamentals, as given under:*

- **Balance of payment** - generally a surplus lead to a stronger home currency, while a deficit weakens the same.
- **Economic growth rate** – a high growth leads to a rise in imports and a fall in the value of home currency, and vice versa.

- **Fiscal policy** – an expansionary policy, e.g., lower taxes can lead to a higher economic growth.
- **Monetary policy** – the way, a central bank attempts to influence and control interest and money supply can impact the value of currency of their country.
- **Interest rates** - high domestic interest rates tend to attract overseas capital, and thus the currency appreciates in the short term. In the longer term, however, high interest rates slow the economy down, thereby weakening the currency.
- **Political issues** - political stability is likely to lead the economic stability, and hence a steady currency, while political instability would have the opposite effect

### Technical Reasons

- Government controls can lead to an unrealistic value of a currency, resulting in violent movement in exchange rates.
- Freedom or restriction on capital movement can affect exchange rates to a larger extent. This is a phenomenon, which was seen in Indonesia, Thailand, Philippines, Korea, etc.

### Speculation

- Speculative forces can have a major effect on exchange rates. In an expectation that a currency will be devalued, the speculator will short sell the base currency (say \$) for buying it back cheaper at a later date.
- This very act can lead to movements in the market, as the expectation for devaluation grows extends to other market participants as well.

## Exchange Rate Mechanism

### Types and Calculation

- **Due to the vastness of the market, operating in different time zones, most of the FOREX deals are done on SPOT basis**, meaning thereby that the delivery of the funds takes place on the second working day following the date of deal/contract.
- The rate at which such deals are done is known as SPOT rates. Spot rates are the base rates for other FX rates. The date of delivery of funds on the date, on which the exchange of currencies actually takes place, is also referred to as "value date" or 'settlement date". The delivery of FX deals can be settled in one or more of the following ways:

## Ready or Cash

- **Settlement of funds takes place on the same day (date of deal)**, e.g., if the date of Ready/Cash deal is 3 October 2016 (Monday), settlement date will also be 3 October 2016.

## Tom

- Settlement of funds takes place on the next working day of the date of deal, e.g., say 1st Nov 2021), e.g., Bank A bought USD 1,000,000 against INR from Bank B @ 74.9600 Value Tom i.e. 2nd Nov 2021.
- This means that the delivery of USD 1,000,000 by Bank B and the settlement of INR 7,49,60,000 by Bank A takes place on the next working day, i.e. 2nd Nov 2021. This is known as a Tom deal. If the settlement date of TOM deal, i.e. 2nd Nov 2021 is not a working day, settlement date would be 3rd November 2021 provided it is a working day for the markets where currency is to be settled). Intervening Saturdays and Sundays will also postpone the settlement date to next working day.

## Spot

- Settlement of funds takes place on the second working day following the date of contract/deal, e.g., say 1st Nov 2021, e.g., Bank A, Mumbai bought USD 1,155,000 against EUR from Bank B, Frankfurt @ EUR/USD 1.1550 Value Spot i.e. 3rd Nov 2021.
- This means that the delivery of USD 1,155,000 by Bank B, Frankfurt and the settlement of EUR 1,000,000 by Bank A takes place on the spot date i.e. on the second working day following the date of the deal i.e. 3rd Nov 2021. This is known as a Spot deal. If the date of Spot deal is 1st November 2021, settlement date will be 3rd November 2021, presuming both markets in Mumbai and Frankfurt are working on 1st, 2nd and 3rd November 2021. If not, it will be the next working day in both the countries. Intervening Saturdays and Sundays will also postpone the settlement date to next working day.

## Forward

- **Delivery of funds takes place on any day after Spot date**, e.g., if the date of forward deal is 3 October 2016 (Monday), for value settlement date 30 October 2016 or 30 November 2016, it is a forward deal.

## Cross Rate

- When we deal in a market where rates for a particular currency pair are not directly available, the price for the said currency pair is then obtained indirectly with the help of cross rate mechanism. **This can be explained with the following example:**
- Suppose, we intend to get a quote for Euro/INR and no one is prepared to quote Euro/INR directly in the market. We can work out a Euro/INR quote through Euro/USD and USD/INR quotes.
- Euro/USD quote would be available in the international markets and USD/INR would be available in the domestic market. By crossing out USD in both the quotes, we can arrive at an effective Euro/ Rs. Quote
- This is the basis for working out cross rates. Cross rate mechanism is a possible solution for calculation of rates for currency pairs which are not actively traded in the market.
- For example, we need to quote GBP against INR, but in India, usually GBP is not quoted directly, as such we need to take rates for USD/INR and GBP/USD to compute GBP/INR rate.
- **If, USD/INR is 68.10/11, and GBP/USD is 1.2100/10, then, to GBP/INR rate, we need to cross (multiply) both the given rates, which would give us GBP/INR rate as Rs. 82.40/82.48.**
- Or say if USD/JPY is 116.50/60, the rate for Rupee/JPY would be Rs. 58.40/46 per 100 JPY (JPY being quoted per 100 units, due to their values).

## Forward Margins –

- Premium and Discounts Forward rates are derived from spot rates, and are a function of the spot rates and the forward premium or discount of the currency being quoted.
- **Forward rate = Spot rate + Premium (or – Discount).**

## Fixed vs. Floating Rates

- **The fixed exchange rate is the official rate set by the monetary authorities for currencies.** It is usually pegged to one or more currencies. **Under floating exchange rate, the value of the currency is decided by supply and demand factors for that particular currency.**

- In some cases, even fixed exchange rates are allowed to fluctuate between definite upper and lower bands, as fixed by the monetary authority of the country.

### Bid and Offer Rates

- **The buying rates and selling rates are also referred to as bid and offer rates.** In a USD/INR quote, of 68.10/11, the quoting bank is bidding for USD at 68.10 and is offering to sell the USD at 68.11. On the other hand, in a GBP/USD rate 1.2100/10, the quoting bank is willing to buy GBP at 1.2100 and willing to sell at 1.2110

### Exchange Arithmetic - Theoretical Overview

- **All foreign exchange calculations have to be worked out with extreme care and accuracy and the decimal point has also to be correctly placed.** Constant check is also required to minimize the risk of mistake, as the markets work on very thin margins. An error in one quote may erode earnings from several trades/transactions.

### Chain Rule

- **It is used in attaining a comparison or ratio between two quantities linked together through another or other quantities and consists of a series of equations,** commencing with a statement of the problem in the form of a query and continuing the equation in the form of a chain so that each equation must start in terms of the same currency as that which concluded the previous equation.

### Per Cent and Per Mille

- **A percentage (%) is a proportion per hundred,** e.g., 1% is one part in every hundred parts such as Rupee 1 per Rupees 100, while per mille means per thousand, e.g., 1 per mille is one part in every thousand, such as Rupee 1 per Rupees 1,000.

### Value Date

- **This is the term used to define the date on which a payment of funds or an entry to an account becomes actually effective and/or subjected to interest,** if any. In the case of payments on Telegraphic Transfers (TT) the value date is usually the same in both centres

## Arbitrage in Exchange

- Arbitrages consist of the simultaneous buying and selling of a commodity or currency in two or more markets to take advantage of temporary discrepancies in prices.

### **Foreign Exchange Dealing Room Operations**

The FOREX dealing room operations comprise functions of a service branch to meet the requirements of customers of other branches/divisions to buy or sell foreign currency, manage foreign currency assets and/or liabilities, fund and manage NOSTRO accounts as also undertake proprietary trading in currencies. It acts as a separate profit centre for the bank/institution.

While conducting treasury management operations, relating to foreign exchange operations of the Bank, the treasurer has to ensure that the operations are in compliance with the:

- Internal Control Guidelines of the Reserve Bank of India
- FEDAI regulations
- Internal guidelines of the Bank.

### **Management and Control of a Dealing Room**

- **Reserve Bank of India, has advised that the Board of Directors of banks should frame an appropriate policy and fix suitable limits for its FOREX dealing functions.**
- The management of dealing room operations should focus on risk associated with foreign exchange dealing room operations, which arise due to complex nature of foreign exchange markets and the volatile nature of exchange rate movements.
- The major risks associated with foreign exchange dealing operations, where the management needs to frame policies and keep a constant vigil, can be summarized as under.

### **Functions of Integrated Treasury**

*The broad functions of an Integrated Treasury are as follows:*

- Meeting CRR and SLR requirements and having an optimum mix of investment portfolio.

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

#### **Internal Control Guidelines of RBI**

It is very important that the dealing room adheres to the internal control guidelines of RBI in the regular conduct of the dealing room operations of the Bank. The following are some of the important Internal Control Guidelines of RBI which needs to be put in place by Banks:

- The data processing systems used must be appropriated to the nature and volume of activities in order to ensure functional separation.
- Access rules for performing distinct functions should be defined in detail and drawn up for persons unconnected with the dealing activities.
- Confidentiality of data in the systems may be ensured in case of outsourcing of IT services to the external agencies.
- Global limits for Inter-Bank deals (both domestic & overseas) to be put in place consistent with the overall risk management processes.
- Adequacy of capital to undertake aggressive dealing activities bearing in mind the Bank's capital and earnings performance.
- Appropriate VAR models for quantifying the extent of market risk for a given level of confidence.

- Periodic review and validation of existing models to test the robustness of such models.
- Every dealer should be advised of the limits (including the stop loss limits) allocated and work within the limits.
- All deals done have to be within the corresponding limits fixed viz., the counter-party 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.
- Evaluation of foreign exchange profits & losses at the closing rates of every month as announced by FEDAI.

<i>Front Office</i>	<i>Mid Office</i>	<i>Back Office</i>
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

**ambitious baba**  
**RBI/FEDAI Guidelines**

**The Reserve BANK of India, being the central bank of the country and the custodian of nation's foreign exchange reserves, has prescribed guidelines for authorized dealers,** permitted by it, to deal in foreign exchange and handle foreign currency transactions. FEMA 1999, also prescribes rules for persons, Corporates, etc., in handling foreign currencies, as also transactions denominated therein.

The Reserve Bank of India issues Authorized Dealers' (AD) licenses to banks and all-India financial institutions to undertake foreign exchange transactions in India. At present there are over 90 ADs, which include all public sector banks, foreign and a large number of private banks, a few all-India financial institutions and a few Scheduled cooperative banks.

The RBI also issues Money Changer licenses to a large number of established firms, companies, hotel, shops, etc., to deal in foreign currency notes, coins and traveller's cheques, to facilitate encashment foreign currency for foreign tourists. Entities authorized to buy and sell foreign currency notes, coins and traveller's cheques are called Full Fledged Money Changers (FFMCs) while those authorized only to buy are called Restricted Money Changers (RMCs).

**Categorization of Authorized Dealers:** In the year 2006, the categorization of dealers authorized to deal in foreign exchange has been changed by the Reserve Bank of India. The entities so authorized are called as Authorized Persons, with category, denoting **their level of authority to undertake variety of transactions, as under:**

- **Authorized Dealer – Category I:** They can handle all current and capital account transactions according to RBI directions issued from time-to-time. Eg., Commercial banks, State and Urban Cooperative Banks
- **Authorized Dealer – Category II:** Entities that can deal in transaction of foreign exchange which are of non-trade nature. Eg., Upgraded FFMCs, Other cooperative banks, Regional Rural Banks.
- **Authorized Dealer – Category III:** Institutions that can deal with forex transactions which are incidental to financing of international trade related activities undertaken by these institutions, eg., Exim Bank, SIDBI.
- **Full Fledged Money Changer:** Purchase of foreign exchange and sale for private and business visits abroad. Eg., Other FFMCs, Dept of Post.
- **Foreign Exchange Operations,** undertaken without any boundaries or controls, can adversely affect the movement of exchange rates and the value of currency, besides profitability of the entity dealing in an undisciplined manner. Hence, RBI has prescribed broad guidelines with regard to foreign exchange operations in order to have regulated and disciplined market operations.
- RBI guidelines include those related to open positions, gaps, borrowing and lending in foreign currencies, interbank dealings in India and Overseas Markets, hedging of bank's own exposures as well as that of its resident and non-resident clients.

**Foreign Exchange Dealers Association of India, (FEDAI),** on the other hand, is a non-profit making body, formed in 1958 with the approval of Reserve Bank of India, consisting of Authorized dealers as members. FEDAI prescribes guidelines and rules for

market operations, merchant rates, quotations, delivery dates, holidays, interest on defaults, etc. In terms of RBI directives, all authorized dealers are members of FEDAI and it is mandatory for them to follow the guidelines/directives issued by FEDAI.

***A few of the major FEDAI guidelines/rules can be summarized as under:***

- All export bills to be allowed standard transit period (NTP – normal transit period), as prescribed, for the purpose of allowing concessional interest rates and calculation of notional due dates.
- Export bills drawn in foreign currency, purchased/discounted/negotiated, must be crystallized in rupee liability, in case of delay in realization of export bills. The same would be done at TT selling rate. The prescription of crystallization of export bills on the 30th day from the due date/notional date, has since been relaxed. Authorized Dealer Banks should formulate their own policy for crystallization of foreign currency liability into Rupee liability. The policy in this regard should transparently available to the customers.
- Unpaid foreign currency import bills drawn under letters of credit shall be crystallized as per the stated policy of the Bank in this respect.
- All forward contracts must be for a definite amount and period with specific delivery dates.
- Option period can be specified by the customer, in case of forward contracts, but in any case, the delivery period under the contract shall not exceed beyond one month. All such contracts must state the start and end dates.
- Cancellation of forward contracts - All contracts, which have matured and have not been picked up, shall be automatically cancelled on the THIRD working day, after the maturity date.
- All cancellations shall be at bank's opposite TT rates, TT selling rate for purchase contracts and TT buying rate for sale contracts.
- In the event of delay in payment of interbank foreign currency funds, interest at 2% above the prime rate of the currency of the specified banks shall be paid by the defaulting bank.
- In the event of delay in payment of rupee settlement funds, interest for delayed period at 2% above the NSE MIBOR ruling on each day shall be paid.

- All currencies to be quoted as – per unit of foreign currency = INR, while JPY, Indonesian Rupiah & Kenyan Shilling are to be quoted as 100 units of foreign currency = INR.
- FEDAI also prescribes code of conduct for FOREX dealers, as also guidelines with regard to dealings with FOREX brokers.

**Example 1**

Inflow of USD 100,000.00 by TT for credit to your exporter's account, being advance payment for exports (credit received in NOSTRO statement received from New York correspondent). What rate you will take to quote to the customer, if the market is 68.09/11?

**Answer**

It will be purchase of USD from customer for which USD will have to be sold in the market. Say when USD/INR is being quoted as 68.09/11, meaning that market buys USD at INR 68.09 and sells at INR) 68.11. We shall have to quote rate to the customer on the basis of market buying rate, i.e. 68.09 less margin, as applicable, to arrive at the IT Buying Rate applicable for the customer transaction.

**Example 2**

Retirement of import bill for GBP 100,000.00 by TT Margin 0.20%, ignore cash discount/premium, GBP/ USD 1.2175/85, USD/INR 68.14/15. Compute Rate for Customer

**Answer**

For retirement of import bill in GBP, we need to buy GBP, to buy GBP we need to give USD and to get USD, we need to buy USD against Rupee, i.e. sell Rupee.

At the given rates, GBP can be bought at 1.2185 USD, while USD can be bought at 68.15.

The GBP/INR rate would be 83.0408 (1.2185X68.15), at which we can get GBP at market rates. Thus the interbank rate for the transaction can be taken as 83.0408.

Add Margin 0.20% 0.1660.

Rate would be 83.0408 +0.1660 = 83.2068 or say 83.2070 for effecting import payment. (Bill Selling Rate).

**Example 3**

On 15 September, a customer requests for booking of a forward contract for export bill of USD 150,000.00, to be realized in the month of December.

Given that USD/INR spot is 68.45/50 and forward premium is as under:

October: 18/19 paise

November: 30/32 paise

December: 41/43 paise

Margin to be charged 0.05 paise per USD.

### **Answer**

For calculating rate for forward purchase contract, we need to take forward premium for November, the one that the market would pay, i.e. 30 paise. Spot rate as 68.45, getting forward interbank rate as 68.75 and deduct 0.05 paise as margin to arrive at 68.70 the customer forward rate for delivery of export proceeds during December, full month at the option of the customer (Forward TT Buying Rate). Forward margin for the period prior to the start of the delivery period would be passed on, as the customer has an option to deliver currency on the first day itself, i.e. 1st December.

### **Management and control of a Dealing room**

Reserve Bank of India, has advised that the Board of Directors of banks should frame an appropriate policy and fix suitable limits for its FOREX dealing operations.

The management of dealing room operations should focus on the risks associated with foreign exchange dealing room operations, which in turn arise from the complex nature of foreign exchange markets and the volatile nature of exchange rate movements.

**The major risks associated with foreign exchange dealing operations, where the management needs to frame policies and keep a constant vigil, can be summarized as under:**

- Operational Risk
- Exchange Risk
- Credit Risk
- Settlement risk
- Liquidity Risk
- Gap Risk/Interest Rate Risk
- Market Risk
- Interest rate risk
- Equity Price risk
- Currency risk
- Legal Risk
- Systemic Risk
- Country Risk
- Sovereign Risk

***The following are some of the risk containment measures which need to be adhered to during the course of dealing room operations:***

- Every dealer should be advised of the limits allocated to him/her and work within the limits.
- All deals done with counter-parties are to be within the corresponding limits.
- Overall position to be arrived at the end of the day and well within the NOOPL, AGL, IGL, as approved by the Bank's Board.
- Adequate monitoring of the mismatches in maturities, positions, etc. should be ensured.
- Evaluation of foreign exchange profits & losses should be carried out periodically.
- Reconciliation of balances in the RBI accounts, Nostro and Vostro accounts should be done periodically, say, atleast once in a month.
- Debits/Credits in Mirror accounts, confirmation of balances should be obtained periodically from the Nostro correspondents and confirmation should be provided to the Banks maintaining Vostro (INR) accounts.

### **Derivative Products**

**Financial Management of the Multinational Enterprises (MNEs) and Multinational Corporations (MNCs)** in the 21st Century has resulted in International trade volumes across the globe and prevalence of risk in all aspects of trade became prevalent. The development and growth of Financial Derivatives products has been one of the extraordinary and important features of the financial markets. Derivatives came into existence because of the prevalence of risk in every business and became an important tool in hedging such risks.

A derivative is a financial product whose value is derived from the value of another underlying asset or exposure viz., Commodity, Equity, Bond, Foreign Currency Position, etc., and includes Futures, Forward contracts, Option contracts, Swaps, etc. These instruments can be used for two very distinct objectives:

- **Speculation** – use of derivative instruments to take a position with the expectation of a profit,
- **Hedging** – use of derivative instruments to reduce the risks associated with the everyday management of corporate cash flows.

### **Foreign Currency Futures**

- A Foreign Currency Futures Contract which is traded in an exchange is an alternative to a forward contract that calls for future delivery of a standard amount of foreign exchange at a fixed time, place and price.
- It is similar to Futures Contracts that exist for other products/commodities such as Cattle, Rubber, Metals, Pulses, Interest-bearing deposits, Gold, etc. The most important market for foreign currency futures is the International Monetary Market (IMM), a division of the Chicago Mercantile Exchange (CME).

## Forward Contracts – Characteristics

- Agreement between the Bank and the customer agreeing on a price for a particular amount specified for delivery at a future date.
- Delivery either under Option basis or on a fixed date.
- Generally for periods upto one year and can extend beyond one year depending on the maturity of the underlying (LTFX contracts – Long-term forward contracts).
- Documentary evidence and genuineness of the underlying. Verification of the underlying and marking on the original documents.
- Maturity of the hedge should not exceed maturity of the underlying.
- Contracts should be in alignment with credit limits and due diligence is to be carried out.
- Contracts are to be utilized either prior to maturity or on maturity date. If not utilized on the maturity and it is cancelled, profits or losses are settled, as the case may be.
- If cancelled after maturity date, losses are recovered but profits will not be passed on.

## Forward Contracts v/s Futures Contracts

- Forwards are of any size while Futures are standardized.
- Forwards are generally for maturities up to one year and beyond while futures are generally up to one year.
- Forwards are between Clients and Banks while futures are between clients and the Exchange.
- Prices in a forward contract are determined by bid/ask quotes while prices in futures determined through an outcry on the floor of the exchange or through Electronic trading platform.
- In forward contracts, there are no explicit collaterals while initial margins and on mark to market basis additional margins are needed in a futures contract.
- Forward contracts are delivered/ utilized or cancelled on due dates while settlement under futures take place through off-setting of positions or through physical delivery some times.
- Forward markets are open 24 hours as per the conveniences of the parties while futures markets function during traditional exchange hours.
- While in forward contracts, parties are in direct contact, the parties in future contracts are not known to each other, but deal through the exchange.
- There is no explicit commission earned under forward contracts and Bank earns through the bid/ ask spreads while under futures, a single commission concept is prevalent.

## Options

- Option is a contract giving the purchaser the right but not the obligation to buy or sell a given amount of the security/stock/currency at a fixed price per unit for a specified time period. The two basic options are Call and Put options.

- Under CALL Option, the Buyer has the right to purchase the currency (generally Imports) and under the PUT Option, Buyer has the right to sell the currency (generally Exports).
- The Buyer of the Option is called the holder while the Seller of the option is referred to as the writer or the grantor of the Option.

#### Every option has 3 different price elements:

- The strike or exercise price, which is the exchange rate at which the option can be purchased or sold.
- The premium, which is the cost of the option paid at the time the option is purchased.
- The actual spot rate in the market at the time the option contract is purchased.

#### Pricing of an option combines the following 5 elements:

- Present spot rate
- Time to maturity
- Forward rate for the underlying matching maturity
- Interest rates for the intervening currency/stock/security
- Volatility, i.e. (standard deviation from spot to forward rates)

**Types of Option** - An American Option gives the buyer the right to exercise the option at any time between the date of writing and the expiration or maturity date. A European Option can be exercised only on its expiration date, not before. The premium, or option price, is the cost of the option.

#### SWAPS

- Swaps are derivative instruments that represent an agreement between two parties to exchange a series of cash flows over a specific period of time. Swaps offer great flexibility in designing and structuring contracts based on mutual agreement. This flexibility generates many swap variations, with each serving a specific purpose.

#### Factors influencing SWAPS

- Investment objectives or repayment scenarios may have changed.
- Increased financial benefit in switching to newly available or alternative cash flow streams.
- The need may arise to hedge or mitigate risk associated with a floating rate loan repayment.

#### Types of SWAPS

- **Interest Rate Swap:** An interest rate swap is a contractual agreement to exchange a series of cash flows where cash flows at a fixed rate of interest are exchanged for those referenced to a floating rate. While one leg of cash flow is based on a fixed interest rate, the other leg is based on a floating interest rate over a period of time. There is no exchange of the principal amounts. The size of

the swap is referred to as the notional amount and is the basis for calculating the cash flows.

- **Currency Swap:** A currency swap is contractually similar to an interest rate swap where cash flows in one currency are exchanged for cash flows in another currency. The transactional value of capital that changes hands in currency markets surpasses that of all other markets. Currency swaps offer efficient ways to hedge forex risk as well interest rate risk at one go.
- **Zero Coupon Swaps:** Similar to the interest rate swap, the zero coupon swap offers flexibility to one of the parties in the swap transaction. In a fixed-to-floating zero coupon swap, the fixed rate cash flows are not paid periodically, but just once at the end of the maturity of the swap contract. The other party who pays floating rate keeps making regular periodic payments following the standard swap payment schedule. A fixed-fixed zero coupon swap is also available, wherein one party does not make any interim payments, but the other party keeps paying fixed payments as per the schedule.
- **Equity Swap:** An equity swap is an exchange of future cash flows between two parties that allows each party to diversify its income for a specified period of time while still holding its original assets. The two sets of nominally equal cash flows are exchanged as per the terms of the swap, which may involve an equity-based cash flow (such as from a stock asset, called the reference equity) that is traded for fixed-income cash flow (such as a benchmark interest rate).
- **Basis Swap:** Where cash flows on both the legs of the swap are referenced to different floating rates. A Basis swap could be an Interest Rate Swap or a currency swap where both legs are based on a floating rate. A basis swap involves a regular exchange of cash flows, both of which are based on floating interest rates. Most swaps are based on payment of a fixed rate against a floating rate, say, SOFR (Secured Overnight Financing Rate). In the basis swap both legs are calculated on floating rates.

### **FX Global Code**

FX Global Committee at their global meet in London has endorsed the publication of the FX Global Code, a **uniform code across the globe for the wholesale foreign exchange markets which aims at the following:**

- Principles of good practices,
- Engaging local participants actively,
- Promoting healthy & disciplined dealing room trading, etc.
- Hongkong Monetary Authority (HKMA), Monetary Authority of Singapore (MAS), Reserve Bank of Australia (RBA), Bank of Korea and RBI apart from the Federal Reserve Bank, USA have already endorsed the FX Global Code,
- The revised FEDAI Code of Conduct Adoption and Implementation in the Indian Foreign Exchange Market is implemented w.e.f. 1st Sept 2021.
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