[Academic Script]

Introduction to Financial Management

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Unit No. & Title:	Unit – 1 Introduction to the Foreign Exchange Market and Fundamental Issues
Lecture No. & Title:	Lecture – 1 Introduction to Financial Management

Academic Script

1. Introduction to Financial Management

International Financial Management is a well-known term in today's world and it is also known as international finance. It means financial management in an international business environment. It is different because of the different currency of different countries, dissimilar political situations, imperfect markets, diversified opportunity sets.

International Financial Management came into being when the countries of the world started opening their doors for each other. This phenomenon is well known by the name of "liberalization". Due to the open environment and freedom to conduct business in any corner of the world, entrepreneurs started looking for opportunities even outside their country boundaries. The spark of liberalization was further aired by swift progression in telecommunications and transportation technologies that too with increased accessibility and daily dropping prices. Apart from everything else, we cannot forget the contribution of financial innovations such as currency derivatives; cross-border stock listings, multi-currency bonds and international mutual funds.

The resultant of liberalization and technology advancement is today's dynamic international business environment. Financial management for a domestic business and an international business is as dramatically different as the opportunities in the two. The meaning and objective of financial management do not change in international financial management but the dimensions and dynamics change drastically.

A sound management of international finances can help an organization achieve same efficiency and effectiveness in all markets. Thus to understand international finance it is important to learn about foreign exchange markets also called as forex markets. For this purpose in today’s session we will learn about the basic of foreign exchange markets, settlement and communication happening in it and the Participants of the market.

2. Foreign Exchange Market

A Foreign exchange market is a market in which currencies are bought and sold. It is to be distinguished from a financial market where currencies are borrowed and lent.

General Features

Foreign exchange market is described as an OTC (Over the counter) market as there is no physical place where the participants meet to execute their deals. It is more an informal arrangement among the banks and brokers operating in a financing centre purchasing and selling currencies, connected to each other by tele communications like telex, telephone and a satellite communication network, SWIFT. The term foreign exchange market is used to refer to the wholesale a segment of the market, where the dealings take place among the banks. The retail segment refers to the dealings take place between banks and their customers. The retail segment refers to the dealings take place between banks and their customers. The retail segment is situated at a large number of places. They can be considered not as foreign exchange markets, but as the counters of such markets.

The leading foreign exchange market in India is Mumbai, Calcutta, Chennai and Delhi is other centers accounting for bulk of the exchange dealings in India. The policy of Reserve Bank has been to decentralize exchanges operations and develop broader based exchange markets. As a result of the efforts of Reserve Bank Cochin, Bangalore, Ahmadabad and Goa have emerged as new centre of foreign exchange market.

Size of the Market

Foreign exchange market is the largest financial market with a daily turnover of over USD 2 trillion. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade. But these markets have developed on their own so much so that a turnover of about 3 days in the foreign exchange market is equivalent to the magnitude of world trade in goods and services. The largest foreign exchange market is London followed by New York, Tokyo, Zurich and Frankfurt.

The business in foreign exchange markets in India has shown a steady increase as a consequence of increase in the volume of foreign trade of the country, improvement in the communications systems and greater access to the international exchange markets. Still the volume of transactions in these markets amounting to about USD 2 billion per day does not compete favorably with any well developed foreign exchange market of international repute. The reasons are not far to seek. Rupee is not an internationally traded currency and is not in great demand. Much of the external trade of the country is designated in leading currencies of the world, Viz., US dollar, pound sterling, Euro, Japanese yen and Swiss franc. Incidentally, these are the currencies that are traded actively in the foreign exchange market in India.

24 Hours Market

The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day. However, a specific market will function only during the business hours. Some of the banks having international network and having centralized control of funds management may keep their foreign exchange department in the key centre open throughout to keep up with developments at other centers during their normal working hours

In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

Efficiency

Developments in communication have largely contributed to the efficiency of the market. The participants keep abreast of current happenings by access to such services like Dow Jones Telerate and Teuter. Any significant development in any market is almost instantaneously received by the other market situated at a far off place and thus has global impact. This makes the foreign exchange market very efficient as if the functioning under one roof.

Currencies Traded

In most markets, US dollar is the vehicle currency, Viz., the currency used to denominate international transactions. This is despite the fact that with currencies like Euro and Yen gaining larger share, the share of US dollar in the total turn over is shrinking.

Physical Markets

In few centers like Paris and Brussels, foreign exchange business takes place at a fixed place, such as the local stock exchange buildings. At these physical markets, the banks meet and in the presence of the representative of the central bankand on the basis of bargains, fix rates for a number of major currencies. This practice is called fixing. The rates thus fixed are used to execute customer orders previously placed with the banks. An advantage claimed for this procedure is that exchange rate for commercial transactions will be market determined, not influenced by any one bank. However, it is observed that the large banks attending such meetings with large commercial orders backing up, tend to influence the rates.

3. Participants

The participants in the foreign exchange market comprise;

(i) Corporates

(ii) Commercial banks

(iii) Exchange brokers

(iv) Central banks

Corporates: The business houses, international investors, and multinational corporations may operate in the market to meet their genuine trade or investment requirements. They may also buy or sell currencies with a view to speculate or trade in currencies to the extent permitted by the exchange control regulations. They operate by placing orders with the commercial banks. The deals between banks and their clients form the retail segment of foreign exchange market.

In India the foreign Exchange Management (Possession and Retention of Foreign Currency) Regulations, 2000 permits retention, by resident, of foreign currency up to USD 2,000. Foreign Currency Management (Realisation, Repatriation and

Surrender of Foreign Exchange) Regulations, 2000 requires a resident in India who receives foreign exchange to surrender it to an authorized dealer

(a) Within seven days of receipt in case of receipt by way of remuneration, settlement of lawful obligations, income on assets held abroad, inheritance, settlement or gift: and
(b) Within ninety days in all other cases.

Any person who acquires foreign exchange but could not use it for the purpose or for any other permitted purpose is required to surrender the unutilized foreign exchange to authorized dealers within sixty days from the date of acquisition. In case the foreign exchange was acquired for travel abroad, the unspent foreign exchange should be surrendered within ninety days from the date of return to India when the foreign exchange is in the form of foreign currency notes and coins and within 180 days in case of travellers cheques.

Similarly, if a resident required foreign exchange for an approved purpose, he should obtain from and authorized dealer.

Commercial Banks are the major players in the market. They buy and sell currencies for their clients. They may also operate on their own. When a bank enters a market to correct excess or sale or purchase position in a foreign currency arising from its various deals with its customers, it is said to do a cover operation. Such transactions constitute hardly 5% of the total transactions done by a large bank. A major portion of the volume is accounted buy trading in currencies indulged by the bank to gain from exchange movements. For transactions involving large volumes, banks may deal directly among themselves. For smaller transactions, the intermediation of foreign exchange brokers may be sought.

Exchange brokers facilitate deal between banks. In the absence of exchange brokers, banks have to contact each other for quotes. If there are 150 banks at a centre, for obtaining the best quote for a single currency, a dealer may have to contact 149 banks. Exchange brokers ensure that the most favorable quotation is obtained and at low cost in terms of time and money. The bank may leave with the broker the limit up to which and the rate at which it wishes to buy or sell the foreign currency concerned. From the intends from other banks, the broker will be able to match the requirements of both. The names of the counter parities are revealed to the banks only when the deal is acceptable to them. Till then anonymity is maintained. Exchange brokers tend to specialize in certain exotic currencies, but they also handle all major currencies.

In India, banks may deal directly or through recognized exchange brokers. Accredited exchange brokers are permitted to contract exchange business on behalf of authorized dealers in foreign exchange only upon the understanding that they will conform to the rates, rules and conditions laid down by the FEDAI. All contracts must bear the clause —subject to the Rules and Regulations of the Foreign

Exchanges Dealers Association of India

Central Bank may intervene in the market to influence the exchange rate and change it from that would result only from private supplies and demands. The central bank may transact in the market on its own for the above purpose. Or, it may do so on behalf of the government when it buys or sell bonds and settles other transactions which may involve foreign exchange payments and receipts.

In India, authorized dealers have recourse to Reserve Bank to sell/buy US dollars to the extent the latter is prepared to transact in the currency at the given point of time. Reserve Bank will not ordinarily buy/sell any other currency from/to authorized dealers. The contract can be entered into on any working day of the Dealing room of Reserve Bank. No transaction is entered into on Saturdays. The value date for spot as well as forward delivery should be in conformity with the national and international practice in this regard.

Reserve Bank of India does not enter into the market in the ordinary course, where the exchanges rates are moving in a detrimental way due to speculative forces, the Reserve Bank may intervene in the market either directly or through the State Bank of India.

4. Settlement of Transactions

Foreign exchange markets make extensive use of the latest developments in telecommunications for transmitting as well settling foreign exchange transaction, Banks use the exclusive network SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.

SWIFT

SWIFT is a acronym for Society for Worldwide Interbank Financial Telecommunications, a co operative society owned by about 250 banks in Europe and North America and registered as a co operative society in Brussels, Belgium. It is a communications network for international financial market transactions linking effectively more than 25,000 financial institutions throughout the world who have been allotted bank identified codes. The messages are transmitted from country to country via central interconnected operating centers located in Brussels, Amsterdam and Culpeper, Virginia. The member countries are connected to the centre through regional processors in each country. The local banks in each country reach the regional processors through the national net works.

The SWIFT System enables the member banks to transact among themselves quickly

(i) International payments

(ii) Statements

(iii) Other messages connected with international banking.

Transmission of messages takes place within seconds, and therefore this method is economical as well as time saving.

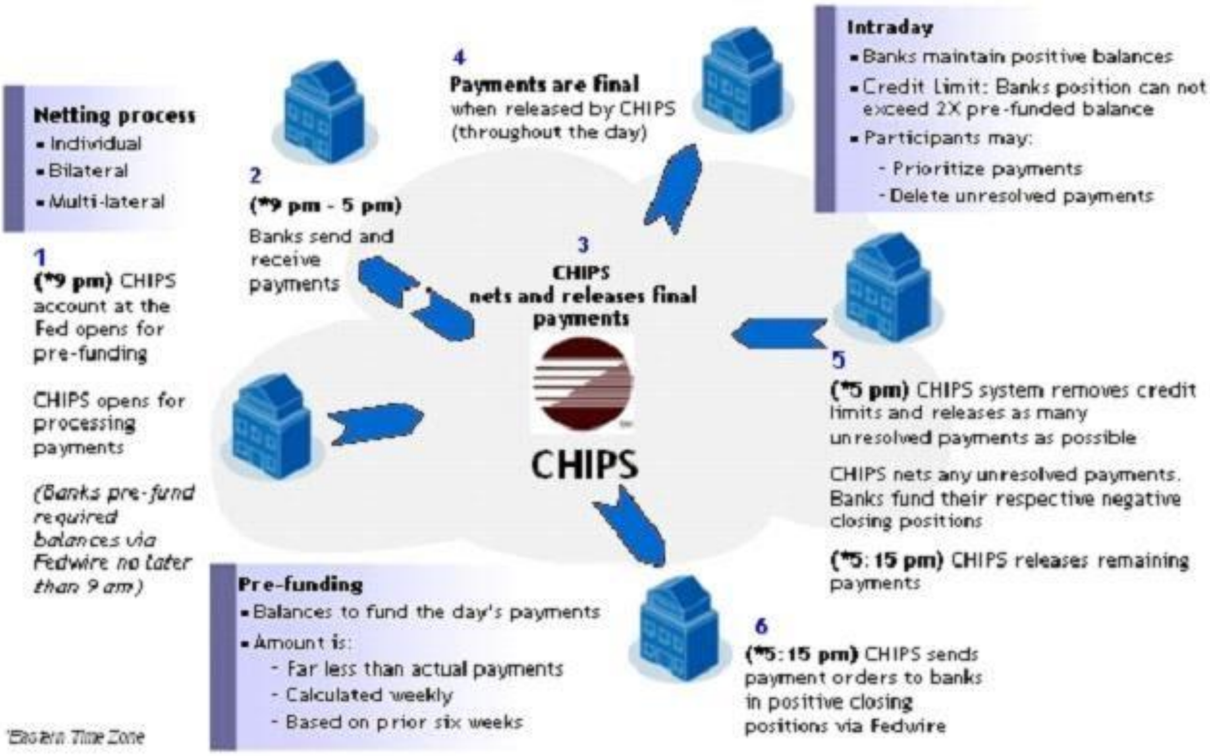
Selected banks in India have become members of SWIFT. The regional processing centre is situated at Mumbai.

The SWIFT provides following advantages for the local banking community:

1. Provides a reliable (time tested) method of sending and receiving messages from a vast number of banks in a large number of locations around the world.
2. Reliability and accuracy is further enhanced by the built in authentication facilities, which has only to be exchanged with each counterparty before they can be activated or further communications.
3. Message relay is instantaneous enabling the counterparty to respond immediately, if not prevented by time differences.
4. Access is available t a vast number of banks global for launching new cross border initiatives.
5. Since communication in SWIFT is to be done using structure formats for various types of banking transactions, the matter to be conveyed will be very clear and there will not be any ambiguity of any sort for the received to revert for clarifications. This is mainly because the formats are used all ove3r the world on a standardized basis for conducting all types of banking transactions. This makes the responses and execution very efficient at the receiving banks end thereby contributing immensely to quality service being provided to the customers of both banks (sending and receiving).
6. Usage of SWIFT structure formats for message transmission to counterparties will entail the generation of local banks internal records using at least minimum level of automation. This will accelerate the local banks internal automation activities, since the maximum utilization of SWIFT a

significant internal automation level is required.

CHIPS



CHIPS stands for Clearing House Interbank Payment System. It is an electronic payment system owned by 12 private commercial banks constituting the New York Clearing House Association. A CHIP began its operations in 1971 and has grown to be the world�trs largest payment system. Foreign exchange and Euro dollar transactions are settled through CHIPS. It provides the mechanism for settlement every day of payment and receipts of numerous dollar transactions among member banks at New York, without the need for physical exchange of cheques/funds for each such transaction.

The functioning of CHIPS arrangement is explained below with a hypothetical transaction: Bank of India, maintaining a dollar account with Amex Bank, New York, sells USD 1 million to Canara Bank, maintaining dollar account with Citibank.

1. Bank of India intimate Amex Bank debuts the account of Bank

through SWIFT to debit its account and transfer USD 1 million to Citibank for credit of current account of Canara Bank.

2. Amex Bank debits the account of Bank of India with USD 1 million and sends the equivalent of electronic cheques to CHIPS for crediting the account of Citibank. The transfer is effected the same day.
3. Numerous such transactions are reported to CHIPS by member banks and transfer effected at CHIPS. By about 4.30 p.m, eastern time, the net position of each member is arrived at and funds made available at Fedwire for use by the bank concerned by 6.00 p.m. eastern time.
4. Citibank which receives the credit intimates Canara Bank through SWIFT.

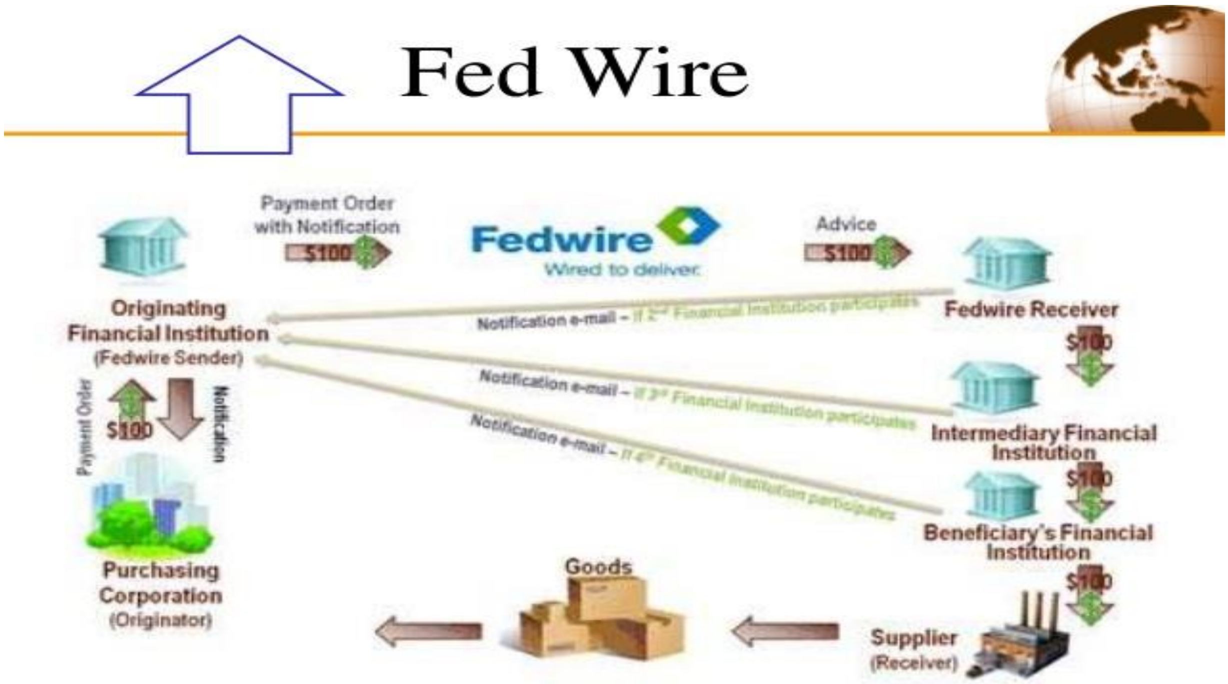
It may be noted that settlement of transactions in the New York foreign exchange market takes place in two stages, First clearance at CHIPS and arriving at the net position for each bank. Second, transfer of fedfunds for the net position. The real balances are held by banks only with Federal Reserve Banks (Fedfunds) and the transaction is complete only when Fedfunds are transferred. CHIPS help in expediting the reconciliation and reducing the number of entries that pass through Fedwire.

CHAPS

It is an arrangement similar to CHIPS that exists in London. CHAPS stands for Clearing House Automated Payment System.

Fedwire

The transactions at New York foreign exchange market ultimately get settled through Fedwire. It is a communication network that links the computers of about 7000 banks to the computers of federal Reserve Banks. The fedwire funds transfer system, operate by the Federal Reserve Bank, are used primarily for domestic payments, bank to bank and third party transfers such as interbank overnight funds sales and purchases and settlement transactions. Corporate to corporate payments can also be made, but they should be effected through banks. Fed guarantees settlement on all payments sent to receivers even if the sender fails.



5. Summary

Let us summarize today's session. International Finance has become an important wing for all big Multi-National Companies. Without the expertise in International Financial Management, it can be difficult to sustain in the market because international financial markets have a totally different shape and analytics compared to the domestic financial markets. Thus in this session we tried understanding the basics of forex market by understanding its basic features, the settlement mechanisms through CHIPS, CHAPS and Fedwire, communication through SWIFT mechanism and also the Participants in the market which includes:

Corporate, Commercial banks, Exchange brokers and Central banks.