

BFM — Bank Financial Management

Complete Book | Table of Contents | 31 chapters + 4 sections

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CH-1

Exchange Rates and Forex Business

Topic 1 — Foreign Exchange — FEMA

Definition

- Need** — Cross-border trade needs conversion of the invoice currency into the trader's home currency.
- Exporter's view** — For an Indian exporter, **USD or EUR** is foreign exchange.
- Buyer's view** — For the American buyer or German seller, the **Indian rupee** is foreign exchange.

Section 2 of FEMA, 1999 defines **foreign exchange** as foreign currency, and includes:

Limb	Instruments covered
(i)	All deposits, credits and balances payable in foreign currency, and drafts, traveller's cheques, LCs and bills of exchange expressed or drawn in Indian currency but payable in foreign currency.
(ii)	Drafts, traveller's cheques, LCs and bills of exchange drawn by banks, institutions or persons outside India but payable in Indian currency.

- Forex transaction** — A contract to exchange funds in one currency for another at an agreed rate.
- Exchange rate** — The price or ratio at which one currency is exchanged for another.
- Examples** — USD 1 = ₹76.10; EUR 1 = USD 1.19.
- Dynamic** — The rate changes several times a second.

Topic 2 — Foreign Exchange Markets and Participants

- Nature** — The forex market is a **communication-system based market** with no physical boundaries.
- Timing** — It operates **round the clock**, within and across countries.
- Time zones** — The **Indian and Middle East** markets open before **Singapore and Hong Kong** close.

Major participants	
1. Central banks	2. Commercial banks
3. Investment funds / banks	4. Forex brokers
5. Corporations	6. Individuals

Topic 3 — Factors Determining Exchange Rates

Spot rates are the base quotes in the market and are the most dynamic. Factors fall into two groups.

Factor	Effect on currency
Balance of payments	Surplus generally strengthens; deficit weakens. BoP records all monetary transactions between residents and the rest of the world in a period.
Economic growth	Affects imports and capital flows; net effect depends on productivity, investment and expectations.
Fiscal policy	Expansionary policy (e.g., lower taxes) can lead to higher growth.
Monetary policy	Central bank control over interest and money supply affects currency value.
Interest rates	Higher relative rates can attract capital; inflation, risk and expectations also matter — not mechanical.
Political issues	Stability → steady currency; instability → weak currency.

Technical reasons

Factor	Effect
Government controls	Can create an unrealistic currency value and violent rate swings.
Capital movement	Freedom or restriction on capital flows moves rates sharply (e.g., oil-surplus funds invested overseas). Capital moves from lower-yielding to higher-yielding currencies.
Speculation	Expecting devaluation, speculators short-sell a currency to buy it back cheaper, which itself moves the market.

Topic 4 — Settlement Types — Cash, Tom, Spot and Forward

Deal	Settlement (value date)	Deal on Mon 5 Oct → value
Ready / Cash	Same day as deal (T + 0)	5 Oct
Tom	Next working day (T + 1)	6 Oct
Spot	Second working day (T + 2)	7 Oct
Forward	Any day after spot (> T + 2)	e.g., 30 Oct or 30 Nov

If a settlement day is a holiday in **either** country, settlement moves to the next working day in **both** countries. The **spot** market has the highest volume, depth and volatility.

Example: Contract dated 29/09/2020: delivery 29/09 → Cash; 30/09 → Tom; 01/10 → Spot; 15/10 → Forward (all days working).

Topic 5 — Forward Margins — Premium and Discount

Forward rates are derived from spot rates. A currency is at a **premium** when its forward value is **higher (costlier)** than spot, and at a **discount** when forward is **cheaper** than spot.

Forward rate, where p = premium and d = discount:

$$\text{Forward rate} = \text{Spot} + p$$

$$\text{Forward rate} = \text{Spot} - d$$

In a two-way quote, if the forward points are **ascending** (e.g., 68/69) they are a premium and are **added**; if **descending** (e.g., 40/35) they are a discount and are **deducted**.

Example: USD/INR spot 48.10/11; six-month premium 68/69 paise → forward 48.78/48.80. USD is at a premium, INR at a discount. GBP/USD spot 1.6000, 1-month 1.6050 → GBP at premium; 3-month 1.5900 → GBP at discount, USD at premium.

- Main driver** — Forward margins depend mainly on the **interest rate differential**.
- Other driver** — Demand and supply of forwards also affect forward margins.
- Perfect market** — In a perfect market, the interest factor is basic.
- Example** — US 3-month bills yield **2%** and UK bills yield **4%**.
- Result** — US investors buy GBP spot and sell GBP forward.
- Effect** — This creates spot demand for GBP and forward demand for USD.

Forward points depend on (i) spot price, (ii) interest rate differential and (iii) the forward period. Approximate forward points, where S = spot, D = annual interest differential, n = days:

$$\text{Forward points} \approx S \times D \times \frac{n}{360}$$

Example: EUR 1 = USD 1.60, differential 6%, 90 days: $1.60 \times 0.06 \times 90/360 = 0.024$. Spot 2.00, 4%, 60 days: $2.00 \times 0.04 \times 60/360 = 0.013333$.



Exact covered interest parity uses both interest rates, where R_h = home-currency (INR) rate, R_f = foreign-currency rate and t = period in years:

$$F = S \times \frac{1 + R_h t}{1 + R_f t}$$

Example: Spot USD/INR 83.00, INR rate 6%, USD rate 4%, 180 days ($t = 0.5$): $F = 83 \times 1.03 / 1.02 = \mathbf{83.8137}$. The differential shortcut is only an approximation.

Annualised forward premium or discount, where F = forward rate, S = spot and m = months:

$$\text{Annualised premium (\%)} = \frac{F - S}{S} \times \frac{12}{m} \times 100$$

Example: Spot 83.00, 3-month forward 83.83: $(0.83 / 83) \times 12 / 3 \times 100 = \mathbf{4\%}$ p.a. premium on USD.

Topic 6 — Direct and Indirect Quotes, Bid-Offer, Per Mille

Quote	Fixed / variable	Profit rule	Example
Direct	Foreign currency fixed; home currency variable	Buy low, sell high	USD 1 = ₹76.10
Indirect	Home currency fixed; foreign currency variable	Buy high, sell low	₹100 = USD 1.31

Conversion between the two forms:

$$\text{Direct rate} = \frac{100}{\text{Indirect rate per 100}}$$

Example: ₹100 = USD 1.20 → USD 1 = 100 / 1.20 = ₹83.33.

- **Bid** — The rate at which the quoting bank **buys**.
- **Offer** — The rate at which the quoting bank **sells**.
- **USD/INR 76.10/11** — The bank buys USD at 76.10 and sells USD at 76.11.
- **GBP/USD 1.6000/10** — The bank buys GBP at 1.6000 and sells GBP at 1.6010.

Per cent is one part per hundred (₹1 per ₹100); **per mille** is one part per **thousand** (₹1 per ₹1,000).

Fixed rate is the official rate set by the monetary authority, sometimes allowed to move within upper and lower **bands**.

Floating rate is determined by **demand and supply**.

Value date is the date on which a payment or entry becomes effective or interest-bearing. For **TT**, the value date is usually the same in both centres, so no party gains or loses interest.

Topic 7 — Cross Rates

When a currency pair is not directly quoted, its rate is derived through a common currency (usually USD).

For a customer buying EUR against INR, where USD/INR is the offer side and USD/EUR the units of EUR per USD:

$$\text{EUR/INR} = \frac{\text{USD/INR}}{\text{USD/EUR}}$$

Example: USD 1 = ₹76.10/76.25 and USD 1 = EUR 1.06. Customer remits EUR (bank sells): $76.25 / 1.06 = \mathbf{₹71.9340}$ per EUR before margin. With single rates USD 1 = ₹76.10 and USD 1 = EUR 1.10: $76.10 / 1.10 = \mathbf{₹69.18}$.

Topic 8 — Arbitrage

Arbitrage is simultaneous buying and selling in two or more markets to profit from temporary price discrepancies. In forex, a currency is bought in one centre and almost immediately resold in another.

Type	Centres involved
Simple / direct arbitrage	Two centres only
Compound / three-point arbitrage	Three or more centres and several currencies

Topic 9 — Merchant Rates — TT and Bill Buying / Selling

Rate	Used when	Base rate
TT buying	Bank buys FC already credited to Nostro — inward remittance, purchase of FC DD, cancellation of a sale contract	Spot bid – margin
Bill buying	Bank purchases / discounts an export bill (Nostro credit later)	Spot bid + forward premium for transit/usance (rounded up to month) – margin
TT selling	Bank sells FC with no handling of documents — outward remittance, DD issue, NRE → FCNR transfer, crystallisation of export bills, cancellation of a purchase contract	Spot offer + margin
Bill selling	Retirement of import bills (bank handles documents)	Spot offer + bill-selling margin

TT buying rate, where m = exchange margin:

$$\text{TT buying} = \text{Spot bid} \times (1 - m)$$

Example: USD 10,000 already in Nostro; spot 76.30/45; margin 0.10%: $76.30 \times 0.999 = \mathbf{76.2237}$; pay ₹7,62,237. Forward points are irrelevant as funds are already received.

Bill buying rate, where p = forward premium for transit period rounded to the higher month:

$$\text{Bill buying} = (\text{Spot bid} + p) \times (1 - m)$$

Example: Export bill USD 50,000; spot 72.30/40; 1-month premium 0.40/0.50; transit 20 days (→ 1 month); margin 0.15%: $(72.30 + 0.40) \times 0.9985 = \mathbf{72.59095}$; pay ₹36,29,547.50 before interest and charges.

TT selling rate:

$$\text{TT selling} = \text{Spot offer} \times (1 + m)$$

Example: DD on USA for USD 50,000; spot 76.32/48; margin 0.15%: $76.48 \times 1.0015 = \mathbf{76.59472}$; debit ₹38,29,736 before fees.

Bill selling rate, where M_b = stated total bill-selling margin:

$$\text{Bill selling} = \text{Spot offer} \times (1 + M_b)$$

Example: Import bill USD 50,000 retired now; spot 72.30/40; total bill-selling margin 0.20%: $72.40 \times 1.002 = \mathbf{72.5448}$; debit ₹36,27,240. Do not add the TT margin again when the 0.20% is the stated total; forward points are irrelevant for immediate retirement.

Remember this

- Bank **buys at bid, sells at offer**; buying margin is **deducted**, selling margin is **added**.

Topic 10 — Dealing Room Operations

The dealing room buys and sells FC for customers of all branches, manages FC assets and liabilities, funds and **Nostro accounts**, and undertakes proprietary trading. It is a **separate profit centre**.

Office	Role
Front office (dealers)	Maintains two positions. Funds position: inflows/outflows; mismatches cause Nostro overdraft interest or idle balances. Currency position: overbought/oversold; exchange risk. Works within management-set limits and manages currency gaps.
Back office	Processing of deals, accounts and reconciliation; supportive and checking role over dealers.
Mid office	Risk management and parameterisation of risks, market information, compliance; independent function.

RBI requires the **Board** to frame a policy and fix limits for forex dealing, focusing on risks arising from complex, volatile markets.

Topic 11 — Authorised Persons under FEMA

Under FEMA, RBI authorises banks and others as **Authorised Persons**. Under the **2026 authorisation framework (effective May 2026)**:

Category	Scope	Entry conditions
AD Category-I	Any current and capital account transaction permissible under FEMA	Must be a licensed bank
AD Category-II	Permissible non-trade current account transactions (other than gifts/donations) and foreign trade up to ₹25 lakh per transaction	Licensed banks / registered NBFCs / qualifying FFCs or Forex Correspondents with 2 years of operations and average forex turnover ₹50 crore over the previous two years; net worth ₹10 crore
AD Category-III	Activities specified in its RBI authorisation (not restricted money changing)	Net worth ₹2 crore
FFMC	Money changing and MTSS agency	No fresh applications except those under process; existing ones renew under stated conditions

- **Forex Correspondents (FxC)** — AD-I / AD-II may appoint them on a **principal-agent** basis.
- **Activities** — Purchase of notes/TCs, travel sales and MTSS sub-agency.
- **Books** — The transactions appear in the principal's books.
- **Multiple ADs** — An FxC may serve more than one AD.
- **Franchisees** — From **6 May 2026**, no fresh franchisee arrangements are allowed.
- **Existing franchisees** — They end within **two years** and may convert to FxCs.

Topic 12 — FEDAI and its Rules

- **FEDAI** — A non-profit body formed in **1958** with RBI approval.
- **Membership** — All ADs are members and must follow its rules.
- **Rules cover** — Market operations, merchant rates, quotations, delivery dates, holidays, interest on defaults, export-import bills, transit period and crystallisation.
- **Advisory role** — It also advises RBI.

Rule area	Current position
Normal Transit Period (DP/sight bills, not under LC)	Foreign currency bills 25 days ; rupee bills 20 days . Not applicable to fixed-due-date bills. Finance beyond NTP limited to 90 days from shipment .
Crystallisation of export bills	Overdue FC bills converted to rupee liability at TT selling rate ; day of crystallisation decided by the bank's policy.
Cancellation rate	At opposite TT rate — TT selling for purchase contracts; TT buying for sale contracts.
Late interbank delivery	Interest at 2% over overnight benchmark (INR FBIL MIBOR, USD SOFR, GBP SONIA, EUR €STR, JPY TONA, CHF SARON, CAD CORRA). Claim within 15 working days covers full delay; later claims capped at 60 days' interest.

- **See** — Ch 8 (p. 26) for the full FEDAI rules on forward contracts, holidays, matured contracts and direct merchant quotes; Ch 4 (p. 11) for crystallisation of unpaid import bills under LC.

Remember this

- NTP: **25 days** FC bills, **20 days** rupee bills; option period max **1 month**.

Topic 13 — RBI Guidelines for Authorised Dealers

Area	Guideline
Vostro accounts	AD-I banks may open/close non-interest-bearing rupee accounts of overseas branches/correspondents without RBI reference (except Pakistani banks outside Pakistan). Exchange House rupee accounts need prior RBI approval .
Nostro accounts	May open/close FC accounts abroad and hold Board-approved balances.
Overseas investment	Money market/debt instruments of foreign states with residual maturity < 1 year , rated as per guidelines.
Use of Nostro surplus	Loans to residents for FC or rupee working capital/capex (with natural hedge or exchange-risk policy); credit to overseas WOS/JV with ≥ 51% resident equity.
Overseas borrowing	Up to 100% of unimpaired Tier 1 capital or USD 10 million, whichever is higher . Excludes export-credit borrowings, HO subordinated Tier II funds and specified capital instruments.
Borrowing above 50%	Beyond 50% of Tier 1 needs Board policy, CRAR 12% and minimum 3-year maturity. Excess is reported to FMRD within 15 days of month-end.
Hedging	Residents may hedge contracted or anticipated exposure. The underlying must exist, be unhedged elsewhere and be provable. Contracted exposure up to USD 100 million outstanding across all ADs needs no initial documentary proof.
Products	Retail: forwards, FX swaps, purchased European calls/puts, call/put spreads. Non-retail threshold: net worth ₹500 crore or turnover ₹1,000 crore .

- **Capital account transaction** (Section 2(e)) — It alters assets or liabilities, including contingent liabilities, outside India of a resident.
- **See** — Ch 8 (p. 26) for capital and current account transactions under FEMA.

BFM | Module A | CH-1 | MCQs

Q1. A contract dated 10 July is settled on 12 August. The rate applied is the: [Ref: Topic 4, p. 2]

- (a) Ready rate (b) Tom rate (c) Spot rate (d) Forward rate

Q2. Spot rate 2.00, interest differential 4% p.a., forward period 60 days (360-day year). Forward points are approximately: [Ref: Topic 5, p. 2]

- (a) 0.011111 (b) 0.012222 (c) 0.013333 (d) 0.014444

Q3. EUR/USD spot 1.3200/1.3210; 1-month forward points 40/35. The 1-month outright EUR/USD quote is: [Ref: Topic 5, p. 2]

- (a) 1.3240/1.3245 (b) 1.3160/1.3175
(c) 1.3160/1.3245 (d) 1.3175/1.3240

Q4. USD/INR 84.10/84.25 and USD 1 = EUR 0.92. A customer remitting EUR will be quoted, before margin, approximately: [Ref: Topic 7, p. 3]

- (a) ₹77.51 per EUR (b) ₹91.58 per EUR
(c) ₹91.41 per EUR (d) ₹77.37 per EUR

Q5. USD 20,000 is already credited to the bank's Nostro. Spot USD/INR 84.20/35, 1-month points 20/30, margin 0.15%. The rupee amount paid to the beneficiary is: [Ref: Topic 9, p. 3]

- (a) ₹16,81,474 (b) ₹16,85,474 (c) ₹16,86,000 (d) ₹16,89,474



Q6. Export bill USD 25,000; spot 84.10/25; 1-month premium 0.30/0.40; transit 25 days; margin 0.15%. The bill buying rate is: [Ref: Topic 9, p. 3]

- (a) 84.0838 (b) 84.4000 (c) 84.3734 (d) 84.2734

Q7. An importer wants a DD for USD 10,000. Spot 84.15/84.30, margin 0.20%. The amount debited before charges is: [Ref: Topic 9, p. 3]

- (a) ₹8,41,500 (b) ₹8,43,000 (c) ₹8,44,686 (d) ₹8,46,686

Q8. Spot USD/INR 83.00 and 3-month forward 83.83. The annualised forward premium on USD is: [Ref: Topic 5, p. 2]

- (a) 1.00% (b) 3.33% (c) 4.00% (d) 12.00%

Q9. A rate of ₹100 = USD 1.20 is an indirect quote. The equivalent direct quote is: [Ref: Topic 6, p. 3]

- (a) USD 1 = ₹120.00 (b) USD 1 = ₹83.33
(c) USD 1 = ₹82.00 (d) USD 1 = ₹1.20

Q10. Spot USD/INR 83, INR interest 6% p.a., USD interest 4% p.a., 180 days. The covered-interest-parity forward rate is about: [Ref: Topic 5, p. 2]

- (a) 83.81 (b) 82.19 (c) 84.66 (d) 83.00

Q11. A customer asks the bank to transfer funds from his NRE account to his FCNR(B) account. The rate applied is: [Ref: Topic 9, p. 3]

- (a) TT buying rate (b) Bill buying rate
(c) Bill selling rate (d) TT selling rate

Q12. Which office of the dealing room handles processing of deals, accounts and reconciliation? [Ref: Topic 10, p. 3]

- (a) Front office (b) Mid office
(c) Treasury office (d) Back office

Q13. Under FEDAI rules, an export purchase contract cancelled by the customer is cancelled at the bank's: [Ref: Topic 12, p. 4]

- (a) TT buying rate (b) TT selling rate
(c) Bill buying rate (d) Spot mid rate

Q14. An AD Category-I bank's overseas foreign currency borrowing ceiling is: [Ref: Topic 13, p. 4]

- (a) 50% of Tier 1 capital or USD 10 million, whichever is lower
(b) 25% of Tier 1 capital
(c) 100% of unimpaired Tier 1 capital or USD 10 million, whichever is higher
(d) USD 100 million flat

Q15. Under the 2026 framework, an AD Category-II entity may handle foreign trade transactions up to: [Ref: Topic 11, p. 4]

- (a) ₹10 lakh per transaction (b) ₹25 lakh per transaction
(c) ₹50 lakh per transaction (d) USD 25,000 per transaction

Answer key

Q	Ans	Q	Ans	Q	Ans	Q	Ans	Q	Ans
1	d	4	b	7	c	10	a	13	b
2	c	5	a	8	c	11	d	14	c
3	b	6	d	9	b	12	d	15	b

CH-2

Liberalised Remittance Scheme (LRS) and other Remittance Facilities for Residents

Topic 1 — Capital and Current Account Transactions

Transaction	FEMA section	Scope
Capital account	Section 2(e)	Alters assets / liabilities, including contingent liabilities, outside India of a resident, or in India of a non-resident.
Current account	Section 2(j)	Any transaction other than capital account — trade payments, interest on loans, income on investments, travel, family maintenance, medical treatment, etc.

Topic 2 — Key FEMA Sections for LRS

Section	Provision
Section 4	Residents may hold, acquire or transfer foreign exchange, foreign securities or immovable property abroad only as permitted under FEMA rules and regulations.
Section 6	Any person may draw or sell foreign exchange through an authorised person for permissible capital account transactions within limits. Section 6(4) protects assets acquired while non-resident or inherited from a non-resident.
Section 10(6)	Foreign exchange must be used for the declared purpose or surrendered within the prescribed period; otherwise deemed contravention.
Section 13	Penalty up to thrice the amount involved (if quantifiable) or up to ₹2,00,000 (if not); continuing contravention up to ₹5,000 per day after the first day.

- See — Ch 8 (p. 26) for Section 11 — RBI directions to Authorised Persons; penalty up to ₹10,000, plus up to ₹2,000 per day for continuing contravention.