Module - 4
Foreign Exchange Market: Market Participants

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Happenings in the foreign exchange market (henceforth forex market) form the essence of the international finance. The foreign exchange market is not limited by any geographical boundaries. It does not have any regular market timings, operates 24 hours 7 days week 365 days a year, characterized by ever-growing trading volume, exhibits great heterogeneity among market participants with big institutional investor buying and selling million of dollars at one go to individuals buying or selling less than 100 dollar.

In this module, different aspects about forex market participants are discussed.

**Learning Objectives:**

Forex market participants can be categorized into five broad categories. These five categories are discussed in this section.

- **Forex Market participants**
  - Banks and financial institutions
  - Merchants
  - Other customers
  - Speculators and hedgers
  - Central bank

- Forex dealers/market makers and brokers
- Forex trading and SWIFT
- Robots & forex trading
The foreign exchange market as discussed in Session 3, is the largest market in the world with average daily turnover of US$ 3.2 trillion. It spans allover the world and operates 24 hours a day. In this session, broad generic categories of forex market participants and the different types of the forex products traded in the market are discussed.

## Types of forex market participants:

The forex market is an OTC market without any centralized clearinghouse. It consists of two tiers:

- **The interbank or wholesale market,**
- **Client or retail market.**

Five broad categories of participants operate within these two tiers:

- Bank and non bank foreign exchange dealers
- Foreign exchange brokers
- Hedgers, Speculators and arbitragers
- Central banks and treasuries
- Individuals and firms conducting commercial or investment transactions

### Wholesale Forex Market:

Major forex trading in the wholesale forex markets is undertaken by banks – popularly known as **interbank market.** In this market, banks and non-bank financial institutions transact with each other. They undertake trading on behalf of customers, but majority of trading is undertaken for their own account by proprietary desks.

Besides banks and non-bank financial institutions, multinational corporations, hedge funds, pension and provident funds, insurance companies, mutual funds etc. participate in the wholesale market.

Big multinational companies earn their revenue and incur expenses in many different currencies. For example, Switzerland based Nestle operates in 86 countries across the globe. To hedge their foreign exchange risk these multinational companies directly participate in the wholesale market. Hedge funds are also major player in this market. Hedge funds collect huge sums from high net worth individuals and undertake speculative trades in equity, debt, forex and derivatives market. Mutual funds with international equity portfolio are also major players in this market.
Foreign Exchange Dealers and Brokers: The role of foreign exchange dealers and brokers need to be discussed in detail. But, let us first understand who forex dealers are.

Dealers: Banks and some nonblank financial institutions act as foreign exchange dealer. These dealers quote both “bid” and “ask” for a particular currency pair (for spot, forward and swap contracts) and take opposite side to either buyers or sellers of currency. They make profit from the spreads between buying and selling prices i.e., bid and ask rate. Brokers are agents, which merely match buyers and sellers and get a brokerage fee.

Before the internet, the brokers, dealers and clients were communicating over telephone or telex and through satellite communication. SWIFT (Society for Worldwide Interbank Financial Telecommunication) facilitated the communication between these brokers and banks. More details about Swift are discussed in Section 4.2. Brokers and dealers used to have terminals from Reuters and Bloomberg indicating the bid and ask spread quoted by different currency transactions.

Box.4.1 highlights the inter-bank bid-ask quotation offered by different banks and collated by a forex broker “OZ forex”.
These dealers are also known as “market maker”. As market makers, these dealers stand willing at all time to buy and sell currencies at the quoted rate. Dealers do not necessarily make markets for all currency but specialize in some currency pair. A person/company intending to trade may directly get in touch with the dealer to get a two way quote and execute a trade.

Before the penetration of computer network and electronic trading systems, most of the forex transaction used to happen by telephone. Box 4.2, highlights an example of forex transaction happening over telephone between a dealer and any trader.
Box 4.2: Example of telephone conversation in a Dealing room


As an example of direct dealing over telephone, if trader Mike were asking market maker Hans to give quotes for buying and selling $10 million for Swiss francs, Mike could contact Hans by electronic dealing system or by telephone and ask rates on “spot dollar-swissie on ten dollars.” Hans might respond that “dollar-swissie is 1.4585-90;” or maybe “85-90 on 5;” but more likely, just “85-90,” if it can be assumed that the “big figure” (that is, 1.45) is understood and taken for granted. In any case, it means that Hans is willing to buy $10 million at the rate of CHF 1.4585 per dollar, and sell $10 million at the rate of CHF1.4590 per dollar.

Hans will provide his quotes within a few seconds and Mike will respond within a few seconds. In a fast-moving market, unless he responds promptly—in a matter of seconds—the market maker cannot be held to the quote he has presented. Also, the market maker can change or withdraw his quote at any time, provided he says “change” or “off” before his quote has been accepted by the counterpart.

It can all happen very quickly. Several conversations can be handled simultaneously on the dealing systems, and it is possible to complete a number of deals within a few minutes. When he hears the quotes, Mike will either buy, sell, or pass—there is no negotiation of the rate between the two traders. If Mike wants to buy $10 million at the rate of CHF1.4590 per dollar (i.e., accept Hans’ offer price), Mike will say “Mine” or “I buy” or some similar phrase. Hans will respond by saying something like “Done—I sell you ten dollars at 1.4590.” Mike might finish up with “Agreed—so long.”

Each trader then completes a “ticket” with the name and amount of the base currency, whether bought or sold, the name and city of the counterparty, the term currency name and amount, and other relevant information. The two tickets, formerly written on paper but now usually produced electronically, are promptly transmitted to the two “back offices” for confirmation and payment.

In fact all telephone conversations in dealing rooms are recorded so that any discrepancy in two legs of any transactions can be settled later.
Dealers also trade foreign exchange as part of their own proprietary trade. In proprietary trading, dealers invest their own capital and undertake currency trading. Unlike the smaller margin received by dealers from the bid-ask spread, in proprietary trades, dealers expect a larger profit margin. They mainly undertake trades based on directional view about a currency depending on interest rate change, major policy move etc.

**Brokers:** Brokers on the other hand, help clients to get a better rate on the currency trade by making available different quotes offered by dealers. Traders can compare rates and accordingly take a decision. Brokers charge a commission for providing these services. Communication between brokers and clients also used to be through dedicated telephone lines. A broker continuously remains connected to dealers to get latest quotes, depth of the market. The broker compares the rates offered by the dealers and provides the best rates to the clients i.e., highest bid prices quoted by different dealers when the client wants to sell and lowest ask price quoted by different dealers when the clients wants to buy. With the emergence of communication technology, now most of the most of broker deals are happening in electronic brokering system.

Foreign exchange dealers trade among themselves through direct dealing and through brokers. In case of direct dealing, two dealers contact each other directly and undertake a trade. Like any other traders, dealers may contact brokers for executing their proprietary trades if these dealers want anonymity in trading.

In India, RBI (Reserve Bank of India), gives permission to an entity to act as authorized dealer in foreign exchange. In fact, RBI has sanctioned three different categories of **Authorized Dealers.** Categorization is done by RBI, depending upon the kind of services an entity is permitted to offer. **Table 4.1** lists some of the **RBI sanctioned “ Authorized Dealers”**.
Table 4.1: Foreign Exchange Authorized Dealers Sanctioned by Reserve Bank of India
Source: http://www.rbi.org.in/Commonman/English/Scripts/AuthorizedDealers.aspx

<table>
<thead>
<tr>
<th>Category I</th>
<th>Category II</th>
<th>Category III</th>
</tr>
</thead>
<tbody>
<tr>
<td>• ABN AMRO Bank N.V.</td>
<td>• Thomas Cook(India) Limited,</td>
<td>• Clearing Corporation of India Limited,</td>
</tr>
<tr>
<td>• Abu Dhabi Commercial Bank Ltd.</td>
<td>• UAE Exchange &amp; Financial Services Limited,</td>
<td>• Export Import Bank of India</td>
</tr>
<tr>
<td>• Allahabad Bank,</td>
<td>• Green Channel Travel Services,</td>
<td>• Small Industries Development Bank of India</td>
</tr>
<tr>
<td>• Andhra Bank,</td>
<td>• Cox &amp; Kings(India) Ltd.,</td>
<td>• Industrial Finance Corporation of India Ltd.</td>
</tr>
<tr>
<td>• Antwerp Diamond Bank NV</td>
<td>• Wall Street Finance Limited</td>
<td>• SBI Factors &amp; Commercial Services Private Limited,</td>
</tr>
<tr>
<td>• AB Bank Limited</td>
<td>• Weizmann Forex Limited</td>
<td>• IFCI Factors Limited,</td>
</tr>
<tr>
<td>• Axis Bank Ltd.</td>
<td>• Vadilal Industries Limited</td>
<td></td>
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**Hedger, Speculators and Arbitrageurs:** Traders buying and selling foreign exchange can take the role of hedgers, or speculators or arbitrageurs.

**Hedgers** are traders who undertake forex trading because they have assets or liability in foreign currency. For example, when an importer requiring foreign currency, sells domestic currency to buy foreign currency, he is termed as a hedger. The importer has a foreign currency liability. Similarly, an exporter sells foreign currency and buys domestic currency is a hedger. The exporter has assets denominated in foreign currency. A MNC entering into a foreign currency forward contract so that it can repatriate its earning to parent company. An Indian company swapping its foreign currency interest payment obligations to INR interest obligation. All these are examples of hedging. Hedgers use the foreign currency market to hedge the risk associated with volatility in foreign exchange market.

**Speculators** are traders who essentially buy and sell foreign currency to make profit from the expected futures movement of the currency. These traders do not have any genuine requirement for trading foreign currency. They do not hold any cash position in the currency.
**Arbitrageurs** buy and sell the same currency at two different markets whenever there is price discrepancy. The principle of **“law of one price”** governs the arbitrage principle. Arbitrageurs ensure that market prices move to rational or normal levels. With the proliferation on internet, cross currency, cross currency arbitrage possibility has increased significantly.

The following box, **Box 4.3** succinctly explains **what is speculations and how Indian companies have burnt their fingers (probably other body parts also!!) by indulging in speculative forex trading.**
Box.4.3 : Forex speculation drives corporate losses
Business Line, February 14th 2009.
Author: S. Balakrishnan

Apart from the poor operating results of manufacturing companies in Q3 of 2008-9, there was a nasty surprise. Practically all, be they giants or SMEs, have incurred large foreign exchange losses.

What is peculiar is that even companies with predominantly rupee income and expense streams have not been spared.

There is much more here than meets the eye. The only plausible explanation is that they have been trading in forex markets much beyond what was necessary just to hedge their business exposures (because of imports, forex liabilities and exports).

One must be clear about the difference between a trading loss and an opportunity loss. An Infosys selling its dollar income forward when the dollar was Rs 40 on the view that the rupee would appreciate could have earned more had it not done that as the rupee is now nearly Rs 49. This is a case of a view or forecast going wrong, which happens often to the best of market players.

On the other hand, a company which sells non-existent dollar revenues loses real money if the dollar rises and it is forced to square its position at a higher exchange rate. One suspects most of the forex losses of corporates belong to the latter category.

Of course, all this is not new news. Much has been reported and written about the derivative losses of small, medium and large companies and businesses. Again, these involved complex products and structures in foreign currencies. So you had a small hosier-exporting proprietary firm in Tirupur dabbling in binary, touch, knock-in and knock-out (this has a nice touch to it!) currency options in yen, Swiss franc and euro without in the least realizing what it was in for. Expectedly, huge losses were the result. (Not that corporates with supposedly savvy Treasuries fared any better).

It is not as if the Reserve Bank of India allows businesses without underlying currency risk to operate in the forex markets. The central bank’s guidelines and regulations in this matter leave no room for doubt. Still, it cannot escape responsibility and blame, because, besides the mandatory reporting on derivative trades and contracts from banks, the market was abuzz for quite some time about the volumes in exotic derivatives and the major players.

The boards and top managements of companies have an important responsibility to rein in financial transactions and activities which violate the RBI’s regulations (quite apart from their potential destruction of shareholder value). Otherwise, they run the risk of being culpable.
Central Banks and Treasuries: All most all central bank and treasuries participate in the forex market. Central banks play very important role in foreign exchange market. However, these banks do not undertake significant volume of trading. Each central bank has official/unofficial target of the forex rate for its home currency. If the actual price deviates from the target rate, the central banks intervene in the market to set a tone. Besides central banks, other commercial banks also buy and sell forex primarily for

Retail Market:
In the retail market, individuals (tourists, foreign students, patients traveling to other countries for medical treatment) small companies, small exporters and importers operate. Money transfer companies/remittance companies (for example like Western Union) are also major players in the retail market.

Retail traders buy/sell currency for their genuine business/personal requirements. For example, an exporter enters into forward contract to convert foreign currency to domestic currency. A tourist buys foreign currency in the spot market before undertaking the journey. A UK patient visiting India to undertake an operation that would have cost him a fortune at UK.

Majority of retail trading happens in the spot market. Why? As retailers’ requirements are normally not repetitive in nature, they buy or sell the currency as when the requirement arises.

Major part of the forex turnover in an economy comes from banks – banks acting as forex dealers (provide two way quotes) as well as acting as brokers. Table 4.2 shows the number of banks accounting for 75% of foreign exchange turnover.
Table 4.2: Number of banks accounting for 75% of foreign exchange turnover

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</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>24</td>
<td>17</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>United States</td>
<td>20</td>
<td>13</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Switzerland</td>
<td>7</td>
<td>6</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Japan</td>
<td>19</td>
<td>17</td>
<td>11</td>
<td>9</td>
</tr>
<tr>
<td>Singapore</td>
<td>23</td>
<td>18</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>26</td>
<td>14</td>
<td>11</td>
<td>12</td>
</tr>
<tr>
<td>Australia</td>
<td>9</td>
<td>10</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>France</td>
<td>7</td>
<td>6</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Germany</td>
<td>9</td>
<td>5</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

It can be seen from the Table 4.2 that the number of banks accounting for three-fourth of foreign exchange turnover in many countries has declined during 1998-2007 period indicating emergence of bigger banks and may be due to M&A activities leading bank consolidation.

### 4.2: Forex Trading and SWIFT

In an interbank forex transaction, no real money changes hand. All transactions are done electronically through SWIFT. Banks undertaking forex transactions simply transfer bank deposits through SWIFT to settle a transaction.

SWIFT is the Society for Worldwide Interbank Financial Telecommunication is a cooperative organization headquartered at Belgium. The Swift network connects around 8300 banks, financial institutions and companies operating 208 countries. Swift provides a standardized messaging service to these members. As and when two counterparties undertake a transaction, SWIFT transports the message to both financial parties in a standard form. As the forex market is mainly an OTC market, SWIFT message provides some kind of legitimacy to the transactions. The following line captures summarizes the activities at SWIFT.

“SWIFT is solely a carrier of messages. It does not hold funds nor does it manage accounts on behalf of customers, nor does it store financial information on an ongoing basis. As a data carrier, SWIFT transports messages between two financial institutions. This activity involves the secure exchange of proprietary data while ensuring its confidentiality and integrity”. For every participating member, SWIFT assigns a unique code. This code is used to transport messages. For example, Box. 4.4 indicate different SWIFT codes assigned to HSBC bank operating at different places.
Computers and internet have become the must have requirement for anybody undertaking forex trading. Many companies are selling software packages guaranteeing unthinkable profit by installing these packages. These packages are popularly known as forex robots. These are not robots in real sense of the word, but these are software which would automate trades based some setting given by the trader. The trader need not physically remain present when they trade is placed and executed.

The variety of such packages available runs into hundreds if not thousands. A typical forex robot would entice traders with tagline like “Our 100% no loss robot will automatically enter and exit profitable trades for you. Imagine always being in the market and making profitable trades while you are free to spend time with the family, go to work, and live life …..”.

Even there are websites that are rating these robots. As a sample, the following website http://www.forexrobottrading.com/ rates the different forex robots available in the market and compares their features.
Multiple Choice Questions:

1. An Indian company enters into a swap contract to replace its US$ borrowing to INR borrowing is an example of
   a) Arbitrage trading
   b) Speculative trading
   c) Hedging
   d) None of these.

2. A broker matches the ____________ bid prices quoted by different dealers when the client wants to ___________ foreign exchange.
   a) Lowest, buy
   b) Highest, buy
   c) Lowest, sell
   d) Highest, sell

3. The foreign exchange market is referred to as a market where one country's currency is exchanged for another currency. The currency exchange is usually made through the following methods ___.
   a) buyers and sellers of foreign exchange meet at a physical location.
   b) buyers and sellers of foreign exchange meet through a telephone network
   c) buyers and sellers of foreign exchange meet through computer communications
   d) A and B
   e) B and C

4. Which types of market participants can be termed as the most important participant in foreign exchange market?
   a) Retail customers
   b) Commercial banks
   c) Foreign exchange dealers
   d) Central banks
   e) None of the above.

5. Which of the following is not a characteristic of speculation?
   a) profit motive
   b) exchange rate fluctuation
   c) hedging
   d) risk taking
   e) deliberate uncovered position
Short Questions:

1. Why forex dealers give two-way quote in terms of Bid-Ask spread?

2. What is the difference among Hedgers, Speculators and Arbitrageurs? Do you think all forex speculation activities should be banned by regulatory bodies like RBI?

3. What is the responsibility of a “Market Maker” in a forex market?

4. What is “Law of One Price” and what relevance it has got with forex trading?

5. Explain the role of SWIFT in forex trading.

Answers to Multiple Choice Questions 1 to 5:

1. c
2. a or d
3. e
4. d
5. c

References:

4. SWIFT available at http://www.swift.com/