

Exchange Rate Mechanism & Role of Banks in International Trade

Where Currency Moves, Business Moves — Master the Power of Exchange Rates & Banking

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ABSTRACT

Currency conversion lies at the heart of every cross-border trade transaction. This article distills the core concepts of Session 7, offering a practitioner-oriented guide to exchange rate mechanics, the typology of forex rates, the indispensable role of Authorised Dealer (AD) banks under India's FEMA framework, the architecture of correspondent banking through NOSTRO and VOSTRO accounts, and the regulatory oversight provided by FEDAI. Readers will leave with a clear understanding of how an export payment travels from a foreign buyer's account to an Indian exporter's rupee balance — and what can go wrong along the way.

1. WHY EXCHANGE RATES ARE CENTRAL TO TRADE

In domestic commerce, both parties share a currency. The moment trade crosses a border, a second currency enters, and with it, exchange rate risk. An Indian exporter calculates costs in INR but invoices in USD, EUR, or GBP. The rate at which those foreign-currency receipts convert to rupees is not fixed at invoice time — it fluctuates daily, driven by macro forces entirely outside the exporter's control.

Consider a straightforward illustration: an exporter invoices USD 1,00,000 at an expected rate of ₹84. Ninety days later, if the rupee appreciates to ₹81, the exporter loses ₹3,00,000. If it depreciates to ₹87, the exporter gains ₹3,00,000. The exchange rate, therefore, is not a footnote — it is a core variable in every deal's profitability calculus.

Key Drivers of the INR/USD Rate

Factor	Impact on Rupee
India's Trade Deficit	Higher imports → more USD demand → rupee weakens
US Federal Reserve Policy	Fed rate hike → USD strengthens → rupee depreciates
FII / FPI Capital Flows	Inflows strengthen; outflows weaken the rupee
Crude Oil Prices	India imports ~85% of crude; higher prices weaken rupee
RBI Intervention	Buys/sells USD reserves to manage sharp movements
Inflation Differential	Higher Indian inflation → gradual rupee depreciation (PPP)
Global Risk Appetite	Crises push investors to USD as safe haven

Factor	Impact on Rupee
India's GDP Growth	Strong growth attracts FDI/FPI → rupee strengthens

2. TYPOLOGY OF FOREIGN EXCHANGE RATES

There is no single 'exchange rate'. Banks operate with a layered rate hierarchy depending on transaction type, direction of currency flow, and whether trade documents are involved.

The Rate Hierarchy at a Glance

Rate Type	Direction	Key Feature
Buying Rate (Bid)	Bank buys USD from exporter	Always below mid-market; bank's buying margin
Selling Rate (Offer)	Bank sells USD to importer	Always above mid-market; bank's selling margin
TT Rate	Clean wire transfer (SWIFT)	Mid-rate ± FEDAI-prescribed exchange margin
Bill Rate (BC Rate)	Trade documents involved	TT Rate ± transit period premium
Card Rate	Retail forex / travel cards	Least favourable; widest retail margin
Cross Rate	Non-USD currency pairs	Derived via USD: e.g., EUR/INR = EUR/USD × USD/INR

The spread between the Buying and Selling Rate represents the bank's exchange margin — its primary revenue on every forex conversion. For a USD 10,000 transaction with a mid-market rate of ₹83.50 and a margin of ₹0.45, the bank earns ₹4,500 irrespective of whether the customer is an exporter or importer.

TT Rate vs. Bill Rate

Both rates are commonly encountered in export-import banking. The TT Rate applies to clean SWIFT remittances with no accompanying trade documents. The Bill Rate applies when shipping documents are involved — such as during LC negotiation or documentary collection. The Bill Rate is typically less favourable than the TT Rate because it incorporates a transit period premium: the bank holds risk during the time documents are in transit before funds are received.

Cross Rate Example

An Indian exporter invoicing a German buyer in EUR needs to know the EUR/INR rate. Step 1: EUR/USD = 1.09 (from market). Step 2: USD/INR = ₹83.50 (from your bank). Step 3: EUR/INR = $1.09 \times 83.50 = ₹91.015$ per EUR. On a EUR 50,000 invoice, the rupee equivalent is approximately ₹45,50,750 before charges.

3. AUTHORISED DEALER BANKS — THE GATEWAY TO FOREX

An Authorised Dealer (AD) bank holds a licence from the Reserve Bank of India under Section 10 of the Foreign Exchange Management Act, 1999 (FEMA), authorising it to deal in foreign exchange. Only AD banks can process SWIFT payments, issue Letters of Credit, negotiate export bills, or handle outward remittances. Every serious exporter or importer must bank with an AD Category-I institution.

AD Bank Categories

Category	Who They Are	Scope of Operations
AD Category I	Full-service commercial banks (SBI, HDFC, ICICI, Axis, etc.)	All forex transactions: remittances, LCs, packing credit, derivatives
AD Category II	Full-fledged money changers, select co-operative banks	Limited: mainly retail money changing; no SWIFT/trade finance
AD Category III	Restricted money changers (hotels, exchange booths)	Only retail encashment of foreign currency notes and cheques

Six Core Functions of AD Banks in Trade

- ▶ **Inward Remittance Processing:** Receives USD into its NOSTRO account abroad; converts to INR at the TT Buying Rate; credits the exporter's account; reports to RBI via EDPMS.
- ▶ **Outward Remittance Processing:** Debits importer's INR account; buys USD at TT Selling Rate; instructs its NOSTRO's correspondent to credit the supplier's bank via SWIFT MT103.
- ▶ **LC Issuance (Imports):** Issues LC on behalf of the importer (MT700 SWIFT message); commits to pay the foreign seller upon compliant document presentation.
- ▶ **LC Advising & Confirming (Exports):** Authenticates the incoming SWIFT LC message; notifies the Indian exporter; may add its own payment guarantee (Confirmed LC).
- ▶ **Export Bill Negotiation:** Examines shipping documents against LC terms under UCP 600 within five banking days; purchases compliant bills at the Bill Buying Rate.
- ▶ **FEMA Compliance & Reporting:** Ensures all transactions comply with FEMA provisions; reports to RBI via EDPMS (exports) and IDPMS (imports); monitors export realisation within nine months.

Journey of an Export Payment — Step by Step

When a US buyer remits USD 50,000, the funds travel as follows: the buyer instructs Bank of America → Bank of America sends a SWIFT MT103 to SBI's NOSTRO at Citibank New York → Citibank credits the NOSTRO and sends an MT910 credit advice to SBI Mumbai → SBI converts at the TT Buying Rate, deducts charges, and credits the exporter's rupee account → EDPMS is updated to record realisation.

Critical Operational Note

The single most common cause of delayed international payments is incorrect bank details on the Commercial Invoice. Always verify your bank's SWIFT/BIC code, account number, and account name directly with your EXIM officer. A single mistyped character in a SWIFT code can cause the payment to be held or returned — adding days or weeks to realisation.

4. NOSTRO, VOSTRO & LORO ACCOUNTS

International payments cannot flow directly between two banks in different countries without a shared intermediary infrastructure. Correspondent banking — the network of cross-border account relationships — solves this problem. Three account types form the backbone of this network.

Account Type Comparison

Term	Literal Meaning	Account Held At	Currency	Primary Use
NOSTRO	Our (account with you)	Foreign bank abroad	Foreign (e.g., USD)	Sending/receiving international SWIFT payments

Term	Literal Meaning	Account Held At	Currency	Primary Use
VOSTRO	Your (account with us)	Indian bank in India	Indian Rupee (INR)	Foreign banks holding INR for bilateral trade
LORO	Their (account with them)	A third bank	Depends on country	Reference term in correspondent banking

NOSTRO — The Export Payment Highway

SBI's USD account at Citibank New York is SBI's NOSTRO account. All USD payments destined for Indian exporters are first credited here before SBI converts them to INR. The bank's Treasury team manages NOSTRO balances daily — insufficient funds delay payments; excess funds generate low returns. This is a sophisticated cash management operation running behind every trade settlement.

VOSTRO — The Foundation of Rupee Trade

When Deutsche Bank (Germany) maintains an INR account at SBI Mumbai, SBI views it as Deutsche Bank's VOSTRO account. A German buyer can pay an Indian exporter entirely in INR by drawing down Deutsche Bank's VOSTRO balance — no international SWIFT transfer is required. India's Rupee Vostro Scheme (RVS) actively promotes this mechanism with banks from Russia, the UAE, and Southeast Asia to reduce USD dependence in bilateral trade.

LORO — The Third-Party View

If SBI (Bank A) references Deutsche Bank's (Bank B) USD account maintained at JPMorgan (Bank C), SBI calls that account a LORO account — 'their account'. LORO is primarily an accounting and examination term; it carries limited operational significance for day-to-day exporters and importers.

5. FEDAI — THE SELF-REGULATORY BODY FOR FOREX

The Foreign Exchange Dealers Association of India (FEDAI), established in 1958, is the industry self-regulatory organisation of AD Category-I banks. It operates under the aegis of the RBI but is not a government body. Its rules are agreed upon by member banks and govern all aspects of forex market conduct that affect exporters and importers.

What FEDAI Governs

- ▶ **Exchange Rate Standards:** Prescribes how banks quote rates, including decimal precision and the maximum permitted exchange margin — limiting arbitrary rate manipulation.
- ▶ **Forward Contract Rules:** Governs how forward contracts are booked, utilised, cancelled, or extended — and the charges applicable in each scenario.
- ▶ **LC Handling Charges:** Standardises advisory, confirmation, negotiation, and amendment charges on LCs, enabling cost comparisons across banks.
- ▶ **Arbitration:** Provides a structured arbitration mechanism for inter-bank forex disputes, protecting clients from being caught in banking disagreements.
- ▶ **Training & Certification:** Administers the FEDAI Certified Forex Professional (FCFP) qualification, ensuring bank officers handling your trade finance are formally competent.
- ▶ **Export Credit Interest Rates:** Issues interest rate guidelines on Packing Credit, PCFC, and Post-Shipment Credit in coordination with RBI — preventing arbitrary rate escalation.

Exchange Margin in Practice — A Numerical Illustration

Component	Export (Inward)	Import (Outward)
Inter-bank USD/INR Rate	₹83.5000	₹83.5000
FEDAI Exchange Margin	-0.45 paisa (buying)	+0.45 paisa (selling)
Customer Rate Offered	₹83.0500 (TT Buying)	₹83.9500 (TT Selling)
Transaction: USD 50,000	Exporter receives ₹41,52,500	Importer pays ₹41,97,500
Bank's Gross Margin	₹22,500	₹22,500

FEDAI and Forward Contracts

Forward contracts are the primary hedging tool for Indian exporters, and FEDAI rules define their operational boundaries. Key rules include:

- ▶ **Booking:** A forward contract can be booked immediately after receiving a purchase order — even before shipment or production begins — locking in the current forward rate.
- ▶ **Utilisation:** The contracted rate applies on or before the maturity date, regardless of where the market moves.
- ▶ **Cancellation:** If the export order is cancelled and the USD never arrives, the contract can be cancelled — cancellation charges apply based on the difference between the contracted rate and the market rate.
- ▶ **Extension:** If the buyer delays payment, the forward contract maturity date may be extended at the then-prevailing forward rate.
- ▶ **Early Delivery:** If the buyer pays before the contracted date, the USD can be delivered early — swap differentials apply as per FEDAI guidelines.

KEY TAKEAWAYS

01	Exchange rate risk is embedded in every cross-border transaction. A ₹1/USD movement on a USD 1,00,000 invoice equals ₹1,00,000 difference in rupee income.
02	Banks quote a lower Buying Rate (buying your USD) and a higher Selling Rate (selling USD to you); the spread is FEDAI-governed exchange margin.
03	The TT Rate applies to clean wire transfers; the Bill Rate applies when trade documents are involved and includes a transit period premium.
04	AD Banks perform six distinct roles: inward remittance, outward remittance, LC issuance, LC advising/confirming, export bill negotiation, and FEMA compliance.
05	A NOSTRO account is an Indian bank's foreign-currency account abroad — the highway through which all SWIFT payments flow before reaching your rupee account.
06	A VOSTRO account is a foreign bank's INR account with an Indian bank — the foundation of India's Rupee Trade Mechanism and the RVS initiative.
07	FEDAI standardises exchange margins, forward contract rules, LC charges, and export credit interest rates across all AD Category-I banks.
08	Forward contracts (covered in depth in Session 20) allow exporters to lock in today's rate for future USD receipts — the most practical tool to eliminate exchange rate risk from a deal.

Source: Session 7 — Exchange Rate Mechanism & Role of Banks in Trade, Professional Education Program: Export, Import & International Business