FOREIGN EXCHANGE RISK MANAGEMENT

RISKS BEING COVERED

- **Foreign Exchange Risk Management** primarily tries to mitigate the **Exchange rate risk** arising out on the risk of an investment's value changing due to changes in currency exchange rates. This risk usually affects exporters and/or importers, but it can also affect investors making international investments.
- The guidelines are enunciated in the Master Circular on Risk Management and Inter-Bank Dealings issued by Foreign Exchange Department of Reserve Bank of India as amended and issued in July 2011.

Basis for managing risk / hedging

1) Resident hedges based on **contracted Exposure**

(to be verified by the AD Category I bank through documentary evidence)

2) Resident hedges the Probable Exposure based on **past performance**

3) **Special Dispensation** for SMEs and Resident *Individuals*

Hedging / Instruments for Contracted Exposure

I. **Forward Foreign Exchange Contracts:**

- Market Makers : AD Category I banks ; Users :Persons Resident in India
- Transactions permitted:
  - transactions for which sale and /or purchase of foreign exchange is permitted under the FEMA 1999
  - market value of overseas direct investments (in equity and loan)
    - Can be cancelled or rolled over on due dates ; Rebooking permitted only upto 50% of the cancelled contracts
    - If a hedge becomes naked in part or full owing to contraction (due to price movement/impairment) of the market value of the ODI, the hedge may be allowed to continue until maturity, if the customer so desires. Rollovers on due date shall be permitted up to the extent of the market value as on that date.
  - Transactions denominated in foreign currency but settled in INR.
    - Settled on cash on maturity
    - once cancelled cannot be rebooked.
    - change of rates due to Government notifications / duty rates - importers can cancel and rebook the contract.

Hedging / Instruments for Contracted Exposure

Contd …. . **Forward Foreign Exchange Contracts**

Operational Guidelines :

- **Maturity** of the hedge should not exceed the maturity of the underlying transaction.
- **Currency** of hedge and **Tenor**, subject to the above restrictions, are left to the customer. Where the currency of hedge is different from the currency of the underlying exposure, the risk management policy of the corporate, approved by the Board of the Directors, should permit such type of hedging.
- Where the exact amount of the underlying transaction is not ascertainable, the contract may be booked on the basis of reasonable estimates. However, there should be periodical review of the estimates.
- **Foreign currency loans/bonds** will be eligible for hedge only after final approval is accorded by the Reserve Bank, where such approval is necessary or Loan Registration Number is allotted by the Reserve Bank.
- Global Depository Receipts (**GDRs**)/American Depository Receipts (**ADRs**) will be eligible for hedge only after the issue price has been finalized.
- **Balances in the Exchange Earner's Foreign Currency (EEFC) accounts** sold forward by the account holders shall remain earmarked for delivery and such contracts shall not be cancelled. They are, however, eligible for rollover, on maturity.

Hedging / Instruments for Contracted Exposure

Contd …. . Forward Foreign Exchange Contracts / Operational Guidelines

- All non-INR forward contracts can be rebooked on cancellation subject to reporting stipulations.
- Forward contracts, involving the Rupee as one of the currencies, booked by residents to hedge **current account transactions,** regardless of the tenor, and to hedge **capital account transactions, *falling due within one year***, may be allowed to be cancelled and rebooked subject to reporting stipulations. This relaxation of cancellation and rebooking will not be available to forward contracts booked on past performance basis without documents as also forward contracts booked to hedge transactions denominated (or indexed) in foreign currency but settled in INR.
- The facility of cancellation and rebooking is not permitted for forward contracts, involving Rupee as one of the currencies, booked by residents to hedge **capital account transactions for tenor greater than one year**. These forward contract(s) if cancelled with one AD Category I bank can be rebooked with another AD Category I bank, subject to the following conditions:
- (i) the switch is warranted by competitive rates on offer, termination of banking relationship with the AD Category I bank with whom the contract was originally booked;
- (ii) the cancellation and rebooking are done simultaneously on the maturity date of the contract; and
- Substitution of contracts for hedging trade transactions may be permitted by an AD Category I bank on being satisfied with the circumstances under which such substitution has become necessary. The AD Category I bank may also verify the amount and tenor of the underlying substituted.

Hedging / Instruments for Contracted Exposure

II. Cross Currency Options (not involving Rupee)

- Market Makers : AD Category I banks as approved for this purpose for Reserve Bank; Users :Persons Resident in India
- Transactions:
  - To hedge exchange rate risk arising out of **trade transactions**.
  - To hedge the contingent foreign exchange exposure arising out of **submission of a tender bid in foreign exchange**.
- Operational Guidelines:
  - AD Category I banks can only offer plain vanilla European options[1]
  - Customers can buy call or put options.
  - These transactions may be freely booked and/ or cancelled subject to verification of the underlying.
  - All guidelines applicable for cross currency forward contracts are applicable to cross currency option contracts also.
  - Cross currency options should be written by AD Category I banks on a fully covered back-to-back basis. The cover transaction may be undertaken with a bank outside India, an Off-shore Banking Unit situated in a Special Economic Zone or an internationally recognized option exchange or another AD Category I bank in India.

Hedging / Instruments for Contracted Exposure

III. Foreign Currency - INR Options

- Market Makers : AD Category I banks **as approved for this purpose** for Reserve Bank; Users :Persons Resident in India
- **Transactions:**
  - To hedge foreign currency exposures in accordance with Schedule I of Notification No. FEMA 25/2000-RB dated May 3, 2000, as amended from time to time.
  - To hedge the **contingent foreign exchange exposure** arising out of submission of a **tender bid in foreign exchange**.
- **Operational Guidelines:**
  - AD category I banks can offer only plain vanilla European options.
  - Customers can buy call or put options.
  - All guidelines applicable for foreign currency-INR foreign exchange forward contracts are applicable to foreign currency-INR option contracts also.
  - AD banks may quote the option premium in Rupees or as a percentage of the Rupee/foreign currency notional.
  - Option contracts may be settled on maturity either by delivery on spot basis or by net cash settlement in Rupees on spot basis as specified in the contract. In case of unwinding of a transaction prior to the maturity, the contract may be cash settled based on market value of an identical off-setting option.

Hedging / Instruments for Contracted Exposure

IV. **Foreign Currency-INR Swaps**

- **Participants**
  - **Market-makers –** AD Category I banks in India.
  - **Users –**
    - **Residents** having a foreign currency liability and undertaking a foreign currency-INR swap to move from a foreign currency liability to a Rupee liability.
    - Incorporated **resident entities** having a rupee liability and undertaking an INR – foreign currency swap to move from rupee liability to a foreign currency liability, subject to certain minimum prudential requirements, such as risk management systems and natural hedges or economic exposures. In the absence of natural hedges or economic exposures, the INR-foreign currency swap (to move from rupee liability to a foreign currency liability) may be restricted to listed companies **or** unlisted companies with a minimum net worth of Rs 200 crore. Further, the AD Category I bank is required to examine the suitability and appropriateness of the swap and be satisfied about the financial soundness of the corporate.
- **Purpose :** To hedge exchange rate and/or interest rate risk exposure for those having long-term foreign currency borrowing or to transform long-term INR borrowing into foreign currency liability.

Hedging / Instruments for Contracted Exposure

- **Contd …. Foreign Currency-INR Swaps**

- **Operational Guidelines:**
  - No swap transactions involving upfront payment of Rupees or its equivalent in any form shall be undertaken.
  - The term **“long-term exposure**” means exposures with **residual maturity** of one year or more.
  - Swap transactions may be undertaken by AD Category I banks as intermediaries by matching the requirements of corporate counterparties. No limits are placed on the AD Category I banks for undertaking swaps to facilitate customers to hedge their foreign exchange exposures.
  - *The **limit of USD 100 million which was earlier** placed for net supply of foreign exchange in the market on account of swaps which facilitate customers to assume foreign currency liability has been removed recently.*
  - The swap transactions, **once cancelled, shall not be rebooked or re-entered**, by whichever mechanism or by whatever name called.
  - AD Category I banks **should not offer leveraged swap structures**. Typically, in leveraged swap structures, a multiplicative factor other than unity is attached to the benchmark rate(s), which alters the payables or receivables vis-à-vis the situation in the absence of such a factor.
  - The **notional principal amount of the swap** should not exceed the outstanding amount of the underlying loan.
  - The **maturity of the swap** should not exceed the remaining maturity of the underlying loan.

Hedging / Instruments for Contracted Exposure

V. Cost Reduction Structures: Cross currency option cost reduction structures & **Foreign currency –INR option** cost reduction structures.

- **Participants**:
  - Market-makers **-** AD Category I banks
  - Users **–** Listed companies and their subsidiaries/joint ventures/associates having **common treasury and consolidated balance sheet or unlisted companies with a minimum net worth of Rs. 200 crore** subject to certain conditions including the company having a risk management policy with a specific clause in the policy that allows using the type/s of cost reduction structures.
- **Purpose :** To hedge exchange rate risk arising out of trade transactions and External Commercial Borrowings (ECBs).
- Operational guidelines :
  - Writing of options by the users, on a standalone basis, is not permitted.
  - Users can enter into option strategies of simultaneous buy and sell of plain vanilla European options, provided there is no net receipt of premium.
  - Leveraged structures, digital options, barrier options, range accruals and any other exotic products are not permitted.

Hedging / Instruments for Contracted Exposure

Contd …. Cost Reduction Structures

- The portion of the structure with the largest notional, computed over the tenor of the structure, should be reckoned for the purpose of underlying.
- The delta of the options should be explicitly indicated in the term sheet.
- AD Category I banks may, stipulate additional safeguards, such as, continuous profitability, higher net worth, turnover, etc depending on the scale of forex operations and risk profile of the users.
- The maturity of the hedge should not exceed the maturity of the underlying transaction and subject to the same the users may choose the tenor of the hedge. In case of trade transactions being the underlying, the tenor of the structure shall not exceed two years.
- The MTM position should be intimated to the users on a periodical basis.

Hedging / Instruments for Contracted Exposure

VI. Hedging of Borrowings in foreign exchange, which are in accordance with the provisions of Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2000.

- **Products** – Interest rate swap, Cross currency swap, Coupon swap, Cross currency option, Interest rate cap or collar (purchases), Forward rate agreement (FRA)
- **Participants**
  - **Market-makers:** AD Category I banks in India ; Branch outside India of an Indian bank authorized to deal in foreign exchange in India ; Offshore banking unit in a SEZ in India.
  - **Users :** Persons resident in India who have borrowed foreign exchange in accordance with the provisions of Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2000.
- **Purpose :** For hedging interest rate risk and currency risk on loan exposure and unwinding from such hedges
- **Operational Guidelines:**
  - The products, as detailed above **should not involve the rupee** under any circumstances.
  - Final approval has been accorded or Loan Registration Number allotted by the Reserve Bank for borrowing in foreign currency.
  - The **notional principal amount** of the product should not exceed the outstanding amount of the foreign currency loan.
  - The **maturity** of the product should not exceed the unexpired maturity of the underlying loan.
  - The contracts may be **cancelled and rebooked freely**.

Hedging based on **Past Performance**

- **Participants :** Market-makers **–** AD Category I banks in India; Users – Importers and exporters of goods and services having a minimum net worth of Rs 200 crores and an annual export and import turnover exceeding Rs 1000 crores and satisfying all other conditions as stipulated in Master Circular on Risk Manaegement.
- **Purpose :**To hedge currency risk on the basis of a declaration of an exposure and based on past performance up to the **average of the previous three financial years**' (April to March) **actual import/export turnover** or **the previous year's actual import/export turnover, whichever is higher**. Probable exposure based on past performance can be hedged only in respect of trades in merchandise goods as well as services.
- **Products :** Forward foreign exchange contracts, cross currency options (not involving the rupee), foreign currency-INR options and cost reduction structures [as mentioned in section B para I 1(v)].
- **Operational Guidelines, Terms and Conditions**
  - The contracts booked during the current financial year (April-March) and the outstanding contracts at any point of time should not exceed the eligible limit i.e. the average of the previous three financial years' actual import/export turnover or the previous year's actual import/export turnover, whichever is higher.

Hedging based on **Past Performance(contd.)**

- Contracts booked in excess of 75 per cent of the eligible limit will be on deliverable basis and cannot be cancelled.
- These limits shall be computed separately for import/export transactions.
- Higher limits will be permitted on a case-by-case basis on application to the Foreign Exchange Department, Central Office, Reserve Bank of India. The additional limits, if sanctioned, shall be on a deliverable basis.
- Any contract booked without producing documentary evidence will be marked off against this limit. These contracts once cancelled, are not eligible to be rebooked. Rollovers are also not permitted.
- AD banks should permit their clients to use the past performance facility only after satisfying themselves that the following conditions are complied with:
  - An undertaking may be taken from the customer that supporting documentary evidence will be produced before the maturity of all the contracts booked.
  - Importers and exporters should furnish a quarterly declaration to the AD Category I banks, duly certified by the Statutory Auditor, regarding amounts booked with other AD Category I banks under this facility, as per Annex VI.

Hedging based on **Past Performance (contd.)**

- For an exporter customer to be eligible for this facility, the aggregate of overdue bills shall not exceed 10 per cent of the turnover.
- Aggregate outstanding contracts in excess of 50 per cent of the eligible limit may be permitted by the AD Category I bank on being satisfied about the genuine requirements of their customers after examination of the following certificates from the Statutory Auditor:
  - that all guidelines have been adhered to while utilizing this facility.
  - Indicating the import/export turnover of the customer during the past three years .

- The past performance limits once utilised are not to be reinstated either on cancellation or on maturity of the contracts.
- AD Category I banks will arrive at the past performance limits at the beginning of every financial year. The drawing up of the audited figures (previous year) may require some time at the commencement of the financial year. However, if the statements are not submitted within three months from the last date of the financial year, the facility should not be provided until submission of the audited figures.

Hedging as per the **Special Dispensation for SMEs**

- **Participants : Market-makers** – AD Category I ; **Users** – Small and Medium Enterprises (SMEs) (as defined by the Rural Planning and Credit Department Circular dated April 4,2007)
- **Purpose :** To hedge direct and / or indirect exposures of SMEs to foreign exchange risk
- **Product :** Forward foreign exchange contracts
- **Operational Guidelines:** Small and Medium Enterprises (SMEs) having direct and / or indirect exposures to foreign exchange risk are permitted to book / cancel / rebook/ roll over forward contracts without production of underlying documents to manage their exposures effectively, subject to the following conditions:
  - Such contracts may be booked through AD Category I banks with whom the SMEs have credit facilities and the total forward contracts booked should be in alignment with the credit facilities availed by them for their foreign exchange requirements or their working capital requirements or capital expenditure.
  - AD Category I bank would be scrutinise and carry out due diligence regarding "*user appropriateness*" and *"suitability*" of the forward contracts to the SME customers as per Para 8.3 of 'Comprehensive Guidelines on Derivatives' issued vide DBOD.No.BP.BC. 86/21.04.157/2006-07 dated April 20, 2007.
  - The SMEs availing this facility should furnish a declaration to the AD Category I bank regarding the amounts of forward contracts already booked, if any, with other AD Category I banks under this facility.

Hedging as per the **Special Dispensation for Resident Individuals**

- **Participants : Market-makers** – AD Category I banks ; **Users:** Resident Individuals
- **Purpose :**To hedge their foreign exchange exposures arising out of actual or anticipated remittances, both inward and outward, can book forward contracts, <u>without production of underlying documents</u>**, up to a limit of USD 100,000**, <u>based on self declaration.</u>
- **Product** Forward foreign exchange contracts
- **Operational Guidelines, Terms and Conditions**
  - The contracts booked under this facility would normally be on a deliverable basis. However, in case of mismatches in cash flows or other exigencies, the contracts booked under this facility may be allowed to be cancelled and re-booked. The notional value of the outstanding contracts should not exceed USD 100,000 at any time.
  - The contracts may be permitted to be booked up to **<u>tenors of one year</u>** only.
  - Such contracts may be booked through AD Category I banks with whom the resident individual has banking relationship, on the basis of an application-cum-declaration in the prescribed format. The AD Category I banks should satisfy themselves that the resident individuals understand the nature of risk inherent in booking of forward contracts and should carry out due diligence regarding "*user appropriateness*" and "*suitability*" of the forward contracts to such customer.

General Instructions for
OTC Forex Derivatives entered by Residents in India

- In case of all forex derivative transactions [except INR- foreign currency swaps i.e. moving from INR liability to foreign currency liability] , AD Category I banks must take a declaration from the clients that the exposure is unhedged and has not been hedged with another AD Category I bank. The corporates should provide an annual certificate to the AD Category I bank certifying that the derivative transactions are authorized and that the Board (or the equivalent forum in case of partnership or proprietary firms) is aware of the same.
- In the case of **contracted exposure**, AD Category I banks must obtain:
  - An undertaking from the customer that the same underlying exposure has not been covered with any other AD Category I bank/s. Where hedging of the same exposure is undertaken in parts, with more than one AD Category I bank, the details of amounts already booked with other AD Category I bank/s should be clearly indicated in the declaration.
  - Quarterly certificates from the statutory auditors of the users, that the contracts outstanding at any point of time with all AD Category I banks during the quarter did not exceed the value of the underlying exposures.
- In any derivative contract, the notional amount should not exceed the actual underlying exposure at any point in time. Similarly, the tenor of the derivative contracts should not exceed the tenor of the underlying exposure. The notional amount for the entire transaction over its complete tenor must be calculated and the underlying exposure being hedged must be commensurate with the notional amount of the derivative contract.
- Derived foreign exchange exposures are not permitted to be hedged. However, in case of INR- foreign currency swaps, at the inception, the user can enter into one time plain vanilla cross currency option (not involving Rupee) to cap the currency risk.

Currency Futures

- The Currency Futures market would function subject to the directions, guidelines, instructions issued by the Reserve Bank and the SEBI, from time to time
- **Participants**

  (i) No person other than 'a person resident in India' as defined in section 2(v) of the Foreign Exchange Management Act, 1999 shall participate in the currency futures market.

  (ii) Notwithstanding sub-paragraph (i), no scheduled bank or such other agency falling under the regulatory purview of the Reserve Bank under the Reserve Bank of India Act, 1934, the Banking Regulation Act, 1949 or any other Act or instrument having the force of law shall participate in the currency futures market without the permission from the respective regulatory Departments of the Reserve Bank. Similarly, for participation by other regulated entities, concurrence from their respective regulators are required. The Guidelines have been issued under Section 45W of the Reserve Bank of India Act, 1934.
- **Features:**
  - USD-INR, EUR-INR, GBP-INR and JPY-INR contracts are allowed to be traded.
  - The size of each contract shall be USD 1000 for USD-INR contracts, Euro 1000 for Euro-INR contracts, GBP 1000 for GBP-INR contracts and JPY 100,000 for JPY-INR contracts.
  - The contracts shall be quoted and settled in Indian Rupees.
  - The maturity of the contracts shall not exceed 12 months.
  - The settlement price for USD-INR and Euro-INR contracts shall be the Reserve Bank's Reference Rates and for GBP-INR and JPY-INR contracts shall be the exchange rates published by the Reserve Bank in its press release on the last trading day.

Currency Futures (contd.)

- **Membership**
  - The membership of the currency futures market of a recognised stock exchange shall be separate from the membership of the equity derivative segment or the cash segment.
- **Position limits**
  - The position limits for various classes of participants in the currency futures market shall be subject to the guidelines issued by the SEBI.

Currency Options

Permission

- Exchange traded Currency option contracts are permitted in US Dollar (USD) - Indian Rupee (INR).
- Only ‘persons resident in India’ may purchase or sell exchange traded currency options contracts to hedge an exposure to foreign exchange rate risk or otherwise.

Features of exchange traded currency options

- The underlying for the currency option shall be US Dollar – Indian Rupee (USD-INR) spot rate.
- The options shall be premium styled European call and put options.
- The size of each contract shall be USD 1000.
- The premium shall be quoted in Rupee terms. The outstanding position shall be in USD.
- The maturity of the contracts shall not exceed twelve months.
- The contracts shall be settled in cash in Indian Rupees.
- The settlement price shall be the Reserve Bank’s Reference Rate on the date of expiry of the contracts.

Membership

- Members registered with the SEBI for trading in currency futures market shall be eligible to trade in the exchange traded currency options market of a recognised stock exchange. Membership for both trading and clearing, in the exchange traded currency options market shall be subject to the guidelines issued by the SEBI.

Structured Derivative Contracts(DBOD)

- The following derivative instruments used to hedge an existing interest rate and forex exposure, on a standalone basis, may be treated as generic derivative products:
  - Forex Forward Contracts
  - Forward Rate Agreements
  - Interest rate caps and floors (plain vanilla only)
  - Plain Vanilla Options (call option and put option)
  - Interest Rate Swaps
  - Currency Swaps including Cross-Currency Swaps
- The following derivative products may be treated as structured derivative products:
  - Instruments which are combination of either cash instrument and one or more generic derivative products
  - Instruments which are combination of two or more generic derivative products