Risk Management and Inter-Bank Dealings
A.P. (DIR Series) Circular No.92 (April 4, 2003)

Reserve Bank of India
Exchange Control Department
Central Office
Mumbai 400001

A.P. (DIR Series) Circular No.92

April 4, 2003

To

All Authorised Dealers in Foreign Exchange

Dear Madam/Sirs,

<u>Risk Management and Inter-Bank Dealings</u>

Attention of authorised dealers is invited to A.P. (DIR Series) Circular No.19 dated January 24, 2002 and various amendments issued on the captioned subject from time to time.

2. Instructions pertaining to forward exchange cover, other derivative products, Rupee accounts of Non-resident banks and inter-bank dealings etc., have been consolidated as indicated in the enclosures to this circular. These instructions supersede the instructions contained in the circulars mentioned above.

3. Authorised Dealers may bring the contents of this circular to the notice of their constituents concerned.

4. The directions contained in this circular have been issued under Section 10(4) and Section 11(1) of the Foreign Exchange Management Act, 1999 (42 of 1999).

Yours faithfully,

G . Padmanabhan

Chief General Manager

PART – A

<u>RISK MANAGEMENT</u>

Section I

<u>Facilities for Residents other than authorised dealers:</u>

Forward Exchange Contracts

A.1 (i) Authorised dealers may enter into forward contracts with residents in accordance with the provisions contained in paragraph 1 of Schedule I to Reserve Bank Notification No. FEMA25/RB-2000 dated 3rd May 2000 and amendments thereto.

(ii) While booking contracts for their constituents, authorised dealers should verify suitable documentary evidence, irrespective of the underlying transaction being a current account or a capital account transaction, to ensure that an exposure exists, to the extent of the amount of cover sought. Full particulars of contract should be marked on such documents under proper authentication and copies thereof retained for verification.

A.2 Authorised dealers may also allow importers and exporters to book forward contracts on the basis of a declaration of an exposure and based on past performance subject to the conditions prescribed by Reserve Bank of India in this regard. {Ref: EC.CO.FMD/453/02.03.75/2001-02 dated December 1, 2001 and AP (DIR Series) Circular No.63 dated December 21,2002}.

A.3 .A forward contract once cancelled may be rebooked subject to conditions prescribed by the Reserve Bank from time to time {Ref: EC.CO. FMD.790/ 02.03.75/2001-02 dated March 26, 2002 and AP (DIR Series) Circular No.63 dated December 21,2002}.

A forward contract cancelled with one authorised dealer can be rebooked with another authorised dealer subject to the following conditions:

a. the switch is warranted by competitive rates on offer, termination of banking relationship with the authorised dealer with whom the contract was originally booked, etc.

b. the cancellation and rebooking are done simultaneously on the maturity date of the contract ,

c. the responsibility of ensuring that the original contract has been cancelled rests with the authorised dealer who undertakes rebooking of the contract.

Contracts other than Forward Contracts

A.4 (i) Authorised dealers in India may enter into contracts, other than forward contracts with residents in India in accordance with the provisions contained in paragraphs 2 and 3 of Schedule I to Reserve Bank Notification No. FEMA 25/RB-2000 dated 3rd May 2000.

(ii) Authorised dealers should ensure that the Board of Directors of the corporate has drawn up a risk management policy, laid down clear guidelines for concluding the transactions and institutionalised the arrangements for a periodical review of operations and annual audit of transactions to verify compliance with the regulations. The periodical review reports and annual audit reports should be obtained from the concerned Corporate by the authorised dealers.

(iii) Foreign currency – rupee swaps between Corporates who run long-term foreign currency or rupee exposures may be arranged by authorised dealers subject to the conditions prescribed by Reserve Bank of India. {Ref: AP (DIR Series) Circular No.63 dated December 21,2002}

NOTE:

i. Authorised dealers should not offer leveraged swap structures to clients.

ii. Authorised dealers should not allow the swap route to become a surrogate for forward contracts for those who do not qualify for forward cover.

Other Derivatives – Foreign Currency Options:

A.5 (i) Authorised dealers in India may write cross currency options in accordance with the provisions contained in paragraphs 2&3 of Schedule I to the Reserve Bank Notification No FEMA 25/RB-2000 dated 3rd May 2000.

(ii) Option should be written 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 authorised dealer in India.

(iii) Authorised dealers desirous of writing options, should obtain one time approval, before undertaking the business, from the Chief General Manager, Exchange Control Department, (Forex Markets Division), Reserve Bank of India, Central Office, Mumbai, 400 001.

Hedging of commodity price risk in the International Commodity Markets

A.6 (i) Residents in India, engaged in import and export trade, may hedge the price risk of commodities in the international commodity exchanges/markets. Applications for commodity hedging may be forwarded to Reserve Bank through the International Banking Division of an authorised dealer giving the details laid down in Schedule III to the Reserve Bank Notification No. FEMA 25/RB-2000 dated 3rd May 2000. A one-time approval will be given by Reserve Bank along with the guidelines for undertaking this activity.

(ii) General permission has been granted to entities in 'Special Economic Zones' to undertake hedging transactions in the overseas commodity exchanges/markets to hedge their commodity prices on export/import, subject to the condition that such contract is entered into on a stand-alone basis.

Note: The term ''stand alone'' means the unit in SEZ is completely isolated from financial contacts with its parent or subsidiary in the mainland or within the SEZs as far as its import/export transactions are concerned. {Ref: A.P. (DIR Series) Circular No. 44 dated November 12, 2002}.

Facilities for Foreign Institutional Investors (FIIs)

A.7 (i) Designated branches of authorised dealers maintaining accounts of FIIs may provide forward cover to such customers subject to the conditions laid down in paragraph 1 of Schedule II to the Reserve Bank Notification No. FEMA 25/RB-2000 dated 3rd May 2000, as amended from time to time. At present, FIIs are allowed to hedge the market value of their entire investment in equity as on a particular date. If a hedge becomes naked in part or full owing to shrinking of the portfolio, for reasons other than sale of securities, the hedge may be allowed to continue to the original maturity, if so desired.

(ii) The eligibility for cover may be determined on the basis of the declaration of the FII. A review may be undertaken on the basis of market price movements, fresh inflows, amounts repatriated and other relevant parameters to ensure that the forward cover outstanding is supported by underlying exposure.

(i) A monthly statement should be furnished to the Chief General Manager, Reserve Bank of India, Exchange Control Department (Forex Markets Division), Central Office, Mumbai-400 001 before the 10th of the succeeding month indicating the name of the FII / fund, the eligible amount of cover and the actual cover taken.

Facilities for Non-resident Indians (NRIs)
And Overseas Corporate Bodies (OCBs)

A.8 Authorised dealers may enter into forward contracts with NRIs/OCBs as per the guidelines set down in paragraph 2 of Schedule II to the Reserve Bank Notification No. FEMA 25/RB-2000 dated 3rd May 2000.

Facilities for hedging of Foreign Direct Investment in India.

A.9.Authorised Dealers may enter into forward contracts with residents outside India to hedge the investments made in India since January 1,1993, subject to verification of the exposure in India.

Section II

Facilities for Authorised Dealers

Management of Bank's Assets-Liabilities:

A.10 Authorised dealers may use the following instruments to hedge their assets-liability portfolio :

- i) Interest rate swaps,
- ii) Currency swaps, and
- iii) Forward rate agreements.

Authorised dealers may also purchase call or put options to hedge their cross currency proprietary trading positions.

The use of these instruments is subject to the following conditions:

(a) An appropriate policy in this regard is approved by their Top Management.
(b) The value and maturity of the hedge should not exceed that of the underlying
(c) No 'stand alone' transactions can be initiated. If a hedge becomes naked in part or full owing to shrinking of the portfolio, it may be allowed to continue till the original maturity and should be marked to market at regular intervals.
(d) The net cash flows arising out of these transactions are booked as income and expenditure and reckoned as exchange position wherever applicable.

Hedging of Gold Prices

A.11 (i) Banks authorised by Reserve Bank to operate the Gold Deposit Scheme may use exchange-traded and over-the-counter hedging products available overseas to manage the price risk. However, while using products involving options, it may be ensured that there is no net receipt of premium, either direct or implied. Banks, which are allowed to enter into forward gold contracts in India in terms of the guidelines issued by the Department of Banking Operations and Development (including the positions arising out of inter-bank gold deals) are also allowed to cover their price risk by hedging abroad in the manner indicated above.

(ii) Authorised banks are permitted to enter into forward contracts with their constituents (exporters of gold products, jewellery manufacturers, trading houses, etc.) in respect of the underlying sale, purchase and loan transactions in gold with them subject to the conditions specified by Reserve Bank.

A.12 Hedging of Tier I Capital

Foreign banks may hedge the entire Tier I Capital held by them in Indian books subject to conditions laid down by Reserve Bank.
{Ref: EC.CO.FMD/6/02.03.75/2002-03 dated November 20, 2002 and Ref: AP (DIR Series) Circular No.63 dated December 21,2002}

PART -B

Accounts of Non-resident Banks

General

B.1 (i) Credit to the account of a non-resident bank is a permitted method of payment to non-residents and is, therefore, subject to the regulations applicable to transfers in foreign currency.

(ii) Debit to the account of a non-resident bank is in effect an inward remittance in foreign currency.

Rupee Accounts of Non-Resident Banks

B.2 (i) Banks may open/close rupee accounts (non-interest bearing) in the names of their overseas branches or correspondents without prior reference to Reserve Bank. Opening of rupee accounts in the names of branches of Pakistani banks operating outside Pakistan requires specific approval of Reserve Bank.

(ii) The Head/Principal Office of each bank should furnish an up-to-date list (in triplicate) of all its offices/branches, which are maintaining rupee accounts of non-resident banks as at the end of December every year giving their code numbers allotted by Reserve Bank. The list should be submitted before 15th January of the following year to the Central Office of Reserve Bank (Central Statistical Division). The offices/branches should be classified according to area of jurisdiction of Reserve Bank Offices within which they are situated.

Funding of Accounts of Non-resident Banks

B.3 (i) Banks may freely purchase foreign currency from their overseas correspondents/branches at on-going market rates to lay down funds in their accounts for meeting their bona-fide needs in India.

(ii) Transactions in the accounts should be closely monitored to ensure that overseas banks do not take a speculative view on the rupee. Any such instances should be notified to the Reserve Bank.

NOTE:

A. ***Forward purchase or sale of foreign currencies against rupees for funding is prohibited.***

B. ***Offer of two-way quotes to non-resident banks is also prohibited.***

Transfers from other Accounts

B.4 Transfer of funds between the accounts of the same bank or different banks is freely permitted.

Conversion of Rupees into Foreign Currencies

B.5 Balances held in rupee accounts of non-resident banks may be freely converted into foreign currency. All such transactions should be reported in Form A2 and the corresponding debit to the account should be in form A3 under the relevant R Returns.

Responsibilities of Paying and Receiving Banks

B.6 In the case of credit to accounts the paying banker should ensure that all Control requirements are met and are correctly furnished in form A1/A2 as the case may be.

Refund of Rupee Remittances

B.7 Requests for cancellation or refund of inward remittances may be complied with without reference to Reserve Bank after satisfying themselves that the refunds are not being made in cover of transactions of compensatory nature.

Overdrafts/Loans to Overseas Branches/Correspondents

B.8 (i) Banks may permit their overseas branches/ correspondents temporary overdrawals not exceeding Rs.500 lakhs in aggregate, for meeting normal business requirements. This limit applies to the amount outstanding against all overseas branches and correspondents in the books of all the branches of the bank in India. This facility should not be used to postpone funding of accounts. If overdrafts in excess of the above limit are not adjusted within five days a report should be submitted to the Central Office of Reserve Bank (Forex Markets Division) within 15 days from the close of the month, stating the reasons therefor. Such a report is not necessary if arrangements exist for value dating.

(ii) Banks wishing to extend any other credit facility in excess of (i) above to overseas banks should seek prior approval from the Chief General Manager, Reserve Bank of India, Exchange Control Department (Forex Markets Division) Central Office, Mumbai.

Rupee Accounts of Exchange Houses

B.9 Opening of rupee accounts in the names of exchange houses for facilitating private remittances into India requires approval of Reserve Bank. Remittances through exchange houses for financing trade transactions are permitted upto Rs.2,00.000 per transaction.

PART -C

Inter-Bank Foreign Exchange Dealings

General

C.1 The Board of Directors of authorised dealers should frame an appropriate policy and fix suitable limits for various Treasury functions.

Position and Gaps

C.2 The overnight open exchange position (vide Annexure I) and the aggregate gap limits are required to be approved by Reserve Bank.

Inter-bank transactions

C.3 Subject to compliance with the provisions of paragraphs C.1and C.2, authorised dealers may freely undertake foreign exchange transactions as under:

a) With authorised dealers in India:

(i) Buying/Selling/Swapping foreign currency against rupees or another foreign currency

(ii) Placing/Accepting deposits and Borrowing/Lending in foreign currency.

b) With banks overseas and Off-shore Banking Units in Special Economic Zones

(i) Buying/Selling/Swapping foreign currency against another foreign currency to cover client transactions or for adjustment of own position,

(ii) Initiating trading positions in the overseas markets .

Note A: Funding of accounts of Non-resident banks - refer to paragraph B.4

B: Form A2 need not be completed for sales in the interbank market, but all such transactions shall be reported to Reserve Bank in R Returns

Foreign currency accounts

C.4 (i) Inflows into foreign currency accounts arise primarily from client-related transactions, swap deals, deposits, borrowings, etc. Banks may maintain balances in foreign currencies up to the levels approved by the Top Management. They are free to manage the surplus in these accounts through overnight placement and investments with their overseas branches/correspondents subject to adherence to the gap limits approved by Reserve Bank.

(ii) Banks are free to undertake investments in overseas markets subject to the limits approved by their Board of Directors. Such investments may be made in overseas money market instruments and/or debt instruments issued by a foreign state with a residual maturity of less than one year and rated at least as AA (-) by Standard & Poor / FITCH IBCA or Aa3 by Moody's. For the purpose of investments in debt instruments other than the money market instruments of any foreign state, bank's Board may lay down country ratings and country - wise limits separately wherever necessary.

Note: For the purpose of this clause, 'money market instrument' would mean any debt instrument whose life to maturity does not exceed one year as on the date of purchase.

(iii) Banks may also invest the undeployed FCNR (B) funds in overseas markets in long-term fixed income securities subject to the conditions laid down by Reserve Bank of India. {Ref: AP (DIR Series) Circular No. 40 dated April29, 2002.}

(iv) Foreign currency funds representing surpluses in the nostro accounts may be utilised for:

a) making loans to resident constituents for meeting their foreign exchange requirements or for the rupee working capital/capital expenditure needs subject to the prudential/interest-rate norms, credit discipline and credit monitoring guidelines in force.

b) extending credit facilities to Indian wholly owned subsidiaries/ joint ventures abroad in which at least 51% equity is held by a resident company, subject to the guidelines issued by Reserve Bank (Department of Banking Operations & Development).

(v) Banks may write off/transfer to unclaimed balances account, unreconciled debit/credit entries as per instructions issued by Department of Banking Operations and Development, from time to time.

Loans/Overdrafts

C .5 (i) Banks may avail of loans/overdrafts from their Head Office, overseas branches, correspondents up to 25% of their unimpaired Tier-I capital or US$ 10 million or its equivalent, whichever is higher. The funds so raised may be used for purposes other than lending in foreign currency to constituents in India and repaid without reference to the Reserve Bank. As an exception to this rule authorised dealers are permitted to use borrowed funds as also foreign currency funds received through swaps for granting foreign currency loans in terms of IECD Circular No 12/04.02.02/2002-03 dated January 31,2003.The aforesaid limit applies to the aggregate amount availed of by all the offices and branches in India from all their branches/correspondents abroad. If drawals in excess of the above limit are not adjusted within five days, a report should be submitted to the Chief General Manager, Reserve Bank of India Exchange Control Department, Forex Markets Division, Amar Building, Fort, Mumbai 400001 within 15 days from the close of the month in which the limit was exceeded. Such a report is not necessary if arrangements exist for value dating.

(ii) Banks may avail of loans in excess of the limits prescribed in sub-paragraph (i) above solely for replenishing their rupee resources in India without prior approval of Reserve Bank. Such rupee funds may be used only for financing the banks' normal business operations and should not be deployed in the call money etc. markets. A report on each borrowing should be immediately forwarded to the Chief General Manager, Reserve Bank of India Exchange Control Department, Forex Markets Division, Amar Building, Fort, Mumbai 400001 whose prior permission will be required for repayment of such loans. Such permission will be given only if the bank has no borrowings outstanding either from Reserve Bank or other bank/financial institution in India and is clear of all money market borrowings for a period of at least four weeks before the repayment.

(iii) Interest on loans/overdrafts may be remitted (net of taxes) without the prior approval of Reserve Bank.

Reports to Reserve Bank

C.6 (i) The Head/Principal Office of each authorised dealer should submit to the Chief General Manager, Exchange Control Department (Forex Markets Division), Reserve Bank of India, Central Office, Mumbai 400 001 daily statements of foreign exchange turnover in Form FTD and Gaps position and cash balances in Form GPB as per Annexure II. These statements should be transmitted online through wide area network (WAN).

(ii) The Head/Principal Office of each authorised dealer should submit a statement in duplicate in form BAL giving details of their holdings of all foreign currencies on fortnightly basis so as to reach the Regional Office of Reserve Bank under whose jurisdiction the Head/Principal Office is situated within seven calendar days from the close of the reporting period to which it relates.

(iii) The Head/Principal Office of each authorised dealer should forward a statement of Nostro/Vostro Account balances on a monthly basis in the format given in Annexure III to the Director, Division of International Finance, Department of Economic Analysis and Policy, Reserve Bank of India, Central Office Building, 8th Floor, Fort, Mumbai-400 001. The data may also be transmitted by fax or e-mail at the numbers/addresses given in the format.

(iv) Authorised dealers may consolidate the data on cross currency derivatives transactions undertaken by residents in terms of Paragraph 2 and 3 of Schedule1 to the Notification and submit half-yearly reports to the Chief General Manager, Exchange Control Department, (Forex Markets Division), Reserve Bank of India, Central Office, Mumbai-400 001 as per the format indicated in the Annexure IV.

(v) Authorised dealers may forward details of exposures in foreign exchange as on 1st April every year as per the format appended to AP (DIR Series) Circular no. 63 dated December 21,2002 to the Chief General Manger, Exchange Control Department, (Forex Markets Division), Reserve Bank of India, Central Office, Mumbai, 400 001.

ANNEXURE I
(See paragraph C.2)

Guidelines for Foreign Exchange Exposure Limits of Authorised Dealers

1. **Coverage**

For banks incorporated in India, the exposure limits fixed by the Management should be the aggregate for all branches including their overseas branches. For foreign banks, the limits will cover only their branches in India.

2. **Capital**

Capital refers to Tier I capital as per instructions issued by Reserve Bank of India (Department of Banking Operations and Development).

3. **Calculation of the Net Open Position in a Single Currency**

The open position must first be measured separately for each foreign currency. The open position in a currency is the sum of (a) the net spot position, (b) the net forward position and (c) the net options position.

a**) Net Spot Position**

The net spot position is the difference between foreign currency assets and the liabilities in the balance sheet. This should include all accrued income/expenses.

b) **Net Forward Position**

This represents the net of all amounts to be received less all amounts to be paid in the future as a result of foreign exchange transactions which have been concluded. These transactions, which are recorded as off-balance sheet items in the bank's books, would include:

(i) spot transactions which are not yet settled;

(ii) forward transactions;

(iii)guarantees and similar commitments denominated in foreign currencies which are certain to be called;

(iv)net of amounts to be received/paid in respect of currency futures, and the principal on currency futures/swaps.

c) **Options Position**

The options position is the "delta-equivalent" spot currency position as reflected in the authorised dealer's options risk management system, and includes any delta hedges in place which have not already been included under 3(a) or 3(b) (i) and (ii).

4. **Calculation of the Overall Net Open Position**

This involves measurement of risks inherent in a bank's mix of long and short position in different currencies. It has been decided to adopt the "shorthand method" which is accepted internationally for arriving at the overall net open position. Banks may, therefore, calculate the overall net open position as follows:

(i) Calculate the net open position in each currency (paragraph 3 above).

(ii) Calculate the net open position in gold.

(iii) Convert the net position in various currencies and gold into rupees in terms of existing RBI / FEDAI Guidelines.

(iv) Arrive at the sum of all the net short positions..

(v) Arrive at the sum of all the net long positions.

Overall net foreign exchange position is the higher of (iv) or (v). The overall net foreign exchange position arrived at as above must be kept within the limit approved by Reserve Bank.

5. **Capital Requirement**

As prescribed by Reserve Bank from time to time.

ANNEXURE II

FTD
(see Paragraph C.6)

Statement showing daily turnover of foreign exchange

		Merchant			Inter bank		
		Spot, Cash, Ready, T.T. etc.	Forward	Cancellation of Forwards	Spot	Swap	Forwards
FCY/INR	Purchase from						
	Sales to						
FCY/FCY	Purchase from						
	Sales to						

GPB

Statement showing gaps, position and cash balances

US Dollars Balances : IN USD MILLION

(Cash Balance + All Investments)

Net Open Exchange Position (Rs.) : O/B (+)/O/S (-) IN Rs.CRORE

Of the above FCY/INR : IN RS. CRORE

AGL maintained : VaR maintained:

US DOLLAR MATURITY MISMATCH IN MILLION

1 month	2 months	3 months	4 months	5 months	6 months	>6 months

Annexure III
[see paragraph C.6 (iii)]

Statement of Nostro/Vostro Balances for the month of.

Name & address of the Authorised Dealer.

Sr.no.	Currency	Net balance	Net balance	

		in Nostro Account	in Vostro Account.	
1	USD			
2	EUR			
3	JPY			
4	GBP			
5	Rupee			
6	Other currencies (in US $ million)			

Note: In case the variation in each item above (given at 1 to 5) exceeds 10% in a month, the reason may be given briefly, as a footnote.

The above statement should be addressed to:

The Director
Division of International Finance
Department of Economic Analysis & Policy
Reserve Bank of India,
Central Office Building, 8th Floor,
Mumbai – 400 001.
Phone: 022-2266 3791
Fax: 022-2262 2993, 2266 0792
e.mail: rkpattnaik@rbi.org.in
brijeshp@rbi.org.in

Annexure IV
[see paragraph 1.6 (iv)]

Cross- currency derivative transactions - statement for the half-year ended….

Product	No. of transactions	Notional principal amount in USD
Interest rate swaps		
Currency swaps		
Coupon swaps		
Foreign currency option		
Interest rate caps or collars (Purchases)		
Forward rate agreement		
Any other product as permitted by Reserve Bank from time to time		