Hedging of Currency Risk arising out of Trade Transactions by Residents under Contracted Route – Draft guidelines

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Hedging of Currency Risk arising out of Trade Transactions by Residents under Contracted Route

Background & Objective

Under the extant regulatory framework under FEMA, 1999 and Regulations[1] thereunder, the various routes available to residents intending to hedge currency risk are as follows:

i. Exposure based on underlying contracts
ii. Probable Exposures based on Past Performance
iii. Special Dispensation for SMEs and Individuals

Under (i), the Contracted Exposure route, clients have to submit evidence of underlying foreign currency exposure to AD Cat-I banks at the time of booking the derivative contract. For operational convenience, a maximum period of 15 days is allowed for production of such documents.

With a view to easing the process of hedging, RBI has proposed to introduce a more liberalized framework for importers and exporters by reducing the documentary requirements for hedging trade transactions under the contracted exposure route in line with the announcement to this effect made in the Monetary Policy statement dated September 29, 2015.

Extract of the regulation

- Residents, viz. exporters and importers, may book forex derivative contracts to hedge the currency risk arising out of trade transactions under the Contracted Exposure Route on the basis of self-declaration by the authorized signatory of existence of a valid underlying in terms of currency, amount and tenor to be provided as part of the deal confirmation process.
- The onus of establishing underlying exposure and its genuineness on the basis of documentary evidence shall rest with the customer entering into the derivative contract and any contravention may invite penal action by Reserve Bank of India under FEMA, 1999.
- AD Cat-I banks may ensure that the contracts booked under this facility are in line with the business activity and track record of the customer and if necessary may seek evidence of underlying exposure from the customer or if requisitioned by RBI as part of the supervisory process.
- AD Cat-I banks will continue to obtain an annual certificate from the statutory auditors of the concerned client to the effect that the contracts outstanding with all AD Cat-I banks at any time did not exceed the underlying contracted exposure.
- AD Cat-I banks, wherever necessary, may advise and educate their clients booking contracts regarding the need to maintain proper records in respect of the underlying exposures under the liberalized framework in view of (iii) above.
- Residents may continue to hedge their currency risks based on past performance as per the extant regulatory framework.

- All other operational guidelines, terms and conditions as laid down in Master Circular on Risk Management and Inter-bank Dealings dated July 1, 2015, as amended from time to time, will continue to apply to derivative contracts booked under Contracted Route for trade exposures.
- This dispensation will be reviewed after a period of one year.

Impact Assessment

The guideline one finalised will have the following impact:

- Bank will no longer be required to collect the underlying documents from the clients booking hedging contracts under the contracted exposure route for their trade transactions (Current Account transactions). Banks will need to modify the deal confirmations to include a self-declaration from the clients duly signed by the authorized signatories about the existence of a valid underlying in terms of currency, amount and tenor.
- Bank will continue to collect the underlying documents from the clients booking hedging contracts under the contracted exposure route for the capital account transactions.
- Banks will continue to obtain an annual certificate from the statutory auditors of the concerned client to the effect that the contracts outstanding with all AD Cat-I banks at any time did not exceed the underlying contracted exposure.
- Under what circumstances an AD category I bank may ask for underlying from the clients would need to be documented in the process notes by the banks.

Questions remain:

- The supervisory expectations around the underlying process for current account transactions need to be articulated by the RBI so that the banks can have an appropriate framework under the new dispensation scenario.
- If clients are allowed to hedge forex exposure on a self-declaration basis for current account transactions, why has the RBI not provided this relaxation to capital account transactions?
- Why will a client use the existing past performance facility given they can now enter into hedge transactions using the self-declaration route under this revised relaxation?
- Since the self-declaration will be part of the deal confirmation, does that mean banks need to collect the deal confirmations for all contracts e.g. including forwards?
- The time limit for submission of returning the signed confirmation back to the banks is not mentioned by the RBI in the draft guideline.
- Statutory audit certificate is the only independent control in place under the revised framework. However in case an exception of over hedging is noted by the statutory auditors during their certification process, what will be the next steps for such scenarios needs to be stated by the RBI.

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