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RESERVE BANK OF INDIA
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The Chairman and Managing Director/
Chief Executive Officer
All Scheduled Commercial Banks
(Excluding RRBs and LABs)

Dear Sir,

Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure

Please refer to the draft guidelines on the captioned subject issued on July 2, 2013 and paragraph 22 of second quarter review of the monetary policy announced on October 29, 2013 (extract enclosed). Unhedged foreign currency exposures of the entities[1] are an area of concern not only for individual entity but also to the entire financial system; entities who do not hedge their foreign currency exposures can incur significant losses due to exchange rate movements. These losses may reduce their capacity to service the loans taken from the banking system and thereby affect the health of the banking system.

2. We have issued various guidelines advising banks to closely monitor the unhedged foreign currency exposures of their borrowing clients and also factor this risk into the pricing. However, the extent of unhedged foreign currency exposures of the entities continues to be significant and this can increase the probability of default in times of high currency volatility. It has, therefore, been decided to introduce incremental provisioning and capital requirements for bank exposures to entities with unhedged

[1] For the purpose of this circular, 'entities' means those entities which have borrowed from banks including borrowing in INR and other currencies.

Department of Banking Operations & Development, Central Office, 12th Floor, Central Office Building, Bhagat Singh Marg, Mumbai
Tel No: 91-22-22661602/Fax No: 91-22-22705691,22705692

foreign currency exposures. For calculating the incremental provisioning and capital requirements, the following methodology may be followed:

a. Ascertain the amount of Unhedged Foreign Currency Exposure (UFCE):

Foreign Currency Exposure (FCE) refers to the gross sum of all items on the balance sheet that have impact on profit and loss account due to movement in foreign exchange rates. This may be computed by following the provisions of relevant accounting standard. Items maturing or having cash flows over the period of next five years only may be considered.

UFCE may exclude items which are effective hedge of each other. For this purpose, two types of hedges which may be considered are - financial hedge and natural hedge. Financial hedge is ensured normally through a derivative contract with a financial institution. Hedging through derivatives may only be considered where the entity at inception of the derivative contract has documented the purpose and the strategy for hedging and assessed its effectiveness as a hedging instrument at periodic intervals. For the purpose of assessing the effectiveness of hedge, guidance may be taken from the pronouncements of the Institute of Chartered Accountants of India on the matter.

Natural hedge may be considered when cash flows arising out of the operations of the company offset the risk arising out of the FCE defined above. For the purpose of computing UFCE, an exposure may be considered naturally hedged if the offsetting exposure has the maturity/cash flow within the same accounting year. For instance, export revenues (booked as receivable) may offset the exchange risk arising out of repayment obligations of an external commercial borrowing if both the exposures have cash flows/maturity within the same accounting year.

b. Estimate the extent of likely loss:

The loss to the entity in case of movement in USD-INR exchange rate may be calculated using the annualised volatilities. For this purpose, largest annual volatility seen in the USD-INR rates during the period of last ten years may be taken as the movement of the USD-INR rate in the adverse direction[2].

c. Estimate the riskiness of unhedged position and provide appropriately:

Once the loss figure is calculated, it may be compared with the annual EBID[3] as per the latest quarterly results certified by the statutory auditors. This loss may be computed as a percentage of EBID. Higher this percentage, higher will be the susceptibility of the entity to adverse exchange rate movements. Therefore, as a prudential measure, all exposures to such entities (whether in foreign currency or in INR) would attract incremental capital and provisioning requirements (i.e., over and above the present requirements) as under:

Likely Loss/EBID (%)	**Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning**	**Incremental Capital Requirement**
Upto15 per cent	0	0
More than 15 per cent and upto 30 per cent	20bps	0
More than 30 per cent and upto 50 per cent	40bps	0
More than 50 percent and upto 75 per cent	60bps	0
More than 75 per cent[4]	80 bps	25 per cent increase in the risk weight

[2] Banks may compute largest annual volatility over a period of last ten years in the following manner: First, daily changes in the USD-INR rates may be computed as a log return of the today's rate over the yesterday's rate. Second, daily volatility may be computed as standard deviation of these returns over a period of one year (250 observations). Third this daily volatility may be annualised by multiplying it by square root of 250. This computation has to be performed on a daily basis for the all the days in the last ten years. The largest annual volatility thus computed should be used for the computation of the likely loss by multiplying it with the UFCE.

[3] EBID, as defined for computation of DSCR = Profit After Tax + Depreciation + Interest on debt + Lease Rentals, if any.

[4] This category is most likely to default on account of high unhedged exposures due to volatility in the USD-INR rate. If the account becomes NPA, bank has to make provisions accordingly.

3. In terms of circular [DBOD.BP.BC.No.61/21.04.103/2012-13 dated November 21, 2012], banks have to monitor the UFCE on a monthly interval. Banks should calculate the incremental provisioning and capital requirements at least on a quarterly basis. However, during periods of high USD-INR volatility, the calculations may be done at monthly intervals.

4. The implementation of these guidelines may pose some issues for exposures to project under implementation and to new entities which may not have annual EBID figure available. The calculation of incremental provisioning and capital requirements for projects under implementation will be based on projected average EBID for the three years from the date of commencement of commercial operations and incremental capital and provisioning should be accordingly computed subject to a minimum floor of 20 bps of provisioning requirement. For new entities also, the same framework may be made applicable.

5. While computing the UFCE of the foreign MNCs (i.e. MNCs incorporated outside India), intra-group foreign currency exposures (e.g. a subsidiary of a foreign MNC in India may have borrowed from its parent) may be excluded if the bank is satisfied that such foreign currency exposures are appropriately hedged or managed robustly by the parent.

6. These guidelines have been framed keeping in view the domestic borrowers' vulnerability to the foreign currency exposure. However, currency induced credit risk may also be considered for exposures of overseas branches and foreign subsidiaries. For operationalizing these guidelines in case of exposures of overseas branches and foreign subsidiaries of the bank, INR should be replaced by the domestic currency of that jurisdiction.

7. Banks may ensure that their policies and procedures for management of credit risk factor their exposure to currency-induced credit risks and are calibrated towards borrowers whose capacity to repay is sensitive to changes in the exchange rate and other market variables. These could include stipulation of internal limits for these exposures, which may be fixed while considering the overall risk appetite. Where such exposures are high, the options available to the banks to reduce the associated risks

may include reducing these exposures, encouraging borrowers to reduce their currency mismatches by hedging foreign currency exposures, maintaining higher provisioning and capital, etc. Banks should also ensure that the risk of unhedged foreign currency exposure are effectively incorporated in their internal credit rating system and ensure that their loan pricing policies adequately reflect overall credit risks. Implementation of these requirements will be dependent on a robust MIS for getting sufficient and credible data on a regular basis from the borrowers.

8. Banks may disclose their policies to manage currency induced credit risk as a part of financial statements certified by statutory auditors. In addition, banks should also disclose the incremental provisioning and capital held by them towards this risk.

9. The quantification of currency induced credit risk will form a part of banks' Internal Capital Adequacy Assessment Programme (ICAAP) and banks are expected to address this risk in a comprehensive manner. The ICAAP should measure the extent of currency induced credit risk the bank is exposed to and also concentration of such exposures. Banks may also like to perform stress tests under various extreme but plausible exchange rate scenarios under ICAAP. Outcome of ICAAP may lead a bank to take appropriate risk management actions like risk reduction, maintenance of more capital or provision, etc. As a part of Supervisory Review and Evaluation Process (SREP) under Pillar 2, RBI may review the risk management measures taken by the bank and its adequacy to manage currency induced credit risk, especially if exposure to such risks is assessed to be on higher side.

10. This framework may be implemented from April 1, 2014.

Yours faithfully,

(Chandan Sinha)
Principal Chief General Manager

Annex

Extract from Second Quarter Review of Monetary Policy Statement for 2013-14

Unhedged Foreign Currency Exposure

22. Unhedged foreign currency exposures of corporates are a cause for concern as they pose a risk to individual corporates as also to the entire financial system. Based on feedback received from industry participants, it is proposed to:

- issue final guidelines on unhedged foreign currency exposures by end-December 2013.