📌 Forward Exposure Limit & Pre-settlement Risk

CCP CHAPTER 18 MODULE D

📑 18.1 Unhedged Foreign Currency Exposures (UFCE)

To manage foreign exchange risks, the RBI has issued guidelines and regulations under the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 (amended up to May 18, 2020).

🔖 Key Definitions

Term	Definition
📅 **Contracted Exposure**	Current or capital transactions already entered into, exposed to forex risk.
⏳ **Anticipated Exposure**	Expected future transactions exposed to forex risk.

⚠️ Risks of Unhedged Foreign Currency Exposures:

- Increased default probability affecting banking system stability.
- Banks required to regularly monitor and factor UFCE into credit risk ratings.

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🛡️ Bank Requirements:

- Regular monitoring of UFCE.
- Board-approved forex risk management policy.
- Information sharing mechanisms in consortium lending.

💡 Incremental Provisioning and Capital Requirements

Banks must follow these steps to address UFCE risks:

Steps	Description
Step 1	Ascertain Foreign Currency Exposure (FCE), including ECBs, annually.
Step 2	Determine Unhedged FCE after accounting natural and financial hedges.
Step 3	Estimate potential loss from UFCE using the highest USD-INR volatility over the past 10 years.
Step 4	Incremental provisioning and capital allocation based on potential losses.

📊 Provisioning & Capital Requirements Table:

Potential Loss (% of EBID)	Incremental Provisioning & Capital Requirement
> 15%	Incremental provisioning required
> 75%	Additional 0.80 bps provision + 25% higher risk weight

Special provision for small entities:

- Total exposure ≤ ₹50 crore: Incremental provisioning is simplified (no incremental capital).

📏 18.2 Concepts of Forward Exposure

🔹 **Forward Contract:** A customized agreement to buy/sell forex at a future date at a predetermined price.

- **Purpose:** Primarily hedging (risk mitigation), occasionally speculative.
- **Example:** An importer locking USD-INR rate today for import settlement next year.

🔹 Foreign Exchange Derivative Contracts (Definition by RBI):

Contracts settled at a future date, defined as derivatives under RBI regulations, including:

Derivative Instrument 📌	Description
Foreign Currency-Rupee Options/Swaps	Agreement exchanging currencies at future date
Foreign Currency Options	Right, not obligation, to buy/sell currency
Covered Call (Put) Option	Writer holds underlying currency/assets

🔹 Types of Forward Exposure:

- **Current/Capital Account Transactions:** Contracts involving INR against foreign currency.
- **Anticipated Transactions:** Future anticipated transactions linked to forex rates.

Example:

- An Indian exporter entering a USD forward contract to hedge USD receivables.

📌 **Non-deliverable forward (NDF):** Contracts settled in INR, linked to foreign currency benchmarks without actual foreign currency exchange.

📝 Summary Table

Aspect	Highlights
UFCE Definition ⚠️	Risks due to unhedged contracted/anticipated forex exposures
Provisioning & Capital	Mandatory incremental provisions if potential losses exceed 15% EBID; extra capital for risks >75%
Forward Contract 🛡️	Customized forex hedging contracts
Covered Option 📈	Option where the writer owns underlying assets
Non-deliverable Forward (NDF)📉	INR settled, foreign-currency-linked derivative

📌 18.3 Regulatory Guidelines Regarding Forward Exposure

The Reserve Bank of India's (RBI) guidelines on forward exposure are categorized into:

- **General Directions for Authorized Dealers (ADs)**

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- **Specific Directions for ADs**
- **Operational Directions for ADs**

📘 General Directions for Authorised Dealers (ADs)

While offering derivative contracts, ADs must ensure:

Condition	Description
✅ **Purpose of Hedging**	Only genuine hedging activities allowed
📆 **Notional & Tenor**	Must match the underlying exposure
🚫 **Duplicate Hedging**	Exposure must not be hedged multiple times
🔄 **Adjustments**	Notional adjusted if underlying exposure changes
📉 **Market Value Divergence**	Notional adjusted if exposure value changes significantly
💸 **Net Gains Transfer**	Gains on anticipated exposure realized at actual cash flow; pro-rata if partial delivery
📝 **Exceptional Cases**	RBI approval required for deviations
🌍 **IFSC Units**	AD Category-1 banks may offer INR non-deliverable derivatives to non-residents

📋 General Directions for Authorized Dealers (ADs)

Direction	Key Details
📊 **Derivative Limit**	Contracts up to USD 10 million without underlying exposure verification
🌐 **Non-Resident Transactions**	Allowed if transactions funded via repatriable funds
🔐 **Central Treasury Authorization**	Must be authorized by the user to act on their behalf

⚙️ Specific Directions for Forward Exposure

Provision	Details
💱 **Underlying Exposure**	All INR contracts must have contracted exposure
📊 **Position Limits (Without Underlying)**	Contracts allowed up to USD 10 million without proving underlying exposure
📌 **Beyond USD 100 Million**	Users exceeding USD 100M positions must appoint an Authorized Dealer/Custodian
📑 **Information Reporting**	Exchanges report day-end positions to Authorized Dealers/Custodians

🛡️ Obligations of Exchanges & Users

- Exchanges must facilitate users to appoint Authorized Dealers for large exposures.
- Users are responsible for complying with RBI guidelines, failing which they face regulatory actions.

📚 Summary Table

Aspect	Key Guidelines Highlights
Hedging Eligibility	Genuine hedging, matching notional & tenor
Non-Resident Deals	Permitted via repatriable funds, IFSC authorized
Limits	USD 10M without underlying proof; >USD 100M needs designated dealer
Compliance Responsibility	Users & exchanges obligated to ensure compliance
Reporting & Monitoring	Exchanges must inform ADs about open positions

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📌 18.3 Regulatory Guidelines Regarding Forward Exposure

The RBI regulatory guidelines on forward exposure are categorized into:

1. **General Directions for Authorised Dealers (ADs)**
2. **Specific Directions for ADs**
3. **Directions for Exchanges**

🔖 18.3.1 General Directions for ADs

ADs must ensure:

Requirement	Explanation
🛡️ **Purpose of Contract**	Only hedging contracts permitted as per definitions.
📅 **Notional & Tenor Limits**	Must match underlying exposure's value and duration.
🚫 **No Double Hedging**	Exposure must not be hedged through multiple derivative contracts.
🔄 **Exposure Adjustment**	Hedge adjustment required if exposure changes materially.
📉 **Market Value Adjustments**	Notional adjusted if exposure reduces significantly (except market-driven).

Requirement	Explanation
📊 **Estimated Values**	Contracts can rely on reasonable estimates if exact values are uncertain.
💸 **Cancellation/Rebooking**	Allowed; gains transferred at actual cash flow realization.
📝 **Exceptional Cases**	Net gains transferable without actual cash flow, only under exceptional circumstances documented by AD.
🌐 **IFSC Transactions**	Non-deliverable derivative contracts permitted through IFSC Banking Units for non-residents.

⚙️ 18.3.2 Specific Directions for ADs

Condition	Details
💼 **Domestic Corporates**	Can convert INR liabilities to forex via currency swaps.
💱 **Derivative Limit (INR)**	Derivative contracts up to USD 10 million allowed without proving underlying exposure.
🌍 **Transactions with Non-residents**	Must ensure payables are funded via repatriable funds.

Condition	Details
🔐 **Central Treasury Authorisation**	Central treasuries must be explicitly authorised by their entity.

📊 18.3.2 Directions for Exchanges

Condition	Requirement
📌 **Position Limit**	Positions allowed without underlying exposure up to USD 100 million across exchanges.
🗃️ **Reporting Requirements**	Exchanges report end-of-day and intra-day positions to designated AD/Custodian.
🛡️ **Compliance Responsibility**	Users responsible for compliance under FEMA, 1999.

📌 18.4 User Classification Framework for Forward Exposure

Users are classified as:

- **Retail Users**
- **Non-retail Users**

User Type	Eligible Entities
🔸 **Non-retail Users**	Financial sector regulated entities, EXIM Bank, NABARD, NHB, etc.
🔹 **Retail Users**	All other users, unless opting otherwise

📌 18.4.1 Directions for Retail Users:

Criteria	Description/Compliance
✅ **Eligible Products**	Forward contracts, European call/put options, call/put spreads.
📈 **Pricing & Fees**	Separate charges; derivatives priced at mid-market rates (without hidden charges).
📄 **Transparency**	Clearly disclosed charges (processing, commissions, fees).

📌 18.4.2 Directions for Non-retail Users

Condition	Description
🛡️ **Risk Limit**	Loss from derivatives should not exceed unhedged loss potential.

Condition	Description
🏦 Board Approval	All new products approved by bank's Board or equivalent body.

🔍 18.4.3 Customer Appropriateness & Suitability

Banks (market-makers) must follow the Customer Appropriateness & Suitability Policy to manage derivatives business effectively:

Responsibility	Requirement
📑 **Policy Framework**	Board-approved suitability policy essential
📋 **Risk Assessment**	Document understanding of product risks, ensuring products match user's business needs
🛠️ **Authority & Limits**	Verify customer's authority to transact derivatives
💬 **Communication & Disclosure**	Detailed disclosures and scenario analyses provided to users
📁 **Documentation & Records**	Detailed records of customer interactions, especially on appropriateness
⚖️ **Dispute Handling**	Fair, prompt, and transparent resolution of complaints

Responsibility	Requirement
📌 **Senior Management Involvement**	Regular reporting to senior management and compliance teams

📝 Summary Table

Aspect	Highlights
AD General Directions	Hedge verification, exposure matching, IFSC unit permissions
Retail vs Non-retail Users	Clearly defined eligibility and requirements
Compliance	Responsibility on users, exchanges, and ADs
Customer Suitability	Board-approved policies, detailed disclosures

📌 18.5 Permissible Foreign Exchange Derivative Contracts

✅ 18.5.1 Eligibility for Derivative Contracts

Any resident or non-resident can engage in foreign exchange derivative contracts through Authorized Dealers (ADs). Contracts involving INR must adhere to the following:

Condition	Details
🏦 **Contract with ADs**	Contracts involving INR allowed through Authorized Dealers only.
📋 **Hedging Purpose**	Primarily for hedging contracted or anticipated exposures.
📑 **Exposure Details**	Users must provide exposure details when required by ADs.

🖋️ 18.6 Remittances Related to Derivative Contracts

Permissible remittances related to foreign exchange derivatives:

Transaction Type 📌	Description
🌍 **Payments Abroad**	Payments incidental to forex derivatives (resident/non-resident).
💱 **Option Premiums**	Premiums payable by residents to non-residents.
🔄 **Derivative Contract Expenses**	Related incidental payments on forex derivative contracts.
🌐 **Compliance**	Transactions must follow RBI regulations.

⚠️ 18.6.1 Pre-settlement Risk

Pre-settlement risk refers to the risk of a counterparty defaulting before contract maturity.

- **Example:**
  - ABC & Co. defaults 3 months before maturity on a forward USD-INR contract with XYZ Bank.
  - XYZ Bank suffers a loss due to a positive market value (replacement cost).

📉 18.5.2 Replacement Cost

- Pre-settlement risk is essentially the **replacement cost**, i.e., cost to replace the defaulting counterparty at current market prices.

📐 18.5.3 Estimating Pre-settlement Risk

Methods of estimating pre-settlement risk:

Method	Explanation
📌 **Replacement Cost**	Cost of replacing the defaulting counterparty at current rates.
📌 **CCF Calculation**	Contracted Exposure (CE) + Anticipated Exposure (AE) base calculation.
📌 **Original Exposure Method**	Uses actual exposure adjusted by historical volatility.
📌 **Option Pricing Models/Monte Carlo Simulations**	Advanced methods (future risk simulations).

- **India uses Replacement Cost Method primarily.**

📐 18.5.3 Estimating Pre-settlement Risk Methods:

- **Credit Conversion Factor (CCF):** Historical volatility (USD-INR rates) applied to exposure.
- **Monte Carlo Simulation:** Future exposure estimation through scenario analysis (not common in India).

🔐 18.5.4 Mitigation of Pre-settlement Risk

Strategies to mitigate pre-settlement risk:

Strategy	Description
📅 **Shorter Tenor Contracts**	Spot contracts have minimal risk; longer tenors carry more risk.
🖥️ **Dynamic Marking-to-Market**	Periodically adjust contract valuations to current market prices.
💳 **Top-up Margins**	Additional margins collected to offset potential losses.
📜 **ISDA Documentation & Standards**	International standardized contract documentation to mitigate legal risks.
🔄 **Early Redemption Option**	Early redemption triggers built into contracts to limit risk.

📚 18.7.3 Customer Appropriateness & Suitability

Banks must ensure that derivative transactions are appropriate and suitable for customers:

Criteria	Details
📑 **Board-approved Policy**	Clear policies defining customer suitability and appropriateness.
⚠️ **Risk Disclosure**	Transparent communication including scenario analysis and risk acknowledgment by customers.
🔍 **User Capability Assessment**	Evaluation of user's understanding and capability to manage risks.
📊 **Periodic Valuations**	Regular valuations and transparent pricing methodologies.
📁 **Documentation & Transparency**	Thorough documentation of all interactions, pricing models, and customer communications.
🔄 **Complaint & Dispute Handling**	Effective dispute resolution mechanisms.

📌 Summary Table

Aspect	Highlights
Permissible Contracts	Primarily hedging through authorized dealers only.
Replacement Cost	Pre-settlement risk as cost of replacing counterparties.

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Aspect	Highlights
Risk Estimation	Replacement cost method, CCF calculation used in India.
Risk Management Tools	Dynamic marking, margin calls, ISDA standards.
Customer Suitability	Policies, disclosures, documentation, and dispute resolution.