CONFIDENTIAL

REPORT

OF

STUDY GROUP

ON

FORWARD COVER FACILITIES

APRIL 1984

RESERVE BANK OF INDIA
EXCHANGE CONTROL DEPARTMENT
CENTRAL OFFICE
BOMBAY

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Report of the Study Group to review Exchange Control Regulations as applicable to Forward Cover Facilities

Chapter I

Introduction

Objective

1. As desired by Governor, an Inter-Departmental Study Group was set up in January 1983 to review the Exchange Control Regulations relating to Forward Cover facilities with a view to enlarging the scope of coverage and also examining the possibility of permitting Forward Cover facilities in cases where parties may be exposed to exchange risks in more than one foreign currency. The Expert Committee set up by the Bank under the Chairmanship of Shri M.S.Patwardhan, Managing Director, NOCIL, to review the Exchange Control regulations relating to exports and imports took note of this separate Study Group set up and did not go into the relevant Exchange Control regulations. The report of the Expert Committee has already been presented to Governor and it would be in the fitness of things that the report of the Study Group on Exchange Control regulations as applicable to Forward Cover facilities should be considered in the Bank concurrently so as to upgrade the facilities for exporters and importers on the widest possible front. The Expert Committee to whom the Draft Report of the Study Group

was submitted for comments and consultation had remarked that the Draft Report was an excellent document analysing clearly the various aspects of a highly technical subject and had come out with many useful suggestions for improvement in the existing range of Forward Cover facilities.

2. It is pertinent to mention here that the Expert Committee emphasised the importance of Exchange Control as a tool for conserving the limited foreign exchange resources and utilising them according to national priorities in the context of the balance of payments position of the country and its outlook for the future. Although the foreign exchange markets and the available Forward Cover facilities are derivatives of the overall Exchange Control objectives and are therefore required to operate within the limitations set thereby, the Study Group made conscious efforts to refashion the Forward Cover facilities for the actual users so that these render vital support to increase the rate of growth of export of goods and services from India. It is hoped that this final report will be found to meet various demands of the actual users to the extent that these could be accommodated within the overall framework and objectives of exchange control practised by India.

3. The finalisation of the report of the Study Group was deferred in the context of **two very** major developments that were announced during October 1983 for becoming effective from 1-1-1984. One related to introduction of "Compulsion" under the mechanism of Asian Clearing Union for settlement of current trade transactions between India and the member-countries of the Union; the other related to abolition of the Sterling Rates Schedule under which it was mandatory for authorised dealers to quote prescribed fixed rates of exchange for merchant transactions in sterling currency. **Alongwith** the abolition of Sterling Rates Schedule, Reserve Bank also introduced certain important exchange market reforms viz., delinking of the interest element from the Exchange rates quoted to merchants in all foreign currencies and also stipulation of a uniform system of accounting for handling of import and export bills by the authorised dealers. Although the work of the Study Group was nearly completed in September 1983 i.e. after consultations held with various experts, offices of Reserve Bank, trade organisations, Foreign Exchange Dealers' Association of India and **select** authorised dealers on the contents of the Group's draft report, it became incumbent to await development of new problems/demands that may emerge with the introduction of "Compulsion" under ACU mechanism, the abolition of Sterling Rates Schedule and other connected

exchange market reforms. It is anticipated that the recommendations now framed by the Study Group would create an enduring base of facilities and regulations in regard to forward cover.

Composition of the Study Group

4. The Study Group comprised members from the following Departments of the Reserve Bank

(a) Exchange Control Department

(b) Department of Banking Operations and Development

(c) Industrial & Export Credit Department

(d) Department of Government and Bank Accounts - Foreign Accounts Division

(e) Department of Economic Analysis and Policy

(f) Bankers' Training College.

The names of individual members of the Group are given in the Annexure I to the Report. The question of associating some experts from the authorised dealers in the Study Group was considered. It was felt that the subject should first receive thorough in-house study in the Reserve Bank on the basis of its vast experience of the working of the existing regulations and the process of continuous internal review. It was, however, decided to share the thoughts of the Group when crystallised with authorised dealers to facilitate

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identification of areas of reasoning not covered/taken into account by the Group. The Group believed that this method may help avoid duplication and permit focussing of attention on critical areas in the Group's interaction with authorised dealers.

Modalities

5. The Group had in all 17 meetings between February 1983 to April 1984 and covered all the regulations contained in Chapter VII, Paragraph 12.5 in Chapter XII of the Exchange Control Manual (1978 Edition) and the following AD(MA/GP Series) circulars

No.4 dated 12.12.1978	re	Corrections to Exchange Control Manual.
No.55 AD(GP) dated 20.8.1979	re	Forward facilities against exports, Chapter VII of Exchange Control Manual.
No.11 dated 26.7.1980	re	Long Term Forward Cover Scheme, Chapter VII and IX of Exchange Control Manual.
No.12 dated 19.9.1980	re	ACU transactions, Chapter V of Exchange Control Manual.
No.13 AD(GP) dated 14.2.1980	re	Forward Facilities against imports, Chapter VII and XIII of Exchange Control Manual
No.4 dated 3.3.1981	re	Merchanting Trade, Chapter XII of Exchange Control Manual.
No.20 dated 28.10.1983	re	Introduction of "Compulsion" under ACU

No.21 dated 1.11.1983 re Abolition of Sterling Rates Schedule and other reforms.

No.25 dated 22.12.1983 re FEDAI guidelines.

The Group adopted desk research techniques to take into account the material available from department files on various related issues, the suggestions received by the Exchange Control Department from time to time from various organisations such as Commodity Export Promotion Councils, Federation of Indian Export Organisations, All India Manufacturers' Organisation and the deliberations of the various seminars on foreign exchange held in Bankers' Training College in which representatives of authorised dealers had also participated. In order to supplement the task, the Group invited specifically suggestions from the 17 Regional Offices of the Exchange Control Department and also important departments like Department of Banking Operations and Development, Industrial & Export Credit Department, Department of Government and Bank Accounts, Department of Economic Analysis and Policy and Bankers' Training College for gathering the maximum feedback to consolidate items for discussion regarding the adequacy/inadequacy of the existing regulations or of their restrictive aspects. The Group also gathered certain statistical data in regard to cases involving cancellation of contracts and requests relating to substitution of export orders in order to arrive at definite conclusions in those areas of discussion. In short, the Study Group collected abundant material to examine the scope for improvement in the existing regulations.

6. As stated earlier, the Group submitted its Draft Report in July 1983 on the basis of the material available and forwarded it for comments to the various offices and departments of the Reserve Bank as also the Foreign Exchange Dealers' Association of India, prominent authorised dealers and the Expert Committee headed by Shri M.S.Patwardhan. The comments/suggestions received from the respondents were comprehensively tabulated and placed before the Study Group for thorough consideration so as to identify the areas in which the draft recommendations could be revised. It was found that in all 49 suggestions had to be tabled before the Study Group to take into account the views of the respondents on the Draft Report. The Group felt encouraged by the enthusiastic and studious response it received on the Draft Report. The interaction provided by this method proved extremely useful and afforded a very fair and thorough treatment of the subject of Forward Cover facilities from the point of view of the actual users. The names of the respondents and the particulars of meetings held by the Study Group are given in Annexures II, III and IV of the Report.

FEDAI Rules outside the scope of Group's study

7. The Group could not include in its study a number of representations received by Reserve Bank from trade bodies export promotion councils relating to bank charges e.g. for cancellations/extensions of forward contracts. The scale of charges is determined by the Foreign Exchange Dealers' Association of India and the Group felt that the matter would have to be a subject of separate study because, the terms of reference of the Study Group were limited to reviewing only the existing Exchange Control regulations. Nevertheless, the Group noted that FEDAI is actively reviewing its Rule Nos. 4, 5, 8, 9, 10 and 11 having a bearing on the Forward Cover facilities with a view to making these suitably attractive and practicable. Since the amendments to the FEDAI Rules are subject to approval by the Exchange Control Department of the Reserve Bank, the Study Group feels confident that the amendments proposed will be examined by the Bank to ensure that these dovetail and integrate well wherever applicable with the improvisations suggested by the Study Group in the Exchange Control regulations.

Fundamental basis of existing regulations as the guiding principle for new facilities/relaxations

8. The Group took into account certain principles governing the forward cover regulations so that its reaction to the various suggestions/complaints would be

well-founded. Briefly stated, the regulations do not make it compulsory/obligatory for importers and exporters to book forward cover for the various transactions undertaken by them. The facilities are provided on an optional basis. Therefore, any decision made by the actual user to book forward cover could prove to be expensive in hindsight in the same way as the decision to keep his foreign currency exposure/commitment uncovered. It is for the authorised dealers and their clients to make the best use of the market mechanism in which the Control did not want to interfere. However, the basic rule is that access to the facilities provided should not be permitted for speculative purposes. The Control is anxious about this because, foreign exchange markets in the country have been perennially short of supply of foreign currencies as compared to the demand, due to excess of imports over exports and also because of the divergence of currencies as well as their maturities entering the markets in the opposite direction, making it difficult for the markets to match all transactions. Speculation could result in cornering of supply by a few traders for profit motive or creation of non-trade based demand thereby not only denying the market facilities to the needy exporters/importers but also making it further difficult for the markets to strike a balance between supply and demand.

The speculators could also upset the rate structure to the detriment of genuine importers and exporters. The Group, therefore, noted that irrespective of the need for new facilities that might be justified by the changes and new trends in the foreign trade of the country, the basic documentation requirements prescribed in the Exchange Control Manual would have to be maintained in some form or the other to ensure that regulations are observed and speculation is effectively curbed. The Group noted that the regulations justifiably prescribe performance-oriented scrutiny of the facilities demanded/utilised. The Group observed incidentally that there was increasing demand for maintenance of foreign currency accounts abroad by some sections of the trade. Such demands had the effect of denying the Indian inter-bank market the necessary supply of foreign currencies. The market can be enriched through not only increase in earnings through export of goods and services but also regular surrender of such exchange earnings to the Control. The Group also noted that save for the situations envisaged in paragraph 12.5 of the Manual, the regulations are designed to offer Forward Cover facilities in foreign currencies against the Indian Rupee and become necessary in the context of overall exchange rate management policies of the Reserve Bank. The Group kept out of its study the price control aspects of the foreign exchange markets in the country and Reserve Bank's relationship with the markets. The Group noted that the Reserve Bank's rates structure does influence market rates but any reforms to be contemplated to improve the pricing picture would have to be undertaken on the basis of some empirical studies which again may not have lasting relevance to the ever changing situations in the area of exchange markets.

9. The Group noted, however,that introduction of "Compulsion" under the Asian Clearing Union for settlement of trade transactions between India and member countries of the Union may bring up issues regarding Reserve Bank's role in promoting exchange markets in ACU currencies. "Compulsion" under ACU may lead to not only a significant increase in two-way trade flows but also increase in the use of member-countries' currencies for settlement of such transactions. The Group felt that such a development may pose new challenges for the Reserve Bank. It may not be enough that Reserve Bank remains commited only to purchase of such currencies in forward maturities though this role is designed to assist exporters. Forward Cover facilities for also the sale of ACU currencies may have to be taken into account. The Group observed that prior to 1.1.1984, settlements through ACU mechanism being optional, trade could be settled through international currencies in which Forward Cover facilities are adequately

available both in Indian as well as in the international markets. Since "Compulsion", however, the access of the trade to these currency markets has been eliminated. In response to a FEDAI questionnaire and also in some meetings few authorised dealers have expressed a feeling that the Indian foreign exchange markets would lack depth as far as ACU transactions are concerned and may not be able to clear all the demands for sale of ACU currencies for forward maturities. The void created needs to be bridged and Reserve Bank may separately examine if it should offer forward sale facility also with the objective of promoting intra-regional trade for which ACU was established.

10. In this context the Group reckoned that the "Compulsion" introduced would lead to stipulation of variety of ACU currency preferences by the respective trading partners according to their strengths and weaknesses and also that the natural leads and lags between imports and exports of the country from/to the ACU member-countries would create unpredictable imbalances in the inter-bank exchange markets in ACU currencies in the country. This may make it difficult for the markets to match transactions in opposite direction in appropriate forward maturities thereby making the rates uncompetitive. The question therefore to be considered is whether Reserve Bank could step into the market for also selling forward the ACU currencies to balance the market.

The time honoured principle had been that Reserve Bank will offer Forward Cover facilities only on the purchase side for the benefit of exporters. This principle has remained valid while large chunk of the trade gets settled in international currencies in which Indian inter-bank market possesses not only considerable depth but enjoys also support of the international markets for clearing the gaps. Since member countries in the Asian Clearing Union are underdeveloped and their own currency markets are not sophisticated, the Indian inter-bank market in ACU currencies will have to find an outlet to clear gaps or else its growth and consequent trade promotion may be stifled. The Group noted that in Sri Lanka, the central banking institution offers forward sale facilities in ACU currencies.

11. Considering the importance of Asian Clearing Union and the favourable economic impact the mechanism may have on the country's balance of payments due to Iran agreeing to sell oil against settlement in ACU currencies, the Study Group found it suitable to raise the above issue although it does not strictly fall within the scope of the present study on Exchange Control regulations. The Group notes that it will need separate and detailed examination.

Limitations of the Study

12. The Group found during its extensive deliberations that it had a very difficult and unenviable task on hand. Prior to historic major devaluation of the Indian Rupee in June 1966, the regulations governing forward cover facilities were not thorough which led to abuse of market facilities by speculators. With experience gained, Reserve Bank made the regulations much more exhaustive and precise with the result that all possible variants of transactions were covered in the new set of regulations. The Group found that the regulations had been progressively perfected and passed the test of time over the last one-and-half decades. Naturally, this set limitations on the number of improvisations which the Group could conceive/concede given the aforesaid abiding principles. Save for its observations in the above regarding the support that may be needed by the newly emerging market in ACU currencies, the Group could not obviously be expected to suggest enabling provisions that could impart additional/artificial market liquidity to clear requests for forward contracts. The Group noted that the scope for improvement in market liquidity for various international currencies lay in eliminating the system of "option" period of delivery presently available to the actual users or narrowing the period from one month. "Option" period was a hangover of the past suited to the system of

fixed exchange rates but is not in vogue any more in the international markets which dealt in "fixed" date deliveries. The Group felt that the much needed reform to homogenise the two-way (sales/purchases) forward maturities entering the markets would not only relieve the authorised dealers of burdensome gaps but also enlarge the market capacity. The Technical Committee of the FEDAI which was already seized of the matter has submitted certain amendments to Rule No.4 of the FEDAI for consideration of the Bank. The Group hopes that a viable solution will be found to resolve the apparent conflict of interests between the actual users and authorised dealers.

13. Another difficult area that the Group had to cover related to absolute technicalities of the subject vis-a-vis the numerous types of suggestions made by people in the past to the Control indicating inadequate appreciation of these technicalities. However, since the Study Group comprised members from different departments to argue for/against the suggestions, there was good role-playing during the Group's deliberations leading to very threadbare consideration of all the suggestions that were piloted before the Reserve Bank in the past. The comments/suggestions received from the various persons/bodies listed in Annexures II and III enabled the Group to do

full justice to its task. In short, the views recorded in this Report contain a balanced and reasoned assessment of the existing regulations and the new suggestions. The Group had to, of course, contend with the arguments about inter-relation between the pricing risk of trade and the attendant exchange risk. The Group found that often the argument in favour of certain facilities went on to elaborate how pricing risk occurs if exchange risk is not allowed to be covered in advance. Not denying the close inter-relation, the Group had to determine carefully the point at which exchange risk is created so that it could be made eligible for forward cover facility. The Group averred that it was not the function of the exchange markets to cover pricing risk <u>per se</u> i.e. before occurrence of the trade commitment.

<u>Categories of Recommendations</u>

14. The Group's recommendations will be seen to fall into three categories (a) Introduction of new facilities, (b) Simplification of formalities e.g. by way of delegation of powers either to Regional Offices of the Reserve Bank or the authorised dealers and (c) Reiteration of how and why some of the existing regulations have to be continued although Reserve Bank has received representations for certain liberalisations/improvements. Since the Group's discussions have been extensively minuted in respect

of meetings listed in Annexure IV, the Report gives only a summarised version of reasoning behind every decision.

Acknowledgements

15. In completing the task assigned to it, the Group received valuable assistance from a number of officials of Reserve Bank and other organisations. The Study Group is thankful to all of them for their contribution. The Group should like to express its deep appreciation for the excellent administrative support rendered by the Member-Secretary, Shri Y.D.Bajpai and his colleagues in the Secretariat, Smt.L.G.Mallya and Shri R.S.Rao, Staff Officers. Their dedicated hard work and unfailing courtesy greatly facilitated the Group's working.

16. The Study Group is particularly grateful for very valuable suggestions and guidance it received from Executive Director, Shri T.N.Anantharam Iyer during the course of the Group's working. The approach suggested by him for conduct of the Study Group's work has yielded rich interaction that was so very necessary to analyse the various complex issues involved in the highly technical subject of Forward Cover facilities.

CHAPTER II

Summary of Recommendations

Presentation

1. In Chapter I, paragraph 14, the Group's recommendations have been broadly classified into three categories viz. (a) new facilities, (b) simplification/modification of existing facilities and (c) reiteration of existing regulations. However, since the subject is vast, as well as technical, and is treated in the Exchange Control Manual in a particular order leading to enunciation of general regulations followed by regulations relating to Purchases and Sales, it has been considered necessary to maintain that order in our presentation for the sake of the reader's convenience. This would naturally facilitate such amendments that may be considered necessary to the regulations pursuant to the adoption of this Report.

2. Also, the recommendations summarised herein have been suitably suffixed with notations (a), (b) or (c) to indicate the categories in which they fall. In all, the number of recommendations under each category comes to

(a)	15	(New facilities)
(b)	6	(Simplification/modification of existing facilities)
(c)	24	(Reiteration of existing regulations)
Total	45	

The relative paragraphs of Chapter VII of the Exchange Control Manual have also been indicated against each recommendation. The mode of implementation of the recommendations falling under the first two categories and the reasoning for all categories of recommendations are given in the next Chapter of the Report.

<u>New facilities (Facilities not covered by present regulations)</u>

i) Indian airline and shipping companies having revenue earnings in one currency but loan repayment liabilities in another, may find it necessary to book forward cover in cross currencies to avoid exchange risk. The Group recommends introduction of the facility. (a)

ii) Borrowers of foreign currency loans may require to cover exchange risk arising out of import procurements invoiced in different currencies that they have to purchase from loaned currency at the time of meeting import bills. The Group saw merit in the suggestion and recommends requisite cross-currency cover. (a).

iii) Indian shipping companies chartering foreign vessels may wish to cover forward charter hire liability in India though they are allowed to discharge such liabilities directly out of freight collections in accounts permitted to be maintained abroad. The Group recommends that the desired flexibility be allowed subject to certain safeguards enumerated later in this Report. (a)

iv) The Group recommends that the revised regulations should state that remittance of technical knowhow fees connected with foreign collaboration agreements could qualify for forward cover although actual dates of remittances may not always be known. Forward cover in such cases could be offered initially for a period of 6 months subject to periodical roll-over as required if the obligant were able to secure such cover in the market. Similar treatment could be extended to forward cover required for erection and commissioning expenses in respect of turnkey import of capital goods. (a)

v) In respect of foreign currency loans, the Group recommends that forward cover facilities permitted under paragraph 7B.4 of the Exchange Control Manual should be extended to cover exchange risk of the borrower on the same principles as for deferred payment imports. (a)

vi) The Group recommends that in the case of loans attracting floating rate of interest, the interest portion should be covered usually for only one interest period when the actual interest liability has become determinate. However, the Group recommends that there could be no harm in booking forward cover for core element of the interest liability for the full period of the loan carrying floating interest rate structure. The core element of the interest liability can be defined for each loan transaction by taking a conservative floor rate of interest at which the core part of the interest liability may be calculated in advance for the entire period on reducing balance basis. The deliveries proportionate to each interest period should, however, be made in respect of effective interest outgo i.e., at the actual applicable rate of interest for that interest period so as to utilise the forward contract at a faster rate. This will preclude any balance remaining unutilised in the future should the future applicable interest rates fall below the floor rate reckoned to calculate overall anticipated interest liability. (a)

vii) The Group recommends that in respect of foreign currency loans permitting multi-currency option clause, the forward cover facilities envisaged above on lines of paragraph 7B.4 of the Manual should <u>not</u> be extended to the borrower as his commitment in any particular currency does not remain firm within the meaning of paragraph 7B.7 of the Manual. (c)

viii) The Group recommends that while debarring the borrower from roll-over forward cover facility in such an event, the facility of allowing forward cover for any one instalment together with interest falling due for payment alongwith the said periodical instalment should be permitted as the currency commitment remains firm in respect of both the instalment and interest due. (a)

ix) The Group disfavoured the suggestion regarding cross-currency forward cover which a borrower of foreign currency loan enjoying facility of multi-currency option clause may demand to cover interim rate movements between the prime/base currency of the loan and the optional currency chosen to roll over the liability into the latter currency. The Group covered the topic extensively, to the conclusion that there could be a tendency to speculate in international currencies. As it is, the multi-currency option clause had several speculative aspects. (c)

x) The Group recommends that third country import transactions connected with project exports as are covered by the approvals granted by the Working Group of the Exim Bank and the Reserve Bank may qualify for booking forward sale contracts subject to conformity with the approvals granted by the Working Group and the Reserve Bank. Such powers may be delegated to the authorised dealers. (a)

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xi) The Group recommends that exporters of turn-key projects repatriating to India advance payments received from the foreign importers or having temporary cash surpluses in foreign currencies should be allowed forward cover facility for retransfer of the funds when needed by the overseas projects at a future date. The Group noted that such repatriation is allowed on approval from the Reserve Bank and forward cover facility should be automatically approved. (a)

xii) The Group recommends that the provision contained in paragraph 7B.9(ii) of the Exchange Control Manual viz. relating to endorsement on import licence in respect of forward sale contract which is cancelled, may be removed. (a)

xiii) The Group favoured the need for introduction of fixed date deliveries in the scheme of forward contracts in the country to facilitate improvement of rate quotations on the international pattern. The Group recommends suitable action by Reserve Bank on the report of the Technical Committee of the FEDAI which has favoured such a reform. The reform can operate side by side with the system of "option" deliveries; under the latter system the option period should narrow down in a phased manner so as to be finally eliminated. Fixed dated contracts can be extended when needed whereas "option" contracts though providing flexibility for the customer cost him extra in terms of premium/discount for one additional month of the option. The system of fixed date delivery will help transactions involving clean TT remittances or foreign currency loan repayments in which the dates of the foreign currency liabilities are fixed.

The Group recommends also that when the foreign exchange markets in the country start accepting fixed dated contracts, Reserve Bank may similarly offer to effect forward purchases from the authorised dealers on fixed date basis. This would require amendment to Paragraph 11 of the RBM memorandum attached to Chapter IX of the Exchange Control Manual. (a)

General-
Paragraph 7.1 of Exchange Control Manual
Forward facilities to non-residents

xiv) In regard to demand for forward cover towards repatriation of foreign capital, the Group noted that inspite of the progressive Indianisation of the FERA companies, the repatriation cases would recur as long as foreign capital came into India or remained invested in companies qualifying for such investments or was subject to repatriation in instalments after sale/dilution of shares. The Group felt that foreign capital was not canvassed as an open door policy. It was welcome under conditions suitable to the country and the foreign investors had to take up the connected risks of equity. The Group recommends that Control need not undertake obligation to provide forward cover to the foreign investors. (c)

xv) Regarding remittance of royalty under collaboration agreements, the Group found no justification to offer forward cover facility to the foreign collaborator willing to accept payments in rupees. (c)

xvi) Regarding remittance of dividends/profits by FERA companies and foreign banks, the Group analysed that these were pure financial transactions the benefits of which were arising out of financial and other resource inputs obtained in India by the investor. Forward cover would be tantamount to offering guaranteed repatriation which otherwise is subject to several checks including tax assessment, etc. The forward facility cannot, therefore, be allowed. (c)

xvii) Requests from banks for forward cover in rupees to foreign importers do not merit consideration in the Group's view since the currency of settlement was chosen by virtue of the bargaining strength of the Indian exporter and the foreign importer. The foreign importer cannot be regulated by our needs/stipulations. (c)

xviii) Indian banks' branches abroad desired forward cover in rupees and adduced internationalisation of the rupee currency as the basis for this demand. The Group felt that it was a dangerous proposition since that could lead to trading in convertible rupee funds abroad causing monetary and exchange rate disturbance as

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international forwards and funds markets were closely linked. The Group is opposed to the idea. (c)

Paragraphs 7.2 to 7.5 of Exchange Control Manual

xix) The Group considers that the broad principles enunciated in these paragraphs are very necessary for guidance of the authorised dealers. (c)

Purchases
Part 'A' of Chapter VII of Exchange Control Manual - Paragraph 7A.2

xx) The Group considered the suggestion made in FEDAI Seminar on 'Credit and Finance for Exports' held in 1982 that exporters be allowed to buy and sell foreign exchange in forward market on lumpsum basis in anticipation of export commitments and concluded that it should not be conceded since it amounted to price support function. The Group observes that in the absence of firm export orders, exchange risk is not assumed and, therefore, cover cannot be offered. The exchange markets in the country lack depth and would experience utter chaos if speculative buying/ selling takes place without actual export/import commitments. (c)

xxi) To a suggestion whether cover can be offered on the basis of past export performance, the Group reiterates that forward cover facilities cannot be offered to cover pricing risks. Forward cover is optional and the trade has to produce evidence of valid export orders to justify demand for the facility. One has to draw a dividing line between pricing risk and exchange risk. (c)

<u>Paragraph 7A.3 of the Exchange Control Manual - Delivery Period</u>

xxii) The Group regards the existing regulation in respect of delivery period as quite appropriate because, forward purchase contract commitments should not be undertaken for periods longer than the prescribed time limit for realisation of export proceeds. (c)

<u>Paragraph 7A.4 of the Exchange Control Manual - Clubbing of Export Orders</u>

xxiii) While the present regulation permits a single contract to be booked by the customer against different firm export orders provided the export orders are denominated in the same currency, the deliveries under such a forward contract have to be regulated proportionately to the performance under each export order. The proviso (b) in the paragraph 7A.4 of the Manual is restrictive and virtually compels the exporter to book full amount of each export order in the block forward cover. The Group recommends removal of this restriction so as to allow flexibility in utilisation of forward cover booked on the strength of various export orders. (b)

xxiv) In regard to clubbing of export orders, FEIO Seminar had made a recommendation that block forward cover may be offered without asking for exact amount of each export order. The Group cannot recommend the facility since strict discipline is necessary in the interest of both export performance and prevention of speculation in exchange markets. (c)

xxv) In regard to A.D.(GP) Circular No.55 of 20th August 1979 requiring authorised dealers to grant forward cover facility against different export bills for collection under a single forward contract subject to the condition that uncovered balance of the listed collection items cannot be considered eligible for covering at any subsequent stage, the Group considers the restriction unnecessary. The Group recommends that exporters may take block forward cover for part value of outstanding collection items without impairing their ability to demand fresh forward cover for the uncovered balance. (a)

Paragraph 7A.5 of Exchange Control Manual - Deferred payment exports.

xxvi) The Group recommends that more powers may be granted to regional offices of the Exchange Control Department for dealing with requests for extension of contracts or for postponement of deliveries thereunder. (b)

Paragraph 7A.7 of Exchange Control Manual - <u>Documentation</u>

xxvii) For reasons stated earlier in the Report, the Group recommends that verification of documents by authorised dealers and marking these with their stamp and initials as evidence of forward purchase contracts booked is imperative in order to ensure that access to the forward markets is for genuine trade transactions and not for speculation. (c)

Paragraph 7A.8 of Exchange Control Manual - <u>Utilisation of cover</u>

xxviii) This regulation intended to ensure that forward purchase contracts fixed are for firm commitments and are taken up without fail by the respective maturity dates for fulfilment of the same transactions in respect of which they were originally fixed is based on the principles cited in ~~the~~ Chapter I of the Report. The Group, however, recommends that it is necessary to take into account the exceptional circumstances under which forward purchase contracts could be permitted to be utilised against other foreign exchange commitments or risks of the constituents. In this context, the Group takes a favourable view of the long standing demand of the exporters for "substitution" i.e. by new orders against

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original export orders which cannot be fulfilled for reasons beyond their control. The Group, therefore, recommends suitable relaxation entirely in the interest of earning foreign exchange by exporting the same goods to alternate buyer where the original buyer would have backed out rendering the exporter incapable of offering foreign exchange delivery to the authorised dealer under the forward contract booked. Alternatively, such a forward contract would require cancellation putting the exporter to a possible loss without any benefit to the country whatsoever. While considering the relaxation, the Group notes that there could be some abuse of the facility of "substitution" to overcome the non-availability of blanket forward cover facility against anticipated export orders, the demand for which has been rejected by the Study Group for reasons mentioned elsewhere in the Report. The Group has, therefore, recommended also certain safeguards to implement the proposed facility of "substitution" to ascertain particulars of genuine commitments. The safeguards and modalities of "substitution" facility are described in Chapter III of the Report. (a)/(b)

xxix) The Group recommends that the authority for approving "substitution" cases should be delegated to Exchange Control Offices of Reserve Bank so as to ensure expeditious disposal of references. (b)

xxx) Subject to the safeguards and modalities (described in Chapter III of the Report) on the basis of which the Exchange Control offices of Reserve Bank would be guided for deciding upon the applications for "substitution", the Group recommends that all other types of such cases should be dealt with in Central Office of the Reserve Bank on their own merits. The Group took notice of "substitution" cases occurring in respect of commodities subject to "quota" system of exports. (b)

xxxi) The Group does not favour that forward cover should continue even while there is repeated substitution of export orders since it constitutes abuse of the facility. (c)

xxxii) The Group recommends that powers should not be delegated in respect of forward purchase cover to authorised dealers for dealing with "substitution" requests of exporters merely because in respect of packing credit advances "substitution" can be permitted by banks. The Group has come to the conclusion that substitution of export order for continuing a forward contract is not at all on all fours with the latter situation. (c)

<u>Paragraph 7B.7 of Exchange Control Manual</u>

xxxiii) The Group does not favour "substitution" of orders for forward cover booked for import transactions. There is no promotional angle involved in facilitating change of import orders. (c)

Paragraphs 7A.9 and 7B.9 of the Exchange Control Manual - Cancellation

xxxiv) The Group recommends that on the basis of extensive statistical data collected and analysed in Exchange Control Department pursuant to recommendations received in the Seminar held in the Bankers' Training College, the reporting limit for the authorised dealers regarding cancellation of forward contracts should be increased from the present level of US$ 500 to US$ 5000. (b)

xxxv) In regard to deferred payment exports and imports, the Group recommends that cancellation cases should continue to be referred to the Reserve Bank. (c)

Paragraphs 7A.10 and 7A.11 of Exchange Control Manual - Export of Services and Export of Foreign Currency Notes.

xxxvi) As regards Forward Cover facilities against export of services from India such as technical know-how, computer software, etc. etc., the Group has not found it necessary to recommend any change in the existing provisions of paragraphs 7A.10 since these adequately meet the demand of such exporters.

Similarly, the Group feels that the provisions of paragraph 7A.11 permitting authorised dealers to enter into forward purchase contracts with full-fledged money changers for export of foreign currency notes for realisation of value, are adequate. (c)

Sales
Part B - Paragraphs 7B.1 and 7B.2 of Exchange Control Manual

xxxvii) The provisions governing forward facilities against import of goods and documentation procedure stipulated for offering such facilities are basically sound. The Group does not find it necessary to suggest any modification. (c)

Paragraph 7B.3 of Exchange Control Manual - Delivery period.

xxxviii) The Group deliberated extensively on the requirement for charging overdue interest in the event of the permissible extension period of two months being availed of by the importer without formal extension of the contract. The Group recommends that the provision stipulated in the A.D.(GP) Circular No.13 of 14th February 1980 should be reviewed once the Foreign Exchange Dealers' Association of India Rules under which the proviso falls, are suitably amended. (b)

Paragraph 7B.4 of Exchange Control Manual - Deferred payment imports.

xxxix) The Group finds the regulation adequate save for certain suggestions which have been made in respect of imports effected under foreign currency loans viz. those already covered in the earlier portion of the recommendations. (a)/(b)

Paragraph 7B.5 of Exchange Control Manual - <u>Surplus freight/passage collections.</u>

xL) The Group considered the demand for extension of forward contracts beyond two months' maturity stipulated in the existing regulations and felt that except where the Reserve Bank is unable to convey approval for remittance within the two months' period, applications for repeated extensions by foreign airlines/shipping companies of the relative forward contracts should not be entertained. (c)

Paragraph 12.5 of Exchange Control Manual - <u>Merchanting Trade</u>

xLi) The Study Group regards the regulations governing forward facilities for merchanting trade as adequate vide the paragraph cited in the reprint version of the Chapter XII covered in A.D.(MA) Circular No.4 of 1981. (c)

Part A and B of Chapter VII of <u>Exchange Control Manual</u>

xLii) The Group took into account the revised accounting procedure introduced by the FEDAI with the approval of Reserve Bank with effect from 1st January 1984 stipulating standard period beyond which overdue import and export bills may not be held by the authorised dealers in their foreign currency portfolios. Although the revised procedure requires the authorised dealers to delink the exchange element of such bills and reverse the foreign exchange entries to crystalise rupee liability of the customer after expiry of the overdue period, the procedure is silent about the status of forward cover commitment that the customer may wish to enter into at the start of the transaction or may have entered into on the basis of expected settlement/realisation of the import/export transaction. The Group recommends that in respect of import bills under 'sight' letters of credit, the forward cover may be taken as usual but should be utilised at the time of reversion of foreign exchange entry for the subject transaction by the authorised dealer. In respect of export bills, however, the reversion of foreign exchange entry after the lapse of maximum permissible overdue period should be without prejudice to the rights of the exporter for continuing the forward cover facility provided it falls within the framework of the regulations laid down in Chapter VII of the Manual, as amended. This is necessary because the exporter carries on the exchange risk till the transaction is finally settled. His entitlement to forward cover facility should subsist for the statutory/approved period within which the export transaction may be settled. (a)

General

xLiii) The Group does not agree that forward cover may be available for exports on consignment basis even when a bill is not drawn. Drawing of a bill ensures commitment of repatriation of proceeds which Control is primarily concerned with. The Group also feels that there is no need to offer forward cover for undrawn balances on export shipments because these are not properly accounted for and may often be misused. (c)

xLiv) The Group disfavours the suggestion that forward cover may be provided for bunkering, servicing, wages of workers etc. incurred by shipping companies at foreign ports. This is because the amount and date of such a liability would not be known in advance. Also, shipping companies are allowed to defray such expenses out of their foreign currency balances and no exchange risk arises. (c)

xLv) Group has not found it possible to recommend forward cover for remittance of royalty payments expressed in foreign currencies since the exact amount of liability, the likely date of remittance, etc. are not known in advance. (c)

CHAPTER III

Gist of discussions on the recommendations made

Mode of implementing new facilities or amendments to existing facilities

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1. In this Chapter are given gist of discussions held to formulate the Study Group's various recommendations and also, wherever appropriate, modalities of implementing the recommendations. The sequence adopted for narration conforms to the one used in Chapter II. For the sake of brevity and convenience, recommendations have been clubbed suitably in order to summarise the discussions. Also, the salient reasons, wherever recorded while narrating any recommendation in Chapter II, have not been repeated in this Chapter.

Multi-currency exposure of Indian companies (Items i, ii and iv to ix)

2. The Group considered the issues in the context of an exhaustive background note prepared separately for discussion in view of the several complexities and it will be very difficult to summarise the discussions in this report. Therefore, only salient arguments have been given. Firstly, the Group agreed that there were genuine problems of airline and shipping companies who may have to raise credits in different currencies for buying

aircrafts/ships whereas their revenue accrues in various other currencies. The currencies of borrowing may not always be of their choice and as such there exists forced mismatch of currencies rather than any element of speculation. The Group felt that although the quantum of periodical fare/freight collections are not fixed, the repayment instalments and interest under foreign currency loans are definitely fixed. If the revenue collections were short, the repayment liabilities could not be postponed and remittance from India would be permitted. In other words, if cross-currency forward contract is allowed to be booked by such a borrower i.e. forward sale of currency of expected revenue to buy currency required to repay fixed amount of periodical loan instalment and interest, means would be always available to the borrower to take delivery under the forward contract. No cancellations would be warranted. Thus, it is not a disability that one cannot determine in advance what would be the exact amount of the revenue receipts in the foreign currency. The Group, therefore, agreed that as long as the loan transaction is approved, facility to book cross-currency forward cover may be given to take care of the next loan instalment and interest due against anticipated revenue receipts provided the period of cover does not exceed 6 months and is booked with an authorised dealer in India. No cancellation of the cover should be permitted in such cases. The Group noted that such a facility would necessitate the borrower to accumulate revenue collections in foreign currency accounts abroad but this need not be regarded as very significant and therefore objectionable.

3. Regarding an importer required to raise loan in one currency but facing multi-currency payment liabilities to acquire imports financed under the loan, the Group agreed that the importer has to budget his imports by fixing procurement prices to determine proper loan utilisation. However, if the currencies of imports strengthen against the currency of the loan, the loan funds would be found insufficient to discharge payment liabilities to the suppliers from various countries and remittances from India in free foreign exchange would be necessitated to supplement the loan resource. The Group agreed that cross-currency forward cover should be allowed in such cases through an authorised dealer in India to cover the risk. The Group noted that such situations occurred in case of untied loans e.g. those raised through International Finance Corporation (World Bank subsidiary) or those canalised through ICICI/IDBI/IFCI. Considering the volatality of exchange rates, the powers in this regard may be delegated to authorised dealers.

4. The question of extending roll-over type of forward cover facility to cover exchange risk on repayments and interest liability under foreign currency loans, was conceded by the Group and was implemented by the Control by issuing suitable circular to Regional Offices vide No.27 dated 4th May 1983. The Group noted that the decision is in alignment with the provisions of paragraph 7B.4 of the Exchange Control Manual. Incidentally during the discussions, the Group observed that the facility may not be popular because of prohibitive roll-over costs. However, the facility is unique and India is the only country extending such long term forward cover to enable importers of capital goods to secure protection against unforeseen decline in the value of the rupee. Since the facility is left, for operational purposes, to the market mechanism, the Control did not wish to come in the way of importers desirous of and successful in securing the exchange risk cover.

5. During the process of discussions, the Group also considered the contents of Circular No.77 dated 15th December 1982 issued to Regional Offices and agreed that the facility of roll-over forward cover on long-term basis should not be applicable to foreign currency

loan transactions carrying multi-currency option, the exercise of which militates against the requirements of paragraph 7B.7 of the Exchange Control Manual. The principles enunciated in the said provisions of the Manual are in the Group's opinion very sound. The Group noted Reserve Bank's unhappy experience of the past when in the absence of such a prohibition, some forward contracts booked on roll-over basis against the prime/base currency of the loan were rendered redundant and required cancellation as fait accompli because the respective borrowers had no more retained the repayment liabilities in contract currency but switched it on to some other. The Group opined that multi-currency option clause has a speculative slant. The proper hedge for any borrower would be to either fix his liability in rupee terms by means of long-term roll-over type of cover by negotiating a single currency loan or choose the loan currency to match the currency in which his earnings accrue e.g. a US dollar loan for ship, as usually the ocean freight is quoted and earned in dollars. If there is currency mismatch which is forced on the borrower, the Control could now offer cross-currency forward cover to hedge the risk as described in item (i) of Chapter II. There could also be borrowers forced to obtain multi-currency loans i.e.

in tranches of different currencies but each tranche can be deemed as an independent loan to avail of either roll-over type of cover in rupee terms or the cross-currency cover on the lines of item (i) of Chapter II.

6. However, if multi-currency options are chosen voluntarily by borrowers, the Control cannot assist them to avoid risk of judgemental errors committed. The option enables the borrower to effect currency switches at his will and the risks are self-created and not transaction-oriented. The argument that the interest cost of running a loan in alternate currency is cheaper compared to that in prime/base currency of the loan, is fallacious because it ignores the exchange cost. The Group agreed with the analysis given in the "Position paper" on the subject. It concluded also that there is no justification for offering cross-currency cover viz. alternate prime/base currencies' risk because, the borrower would need such cover for the entire loan liability with switch of loan from one currency to another as the only means of taking delivery under the proposed cross-currency forward contract. In other words, the borrower wished to play with the effective value of capital liability of

the loan by using multi-currency options and needed forward cover for pure rescue type of operation. The Group considered the demand as exaggerated and unjustified and rejected the suggestion.

7. Commenting on the use of multi-currency option in foreign currency loans, the Group remarked that any loan that is raised is necessarily to acquire capital goods for which the borrower has to pay a fixed amount which in turn becomes the amount of drawal/disbursement of the loan. The borrower has responsibility to ensure that use of multi-currency option in the succeeding period of the loan does not result in appreciation of the loan liability as it would amount to paying more than the agreed price of capital goods imported. Such an eventuality implies not only capital loss to the borrower but also extra/avoidable foreign exchange cost to the country. The Group did not appreciate the argument from the claimants to such options that there could be also gains made in the use of multi-currency option. The Group felt that such gains are not germane to the business activity of the borrower and cannot be called as anything but speculative gains. The Group noted that banks lending foreign currencies and offering multi-currency option played it safe in the "head I win, tail you lose" style. They require the

borrower to make good immediately the exchange difference when there is a loss. There is thus no merit in borrowers going in for gimmicks or innovations which they cannot cope with especially when the international exchange markets have been quite volatile. Even expert international bankers cannot risk prediction of rate movements. While borrower may hope for the option currency to depreciate and reap in benefits, the opposite can and has happened in practice. Cross-currency forward cover is no panacea for unpredictable minute-to-minute rate movements because ideal timing of taking the cover either to lock in the benefit or stop further losses cannot be prescribed or regulated as any roll-over period spans over 3 or 6 months. Perceptions can vary given this wide span. Borrowers may choose to bank on hopes till the end of roll-over period for favourable turn of rates which can either enlarge an exchange benefit or reduce possible loss, if not, turn it into profit. By the same logic, interim forward cover decision may be regretted as hasty/panic action if rates indeed move more favourably later, thereby giving rise to demand for repetitive switches of currencies to reverse previous decisions. The Group, therefore, concluded that the tendency should not be encouraged.

8. The Group debated extensively a suggestion received from AIMO that the cross-currency forward cover i.e. between the prime/base currency of a

loan and alternate currency used under multi-currency option should be regarded as absolutely independent and separate from any cover on roll-over basis that a borrower may wish to obtain to protect his exchange risk between the base currency and the Indian rupee. The point sought to be made is that even if multi-currency option is exercised, the facility of forward cover on roll-over basis should not be denied since it could still be utilised in the same manner in which such a cover is used for loans operated in a single fixed currency. The Group deliberated on this extensively and came to the conclusion that the suggestion would be tantamount to asking for double cover viz. in cross-currencies as well as between the base currency and the rupee. It is abundantly clear that the base currency to rupee cover cannot be used unless the liability reverts itself to the base currency from the option currency. The veiled objective of the suggestion is that the roll-over cover will be used to buy base currency from the authorised dealer and the latter will be sold in the overseas markets to secure the option currency. Obviously, this cannot be permitted given the principles on which facilities can be offered to serve the community.

9. In the same context, AIMO further suggested that borrowers of foreign currency loans should be allowed to take recourse to the interest futures markets in order to hedge the interest fluctuation risks. The Group felt that this issue lay outside the scope of its study. Secondly, the Group opined that since our international borrowings are mainly for developmental purposes and not prompted solely by the international market facilities/sophistications, the suggestion could not be considered. The Group also received a somewhat similar suggestion that authorised dealers in the country should be allowed access to the futures market abroad in international currencies in addition to the international inter-bank markets. The Group felt that such a development was not justified by the needs of the actual users. The facilities available and those proposed can adequately serve the country's needs.

10. As far as foreign currency loans carrying multi-currency options are concerned, the Group agreed that the borrowers may be allowed to avail of forward facilities with an authorised dealer to cover exchange risk on any particular instalment and interest falling due within 6 months from the date of roll-over when the

commitment and the currency thereof are firmed up. The Group noted that Exchange Control Department has already advised the Government to include this provision in approval letters issued by the Government for foreign currency loans carrying multi-currency option, instead of merely mentioning the prohibition that no roll-over forward contract would be permitted for such loans.

11. Regarding stipulation in Central Office Circular No.27 of 4th May 1983 that forward cover on roll-over basis for foreign currency loans operated in a single fixed currency, should be allowed through only a designated authorised dealer, the Group agreed that competitive rate for such cover was not the only criterion. The authorised dealer carrying credit risk on the borrower should have full control on the borrower's forward cover commitments.

12. The Group felt that foreign currency loans carrying floating rate of interest would have determinate interest liability if some core element of the interest rate could be identified. The Group agreed that this was possible with reference to historical record of average interest rates of the preceding years of the currency of the loan. Such record is published by IMF

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every month in its International Financial Statistics and can be used to lay down a floor rate of interest for computing the core portion of the cost of interest on the loan on reducing balance basis. This core portion can qualify for forward cover in conformity with the provisions of paragraph 7B.4 of the Exchange Control Manual.

Forward cover for remittance of charter hire payments (Item iii)

13. The Group considered favourably the demand of Indian ship owners although they enjoy the facility of making such charter hire payments directly out of freight collections deposited in foreign currency accounts permitted to be maintained abroad. The Group, however, decided to stipulate a condition that no payments committed under forward contract booked in India should be made from the funds lying in foreign account as that would result in non-delivery under the forward contract requiring its cancellation.

Forward cover for third-country imports (Item x)

14. The Group agreed that the exporter of turn-key project incurs exchange risk against the rupee in respect of third country imports for which payment

has to be made to the foreign suppliers. The Group decided that the modalities of required forward contract may differ from case to case depending upon the deliberations of the Working Group granting approval for export projects. The forward cover facility for third country imports could be allowed to the exporter in conformity with the approvals of the Working Group for the export project.

Endorsement on import licence
regarding cancelled forward sale contract
(Item xii)

15. As regards cancellation of forward contract for imports requiring endorsement of the cancelled amount on the import licence as per the provisions of paragraph 7B.9 of the Exchange Control Manual, the Group felt that the requirement was discriminatory in the context of importers not requiring to forgo entitlement to import by virtue of cancellation of forward contract if booked for an OGL item. The Group also noted that endorsement of 'Exchange Control Copy' of the import licence was not an adequate safeguard to prevent imports as the Custom's copy was not similarly blocked. The penalty sought to be imposed was thus not quite effective and in any case discriminatory since no penalty was prescribed for other cancellation

cases e.g. OGL imports and all exports. The Group, therefore, decided in favour of removing the discrimination.

Forward facilities to non-residents
(Items xiv to xviii)

16. The Group approached the topic from the view point as to whether it is obligatory for the Control to offer risk cover to foreign investors. In the regime of exchange control followed by the country, the Control has the task of making available facilities to the Indian resident participants of the trade and in the process distribute the available resources equitably. There is no scope to admit non-resident claimants to our market facilities. Regarding FERA companies, the Group noted that the process of disinvestment is by and large over. Most of the foreign companies would be able to get the disinvested capital repatriated without much loss of time because repatriation process itself had been liberalised permitting remittance of an equivalent of Rs.2 crores in a year subject to maximum of 4 annual instalments. Counter arguments e.g. why not allow forward cover if such claimants are few and/or especially since they were forced to keep funds in India pending repatriation, were considered but the principles militated against such relaxations such as those narrated in items (xiv) and (xvi) in Chapter II.

The only exception made by the Control relates to requirement of foreign airlines/shipping companies operating in India for booking forward cover against surplus freight/passage collections vide paragraph 7B.5 of the Exchange Control Manual as these are current transactions and not capital transactions. The Group observed that these were also purely commercial transactions arising out of financial inputs made in foreign exchange. Therefore, their periodical rupee collections were subject to genuine exchange risk pending final repatriation. Our own shipping and airline companies are placed in similar situations abroad.

17. Regarding forward cover in rupees to foreign importers or banks/correspondents, the Group noted that the latter half of 1981 and the whole of 1982 witnessed hot and speculative trading in spot rupees in the international markets and opening of forward market abroad would lead to much worse speculation causing the external value of the rupee to come under undue pressures. Such forward transactions would not also come to the notice of the Control readily. The Group felt that since the spot trading problem was recently contained by issuance of AD(GP Series) Circular No.5 of

January 1983, one could not afford to license forward trading activity which had much deeper gravity because the non-residents are not subject to the Indian Control. The Group also relied on the Japanese example quoting that even Bank of Japan disfavoured Yen becoming a prominent international currency though Japanese economy has been quite sound. The Group also recalled how, in the recent months, speculative pressure against the French Franc was combated by the French authorities by disallowing overdrafts to non-resident banks wanting to remain "short" in that currency. This resulted in euro-franc funds outside France costing interest at the unbelievably high rates of over 1000 per cent per annum. In short, the prohibition in paragraph 7.1 of the Exchange Control Manual was a valuable insulatory protection against external pressures on our currency.

Demand for block forward cover for exports on anticipated turnover basis/clubbing of export orders/export bills for collection (Items xix to xxi & xxiii to xxv)

18. The Group noted from letters received from various offices of Reserve Bank that there was definite tendency on part of the authorised dealers and also customers to book forward contracts without properly completing the documentation formalities. In certain regions, customers found it possible to book forward contracts through

exchange brokers which was highly irregular because exchange brokers are not authorised dealers and are liable to prosecution under provisions of FERA for selling/buying currencies as principals instead of brokers. The Group felt that it was necessary to include suitable cautionary notice at the time of revising the regulations.

19. The Group considered the demand made by exporters of certain bulk commodities for block forward cover facility based on past performance cirterion. The representations for the demand were made by organisations such as Indian Jute Mills' Association, Leather Export Promotion Council, Tea Exporters' Association and certain tobacco exporters. The argument advanced was that lot of preparatory work/investment has to be done by the exporters in anticipation of firm export orders or contracts and since export was an ongoing activity, there should be some consideration shown for the problems of such exporters. The Group, however, felt that such a facility could create wide scope for speculation and disturb the market harmony. The Group affirmed that in the context in which the various Exchange Control regulations have been instituted, there is need to ensure access to the forward cover facilities only on the basis of firm orders showing price and quantity of goods to be shipped and the delivery period.

20. Various arguments recorded in the department in the past about pricing risk faced by the exporter as a result of his inability to determine the exchange rate in terms of the rupee for finalising the cost of goods purchased for exports were also considered. The Group agreed that the dividing line between the two types of risks could be thin but the problem of price fluctuations in commodity markets could not be taken care of by the exchange market facilities. The Group categorically recorded that access to exchange market facilities should be made available only after assumption of exchange risk exposure by the exporters or the importers. Therefore, no relaxations have been recommended by the Group in the regulations discussed.

21. In regard to clubbing of export orders, the Group took note of the practice on part of sea food exporters where the processors are reportedly booking forward cover on account of different export houses involving export orders from different buyers. In Group's opinion this leaves lot of scope for speculation. It was felt that processors cannot book forward contracts. This was the function of the export houses who alone can deliver foreign exchange to the authorised dealers on shipment of goods. However, the Group decided that this

particular commodity problem should be separately studied by the Exchange Control Department.

22. In regard to clubbing of export orders for booking forward cover and procedure stipulated for making deliveries,the Group considered carefully the restriction contained in provision (b) of Paragraph 7A.4 of the Exchange Control Manual and felt that it could be removed. In so deciding, the Group was guided by the discussions held on similar type of restriction contained in A.D.(GP) Circular No.55 of 1979 in regard to block forward cover against export bills on collection vide item (xxv) of Chapter II of the Report. The Group felt that exporter should have the flexibility to take forward cover and effect deliveries against various export orders according to his own convenience.

23. The Group agreed that as long as an exporter actually exports the goods and the genuineness of every collection item is established, there is no purpose served by the restriction contained in A.D.(GP)Circular No.55 of 1979. The Group, accordingly, recommends that exporters sending bills for collection may be allowed to book forward cover in suitable lots as convenient to them.

"Substitution" of export/import orders
(Items xxviii to xxxiii)

24. The substitution cases were studied by the Group on basis of actual case records in the Exchange Control Department for arriving at the decisions. The Group felt that the demand for substitution of orders was an old one and should be sympathetically considered as long as the concession given does not result in speculative booking of forward contracts by the exporters by producing initially fictitious export orders to be replaced by genuine export orders secured subsequently. In other words, while considering the question of permitting substitution, we have to carefully avoid the pitfall of the facility being utilised for booking forward cover for anticipated exports. During the discussions, the Group felt that the case for substitution of orders in respect of forward contracts booked for imports was a very weak one and should not merit consideration at all. Exports, on the other hand, involve a promotional angle and if any exporter found himself stuck with a forward cover liability due to the original buyer going back on the order placed with the exporter, the Control should not come in the way if the exporter showed willingness to take delivery of the forward contract under a substitute export order. The Group recorded that the regulation to be designed should include necessary

safeguards to ensure that only genuine cases of substitution are entertained. It took into account the possibility that favourable rate movements might influence "substitution" decision of the exporter who may otherwise prefer to cancel the forward contract on the grounds that the export order could not be performed due to buyer's willingness to consummate the transaction. On discussion of this aspect, it was felt that since contract booking is not a compulsory but only an optional facility, the substitution of export order could not be made mandatory purely for avoiding cancellation cases. In other words, the "substitution" problem would occur within narrow limits because non-performance in export contract has to be followed by two events, viz. the contract rate remaining favourable in relation to the current rate of exchange and the exporter finding a substitute order.

25. The Group examined statements showing (a) details of 14 different cases wherein substitution of export orders was allowed in the past, (b) 10 different cases wherein substitution requests were rejected and (c) cases relating to cancellation/postponement of forward cover. It found that some powers could be delegated to the offices of Exchange Control Department with

due safeguards instead of all references coming to Central Office. The Group was not, however, in favour of delegating powers to authorised dealers as "substitution" requests are not known to be a normal feature of the trade problems.

26. The Group noted that there could be demands for multi-commodity approach since in respect of exports of engineering goods, substitute order may not be for the same items of export for which the forward cover was originally booked. The Group, however, remarked that "substitution" should not imply "substitution" of exporter as had been attempted in some cases which came up for consideration. Such a situation implies exporter buying forward exchange and then selling it to some other exporter. This cannot be permitted under FERA, 1973. In this context, the Group noted the practice of sea food exporters delivering exchange under forward contracts booked by processors and desired that this matter to be independently investigated.

27. While discussing "substitution" proposition, the Group considered the following points :-

(i) What could be the period (original period of the contract or extended period of the contract) during which the substitution could be allowed;

(ii) If extensions were to be admitted, how many extensions can be allowed;

(iii) Whether substitution could be allowed in anticipation of a contract in case there happens to be a trade ban in respect of commodity originally contracted. In case the exporter can bring another contract within a reasonable time, why should we not allow substitution?

The Group concluded that substitution may be allowed only during the validity of the original contract and not during extended period of the contract. In Group's opinion, there is no case to allow "substitution" in anticipation of a contract. However, force majeure situations warrant different treatment as non-performance of forward contract by the exporter would be due to factors beyond his control e.g. exchange/trade restrictions clamped in buyer's country, disruption of shipping services, trade embargo, war, natural calamities etc. etc. In such cases the "substitution" cases could be considered during extended period of the contract.

28. Taking an overall view, the Group agreed that "substitution" should be allowed, in the interest of export promotion, for forward purchase contracts subject, however, to various safeguards listed below. Also suitable guidelines should be issued to the offices of the Reserve Bank to facilitate prompt disposal of "substitution" requests by exporters facing genuine

difficulties due to events of both force majeure and non-force majeure nature. The safeguards suggested by the Study Group are

(a) "Substitution" may be allowed during the original validity period of the forward contract and not the extended period of the contract. The exporter should have a firm export order for substitution. "Substitution" should not be allowed in anticipation of export order.

(b) "Substitution" may be allowed during the extended period of the contract only under force majeure situations such as trade/exchange restrictions, disruption of shipping services or other similar situations beyond the control of the customer.

(c) "Substitution" may be allowed to the same exporter. The forward purchase contract should not be transferred in favour of any other exporter to fulfil the fresh export order.

(d) Goods/commodities to be exported under the fresh export order should be the same (price may vary).

(e) "Substitution" may be allowed only once for any forward purchase contract. In other words, an order substituted in place of original should not qualify for another substitution and so on.

29. The Group considered it necessary that the offices of Reserve Bank should satisfy themselves about the bonafides of the original export order before allowing "substitution" by another export order for continuation of the forward contract booked. The Group indicated the following illustrative guidelines to verify the genuineness of original export order

(a) By asking for a bank report on the overseas buyer of the original order. If report is not available and still the exporter desires substitution of the export order, there would be enough grounds to doubt bonafides of the original order warranting rejection of the substitution request.

(b) By verifying whether the foreign buyer is on the approved list of ECGC. This is one way to find out if the overseas buyer is a genuine party.

(c) By verifying whether there is a letter of credit opened by overseas buyer in which case there could be no grounds for doubting bonafides of the original order. No buyer having intention to back out of the order would open a letter of credit as cancellation of the same would be subject to the consent of the exporter beneficiary.

(d) By verifying whether there has been any part delivery of the contract. In case part delivery has taken place, the bonafide character of export order stands established because, some goods have been shipped to the original buyer.

30. The Group felt that the above check list should be treated as purely illustrative and could be adopted in whatever combination found necessary for making enquiries with the exporter. The check list can be further refined on experience. The central objective should be that the "substitution" facility is not abused. Reserve Bank should also prescribe an application form to assist exporters wishing to avail of the "substitution" facility so that there could be clarity of communication between the applicant and the Reserve Bank.

31. The Group did not, however, favour substitution of orders for forward sale cover booked for import transactions vide item (xxxiii) of Chapter II of the

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Report. The Group carefully considered that there can be no charge of discrimination by the importers on the ground that "substitution" facility is made available only to the exporters. The Group's view was that exports involve a promotional angle and have to be treated on a different footing i.e. more liberally in national interest. Similar considerations do not always apply to imports. While taking this decision, the Group noted that recently an importer had filed a writ petition in Bombay High Court challenging rejection of his "substitution" application in respect of the forward contract booked for an import transaction. The petition was dismissed by the High Court. The Group reiterated its earlier stand and felt that speculative booking of forward exchange can also take place on part of an importer who may not necessarily open a letter of credit for booking purchase orders abroad and thus may easily back out of the order. Speculative booking of forward exchange for import transactions can occur in sensitive commodities like edible oils which are regularly imported into India.

Cancellation of forward cover
(Items xxxiv & xxxv)

32. The Group examined the vast statistics and particulars of several cases tabulated by offices

of Reserve Bank for the purpose briefly recorded below

No. of cases of cancellation of contracts booked for	1979	1980
Exports (Purchase)	1018	600
Imports (Sale)	167	215

The Group also examined the arguments advanced in the Seminar held in Bankers' Training College in which representatives of authorised dealers participated. It was noted that certain offices of Reserve Bank had also complained about heavy volume of work due to low reporting limit of US$500 prescribed in the Exchange Control Manual for cancellation of the unutilised portion of any forward contract. The Group considered the problem in the context of substantial growth in value of two-way trade of the country since 1978 when the regulations were last revised. The value of individual trade transactions has since gone up and the possibility of some portion of connected forward exchange contract commitments remaining unutilised would have to be reckoned as part of normal business. The Group thus considered whether the limit of $500 should be raised and, if so, to what extent and on what criteria. On scrutiny, the Group concluded that post-facto verification of the cancellation reports in the Control is serving as a valuable check to curb speculation and much emphasis need not be placed on resultant workload as it is not a bureaucratic process. Nevertheless in proper appreciation of trade difficulties, i.e. where the major portion of forward contract has been utilised and evidences the genuineness of the underlying transaction, the cancellation of unutilised portion even if it is a little high in amount should not be looked at with disfavour. In other words, the approach should be one of evaluating performance in order to isolate instances of speculation. The Group considered two methods of raising the limit e.g. amount of non-utilisation as percentage of original commitment or an absolute ceiling at a higher level than the one presently operating i.e. $ 500. On careful consideration, the Group felt it proper to raise the reporting limit by authorised dealers to an absolute level of $ 5000/- (10 times higher than the present limit for cancellation of unutilised portion of a forward contract) without diluting of course, the post-facto scrutiny by the Control of "cancellation" cases beyond this amount. The Group incidentally discussed and reassessed the need for delegating more authority to junior levels in offices of Reserve Bank in order to avoid concentration of the scrutiny work at the level of in-charges of Exchange Control Department. In regard to deferred payment imports and exports, the Group considered it necessary for cancellation cases to be referred to the Reserve Bank for prior approval.

Asian Clearing Union

33. ACU "compulsion" may bring about a significant change in the country's trade pattern and balance of payments outlook as Iran has agreed to include oil under the compulsory ACU settlement mechanism. There is, therefore, good scope for the country to match the trade with Iran by adequate volume of exports in order to minimise the bi-monthly settlement of ACU balances in free foreign exchange. Since ACU system of settlement was optional prior to 1st January 1984, the experience of the system among the authorised dealers as well as importers and exporters during that period may not be a worthwhile guideline to forecast future trade flows. The "compulsion" now introduced may bring about a significant shift and activisation of India's trade with member-countries of the Union. The economy in costs of banking services due to non-use of third country currencies and correspondent banks e.g. in London/New York, the speed with which transactions can now be settled directly through ACU due to elimination of services of third country banks are some other significant advantages. The Group noted that an increased flow of transactions through ACU system may also activise inter-bank markets in these currencies. In that context, the problem of forward cover should

receive attention vide Group's observations in Chapter I of the Report.

34. The Group noted that ACU "compulsion" is for current trade transactions only. It will not cover deferred payment imports and exports for which settlement through international currencies would be permissible. Accordingly, the Group noted that forward cover facilities for such transactions and also for current transactions which have to be compulsorily settled through ACU mechanism could be availed of by the importers and exporters within the framework of existing regulations and proposals for amendments thereto examined by the Study Group.

Abolition of Sterling Rates Schedule
and other exchange market reforms.
(Item xLii)

35. The Group noted that the various exchange market reforms introduced by the Reserve Bank and the FEDAI should not affect the eligibility of the importers and exporters to forward cover facilities which may be governed by the relevant regulations as amended.

Conclusion

36. In conclusion, it may be mentioned that while taking note of the work entrusted to the Study Group,

the Expert Committee on Exports and Imports headed by Shri M.S.Patwardhan recorded the following in the report submitted to the Governor on 22nd December 1983

> "RBI had set up, in January 1983, an Inter-Departmental Study Group under the Chairmanship of the Controller (Member-Secretary of this Committee) to review the entire range of exchange control regulations relating to forward exchange cover facilities. The appointment of the internal Study Group came soon after the appointment of the Committee and its work has progressed apace with the work of the Committee. Consequently, although the terms of reference of the Committee also included the subject of forward facilities for importers and exporters, the Committee did not consider it necessary to duplicate the effort on studying the same issue through two different channels. Instead, it was decided to refer to the Study Group for expert examination, all important suggestions on the subject made to the Committee by different organisations, either in writing or in their oral submission. Members of the Committee also had an opportunity to see the draft of the Study Group's report and make certain suggestions for changes in it.
>
> The Study Group has since completed its deliberations and is expected to submit its report to the RBI Governor shortly. It has done a commendable job of analysing methodically a highly technical and complex subject. The Committee hopes that the major recommendations of the Study Group, which are expected to include introduction of a few entirely new forward cover facilities, would go a long way in meeting the demand of the trade for liberalisation of the existing forward facilities. "

37. The Expert Committee, in one of its suggestions, had mentioned that the "spread" between buying and selling rates for foreign currencies should be narrowed down so that finer rates are available to exporters and importers. The Study Group believes that this demand would have

been now met by virtue of the various exchange market reforms introduced by the Reserve Bank in the form of abolition of Sterling Rates Schedule, delinking of interest element from exchange rates and standard accounting procedure prescribed for import and export bill transactions. The guidelines issued by FEDAI to the authorised dealers with the approval of the Reserve Bank for implementation of these reforms prescribe the maximum "spread" for various currencies and also the minimum and maximum exchange margins allowed to be loaded by authorised dealers. These reforms would undoubtedly bring about an improvement of the rates structure for forward cover transactions also. Most importantly, the standard accounting procedure stipulated for import and export bills precluding overdue transactions to be held in exchange portfolios of banks beyond prescribed period, would enable the exchange markets to provide better forward cover facilities. Also, the incidence of swap costs hitherto borne by the customers would be eliminated and instead be borne by the authorised dealers themselves. The Group hopes that the range of reforms already introduced by Reserve Bank and those recommended in this Report would be found useful by the actual users. The Group thanks the Expert Committee for expression of confidence in the work undertaken by the Group to review regulations relating to Forward Cover facilities.

ANNEXURE I

Study Group to review Exchange Control Regulations relating to Forward Cover facilities - Members of the Study Group

1.	Shri S.S.Thakur, Controller	Chairman
2.	Shri G.H.Deolalkar, Additional Controller	Convenor
3.	Shri T.K.Velayudham, Principal, BTC	Member
4.	Shri K.L.Deshpande, Adviser, Department of Economic Analysis & Policy	"
5.	Shri B. Ray, Joint Controller, Central ECD (Now, Chief Accountant, RBI)	"
6.	Shri R.K.Jalan, Joint Controller, Central ECD.	"
7	Shri P.R.Anantharaman, Deputy Chief Accountant, Department of Government & Bank Accounts	"
8.	Shri A.M.M. Sarma, Deputy Chief Officer, Central DBOD	"
9.	Shri A.I.Rasquinha, Deputy Chief Officer, IECD. (Now, Joint Chief Officer, IECD)	"
10.	Shri K.S.Krishnarao, Deputy Controller, Central ECD (Now, Joint Controller ECD)	"
11.	Shri V.Subrahmanyam, Deputy Controller, Central ECD, (Now, Joint Controller, New Delhi)	"
12.	Shri I.D.Agarwal, Deputy Controller, Central ECD	"
13.	Shri K.N.Gangurde, Deputy Controller, Central ECD.	"
14.	Shri D.S.R.Simhudu, Deputy Controller, Central ECD.	"
15.	Shri G.P.Muniappan, Deputy Controller, Central ECD.	"
16.	Shri D.N.Prasad, Deputy Controller, Central ECD.	"
17.	Shri M.K.Ramamurthy, Assistant Controller, Central ECD	"
18.	Shri Y.D.Bajpai, Assistant Controller, Central ECD	Member Secretary

ANNEXURE II

Names of the experts who responded with comments on the Draft Report of the Study Group

1. Dr. K.K.Mukherjee,
   Additional Chief Officer,
   Department of Banking Operations & Development,
   Reserve Bank of India, Bombay.

2. Shri M.L.Inasu,
   Additional Chief Officer,*
   Department of Banking Operations & Development,
   Reserve Bank of India, Bombay.
   *(Now, Addl.C.O., IECD)

3. Shri V.Subrahmanyan,
   Additional Controller, (Since retired)
   Exchange Control Department,
   Reserve Bank of India, Bombay.

4. Shri S.Jayaraman,
   Joint Chief Officer,
   Industrial & Export Credit Department,
   Reserve Bank of India, Bombay.

5. Shri B.Y.Pandit,
   Joint Chief Officer,
   Industrial & Export Credit Department
   Reserve Bank of India, Bombay.

6. Shri B.M.Bhide,
   Joint Chief Officer,
   Industrial & Export Credit Department,
   Reserve Bank of India, Bombay.

7. Shri P.B.Kulkarni,
   Joint Chief Accountant,
   Department of Government & Bank Accounts,
   Reserve Bank of India, Bombay.

8. Shri S.Balakrishnan,
   Deputy Controller,**
   Exchange Control Department,
   Reserve Bank of India, Bombay.
   **(Now, Joint Controller)

9. Shri B. Maheswaran,
   Deputy Controller,
   Exchange Control Department,
   Reserve Bank of India, Bombay.

ANNEXURE III

Names of Offices/Organisations/Authorised Dealers who responded with comments on the Draft Report of the Study Group.

Reserve Bank Offices

1.	Exchange Control Department,	Ahmedabad
2.	--do--	Bombay
3.	--do--	Bangalore
4.	--do--	Calcutta
5.	--do--	Cochin
6.	--do--	Hyderabad
7.	--do--	Kanpur
8.	--do--	Madras
9.	--do--	Nagpur
10.	--do--	Srinagar

11. Bankers' Training College, Bombay.

Authorised Dealers

12. Bank of India
13. Bank of Baroda
14. Banque Nationale De Paris
15. Bank of America
16. Citibank
17. Corporation Bank
18. Dena Bank
19. Grindlays Bank
20. Punjab National Bank

21. State Bank of Saurashtra
22. State Bank of Travancore
23. State Bank of Bikaner & Jaipur
24. State Bank of Indore
25. State Bank of Patiala
26. Vijaya Bank

Organisations

27. Foreign Exchange Dealers' Association of India.
28. Expert Committee on Exports & Imports headed by Shri M.S.Patwardhan, Managing Director of NOCIL.

ANNEXURE IV

Dates of various meetings held by the Study Group

Meeting No.	Date of the Meeting
I	16th February 1983
II	23rd February 1983
III	4th March 1983
IV	8th March 1983
V	16th March 1983
VI	23rd March 1983
VII	31st March 1983
VIII	7th April 1983
IX	18th April 1983
X	29th April 1983
XI	10th June 1983
XII	15th June 1983
XIII	11th July 1983
XIV	25th August 1983
XV	13th September 1983
XVI	23rd September 1983 & 24th September 1983
XVII	6th April 1984

Note: The discussions held were fully minuted for serving as office record/background material to support amendments to be made to Exchange Control Manual on adoption of the recommendations made by the Study Group.