Annex I

Explanatory Note to Chapter on Unhedged Foreign Currency Exposure

Introduction

1. Unhedged foreign currency exposures of any entity are an area of concern not only for the individual entity but also to the entire financial system. Entities which do not hedge their foreign currency exposures can incur significant losses during the period of heightened volatility in foreign exchange rates. These losses may reduce their capacity to service the loans taken from the banking system and increase their probability of default thereby affecting the health of the banking system.

Background and Rationale

2. The Reserve Bank first introduced the concept in October 1999 as part of risk management systems after it was observed during the economic crises in some countries that banks bear additional credit risk on entities which have unhedged foreign currency risk. Accordingly, banks were advised to evolve a suitable framework for regular monitoring of foreign currency risk exposure of entities which do not have natural hedge and to factor such unhedged exposures of entities into the risk rating system for taking credit decisions.

3. The aim of the framework was that the banks shall price the risk from Unhedged Foreign Currency Exposure (UFCE) as credit risk premium which may nudge entities to hedge their foreign currency exposures in the market. To this end, banks were further advised though a series of instructions to a) regularly monitor the unhedged portion of large foreign currency exposures of entities; b) have a Board approved policy on hedging of foreign currency loans; and c) have a mechanism for information sharing on UFCE in case of consortium lending. However, a sizeable portion of entities' foreign currency exposures remained unhedged resulting in significant but avoidable risks to entities' balance sheets, in turn, impacting the quality of bank's assets.

4. To address the risk on bank's books, banks were advised to maintain incremental provisioning and capital requirements for their exposures to entities with UFCE. The process of computing incremental provisioning and capital requirements can be summarised in following steps:

a) Step 1: Assess the foreign currency exposure (FCE) of the entity.
b) Step 2: Ascertain the amount of UFCE from entities' FCE taking into account two types of hedges – natural hedge and financial hedge.
c) Step 3: Estimate the potential loss to the entity from UFCE exposure of entity due to exchange rate movements.
d) Step 4: Maintain incremental provisioning and capital requirements against banks' exposure to the entity based on impact of likely / potential loss on entity's overall profitability.

5. Based on banks' feedback, a few amendments were made to the guidelines for operational clarity and accuracy of information obtained. These included, inter alia, allowing collection of information on UFCE directly from entities (through self-certified / audited UFCE certificates); clarification on capital treatment of incremental provisioning requirement for UFCE; and treatment in case bank is unable to obtain information on UFCE from entity. Banks were also given an option to follow an alternative method for their exposure to smaller entities. Under this alternative method, instead of obtaining information on UFCE from smaller entities, bank could maintain incremental provisioning of 10 bps for such exposures.

6. Further, some exposures were excluded from the ambit of these instructions, namely, inter-bank exposures, intra-group exposures of Multinational Corporations incorporated outside India and exposure to entities which have not borrowed from Indian banking system.