



भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA



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October 11, 2022

Dear Sir / Madam,

Reserve Bank of India (Unhedged Foreign Currency Exposure) Directions, 2022

The Reserve Bank of India has, from time to time, issued several guidelines / instructions / directives to the banks on Unhedged Foreign Currency Exposure (UFCE) of the entities which have borrowed from banks.

2. We have received references from banks seeking clarification on various aspects including *inter-alia* clarity in the definition of 'entities' for which banks shall assess UFCE, exempted exposures / entities, alternative method for smaller entities, assessment of UFCE of entities incorporated outside India by overseas subsidiaries / branches of Indian banks etc.

3. Accordingly, a comprehensive review of the extant guidelines has been undertaken and all the existing instructions on the subject including the revisions / clarifications on the issues stated above have been consolidated in the Directions enclosed herewith. An Explanatory Note providing the background for these Directions is also enclosed.

Applicability

4. This circular is applicable to all commercial banks (excluding Payments Banks and Regional Rural Banks).

5. These instructions shall come into force from January 1, 2023.

Yours faithfully,

(Usha Janakiraman)
Chief General Manager

DEPARTMENT OF REGULATION

Notification No.DOR.MRG.77/00-00-007/2022-23 dated October 11, 2022

Reserve Bank of India (Unhedged Foreign Currency Exposure) Directions, 2022

In exercise of the powers conferred under Section 35 A of the Banking Regulation Act, 1949 (hereinafter called the Act), the Reserve Bank of India (hereinafter called the Reserve Bank), being satisfied that it is necessary and expedient in the public interest to do so, hereby, issues the Directions hereinafter specified.

CHAPTER I - PRELIMINARY

1. Short title and commencement

a) These Directions shall be called the Reserve Bank of India (Unhedged Foreign Currency Exposure) Directions, 2022.

b) These Directions shall come into effect from January 1, 2023.

2. Applicability

The provisions of these Directions shall be applicable to all commercial banks excluding Payments Banks and Regional Rural Banks (hereinafter collectively referred as "banks"). These Directions shall be applicable to overseas branches / subsidiaries of banks incorporated in India as specified in clause 10 hereinafter.

3. Definitions

(a) In these Directions, unless the context states otherwise, the terms herein shall bear the meaning assigned to them below:

- i. "Earnings before Interest and Depreciation (EBID)" shall have the same meaning as defined for computation of Debt Service Coverage Ratio (DSCR) i.e., $EBID = Profit\ After\ Tax + Depreciation + Interest\ on\ debt + Lease\ Rentals$, if any.
- ii. "Entity" means a counterparty to which bank has exposure in any currency.

Explanation: Exposure shall mean all fund-based and non-fund-based exposures.

- iii. “Financial hedge” shall mean hedging through a derivative contract with a financial institution. Financial hedge shall be considered only where the entity has documented the purpose and the strategy for hedging at inception of the derivative contract and assessed its effectiveness as a hedging instrument at periodic intervals.

Note: For the purpose of assessing the effectiveness of hedge, guidance may be taken from the applicable accounting standards and the relevant guidance notes of the Institute of Chartered Accountants of India on the matter.

- iv. “Foreign Currency Exposure (FCE)” of an entity shall mean the gross sum of all items on the entity’s balance sheet that have impact on its profit and loss account due to movement in foreign exchange rates.
- v. “Listed entities” shall mean entities listed on the recognized stock exchanges.
- vi. “Natural hedge” shall mean a hedge arising out of the operations of the company when cash flows offset the risk arising out of the Foreign Currency exposure (FCE).

Note: An exposure shall be considered as naturally hedged only if the offsetting exposure has the maturity / cash flow within the same accounting year.¹

- vii. “Unhedged Foreign Currency Exposure (UFCE)” shall mean Foreign Currency Exposure (FCE) excluding items which are effective hedge of each other. While estimating UFCE of an entity, banks shall consider only two types of hedges - financial hedge and natural hedge.

(b) All other expressions unless defined herein shall have the same meaning as have been assigned to them under the Banking Regulation Act, 1949 or the Reserve Bank of India Act, 1934 and rules/regulations made thereunder, or any statutory modification or re-enactment thereto or as used in commercial parlance, as the case may be.

¹ For instance, export revenues (booked as receivable) may offset the exchange risk arising out of repayment obligations of an external commercial borrowing if both the exposures have cash flows / maturity within the same accounting year.

CHAPTER II – GENERAL GUIDELINES

4. Computation of UFCE

(a) Banks shall ascertain the Foreign Currency Exposure (FCE) of all entities² at least on an annual basis. Banks shall compute the FCE following the relevant accounting standard applicable for the entity.

Explanation: Banks shall consider the items maturing or having cash flows over the period of next five years.

Note: For arriving at the foreign currency exposure of entities, their exposure from all sources including foreign currency borrowings and External Commercial Borrowings shall be taken into account.

(b) Banks shall assess the Unhedged Foreign Currency Exposure (UFCE) of entities with FCE by obtaining information on UFCE from the concerned entity.

Provided that the information on UFCE shall be obtained from entities on a quarterly basis based on statutory audit, internal audit or self-declaration by the concerned entity.

Provided further that UFCE information shall be audited and certified by the statutory auditors of the entity, at least on an annual basis.

5. Provisioning and Capital Requirements

(a) Banks shall determine the potential loss to an entity from UFCE using the largest annual volatility in the USD-INR exchange rates during the last ten years.³

Note: The Unhedged Foreign Currency Exposure (UFCE) in currencies other than USD shall be converted into USD using the current market rates for determining the potential loss from UFCE.

(b) Banks shall determine the susceptibility of the entity to adverse exchange rate movements by computing the ratio of the potential loss to entity from UFCE and the

² The requirement in clause 4(a) would not be applicable for entities which are already submitting the information on UFCE as per clause 4(b).

³ Banks shall use the data published by FEDAI on largest annual volatility of USD-INR rate over a period of last 10 years and the same shall be used for computation of potential loss by multiplying it with UFCE.

entity's EBID over the last four quarters as per the latest quarterly results certified by the statutory auditors⁴.

Note: (1) In cases where banks are not in position to obtain information on UFCE or EBID from listed entities for the latest quarter due to restrictions on disclosure of such information prior to finalisation of accounts, banks shall have the option to use data pertaining to the immediately preceding last four quarters for computing capital and provisioning requirements.

(2) In case of unlisted entities where the audited results of the last quarter are not available, the latest audited quarterly or annual results available shall be used. The annual EBID figure used shall at least be of the last financial year.

(c) Accordingly, banks shall apply incremental capital and provisioning requirements⁵ to all exposures to such entities as under:

Potential Loss / EBID (%)	Incremental Provisioning Requirement	Incremental Capital Requirement
Upto 15 per cent	0	0
More than 15 per cent and upto 30 per cent	20bps	0
More than 30 per cent and upto 50 per cent	40bps	0
More than 50 percent and upto 75 per cent	60bps	0
More than 75 per cent	80 bps	25 per centage point ⁶ increase in the risk weight

⁴ For the purpose of this sub-clause, the directions do not differentiate between limited audited results and full audited results.

⁵ Incremental capital and provisioning requirements shall be over and above the present requirements i.e., general provision for standard assets and applicable credit risk weights as per Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated April 1, 2022 and Master Circular – Basel III Capital Regulations dated April 1, 2022 respectively.

⁶ For example: for an entity which otherwise attracts a risk weight of 50 per cent, the applicable risk weight would become 75 per cent.

Note: The incremental provisioning for UFCE shall be based on the total exposure amount which is used for computing standard asset provisioning and incremental capital requirements for UFCE shall be based on the total exposure amount which is used for computing credit risk capital requirements.

(d) Banks shall calculate the incremental provisioning and capital requirements at a minimum on a quarterly basis.

(e) For projects under implementation and the new entities, banks shall calculate the incremental provisioning and capital requirements based on projected average annual EBID for the three years from the date of commencement of commercial operations.

Provided that the incremental capital and provisioning requirement shall be subjected to a minimum floor of 20 bps of provisioning requirement.

(f) In cases where the bank is not able to get sufficient data to assess UFCE and compute incremental capital and provisioning requirements except for the smaller entities covered under the alternative method provided in sub-clause (g) below, the bank shall take a conservative view and place the exposure to the entity at the last bucket which requires incremental provisioning of 80bps and a 25 per centage point increase in risk weight.

(g) Banks shall have the option to follow an alternative method for exposures to smaller entities which are having foreign currency exposures and are not in position to provide information on their UFCE as per clause 4(b). Under this alternative method, banks shall apply an incremental provisioning of 10 bps over and above extant standard asset provisioning instead of computing incremental capital and provisioning requirements as provided in clause 5(a) to 5(e).

Explanation: For this purpose, smaller entities are those entities on which total exposure of the banking system is at Rs.50 crore or less.

6. Systems and Controls

(a) Banks shall incorporate the risk of UFCE of entities in their internal credit rating system and credit risk management policies and procedures.

(b) Banks shall stipulate internal limits for UFCE within the overall Board approved risk policy of the bank.

7. Consortium Lending

(a) In the case of consortium / multiple banking arrangements, the consortium leader / bank having the largest exposure shall have the lead role in monitoring the unhedged foreign exchange exposure of entities.

Note: Banks shall put in place a system for information sharing and dissemination in terms of circular DBOD.No.BP.BC.94/08.12.001/2008-2009 dated December 8, 2008 on 'Lending under Consortium Arrangement / Multiple Banking Arrangements', as amended from time to time

8. Exemption / Relaxation

(a) Banks shall have the option to exclude the following exposures from the calculation of UFCE:

(i) Exposures to entities classified as sovereign⁷, banks⁸ and individuals.

(ii) Exposures classified as Non-Performing Assets.

(iii) Intra-group foreign currency exposures of Multinational Corporations (MNCs) incorporated outside India⁹.

Provided that the bank is satisfied that such foreign currency exposures are appropriately hedged or managed robustly by the parent.

(iv) Exposures arising from derivative transactions and / or factoring transactions with entities, provided such entities have no other exposures to banks in India.

9. Capital Treatment and Disclosures

The incremental provision requirement for UFCE shall be treated as general provision for disclosures and inclusion in Tier 2 capital.

10. Overseas Branches/Subsidiaries

(a) The provisions of these Directions shall be applicable to overseas branches/subsidiaries of banks subject to the following:

⁷ For this purpose, sovereign shall include domestic and foreign sovereign as provided in paragraph 5.2 and 5.3 of Master Circular on Basel III Capital Regulations dated April 1, 2022, as amended from time to time.

⁸ For this purpose, RBI regulated financial institutions (SIDBI, NABARD, NHB, EXIM Bank and NaBFID), Bank of International Settlement (BIS), International Monetary Fund (IMF) and eligible Multilateral Development Banks (MDBs) listed in paragraph 5.5 of Master Circular on Basel III Capital Regulations dated April 1, 2022 shall be considered as 'bank'.

⁹ For example, an Indian subsidiary of an MNC incorporated outside India may have borrowed from its parent.

(i) With respect to the exposure to entities incorporated outside India, information on UFCE shall be obtained from such entities on a quarterly basis based on internal audit or self-declaration and the requirement of certificate from statutory auditors on annual basis, as provided in clause 4(b), may not be insisted upon. In cases where bank is not able to obtain information on UFCE from concerned entities, the treatment provided in clause 5(f) shall apply.

(ii) Banks shall compute the potential loss due to UFCE by replacing INR with the domestic currency of that jurisdiction and USD with the foreign currency (i.e., currency other than domestic currency of that jurisdiction) in which the entity has maximum exposure in clause 5(a).

Note: Banks shall compute the largest annual volatility over a period of last ten years in the following manner: First, daily changes in the foreign exchange rates shall be computed as a log return of today's rate over the previous day's rate. Second, daily volatility shall be computed as standard deviation of these returns over a period of one year (250 observations). Third, this daily volatility shall be annualised by multiplying it by square root of 250. This computation shall be performed on a daily basis for the all the days in the last ten years. The largest annual volatility thus computed shall be used for the computation of the potential loss by multiplying it with the UFCE.

Chapter III – REPEAL PROVISIONS

11.1 With the issue of these Directions, the instructions / guidelines contained in the following circulars issued by the Reserve Bank stand repealed.

	Circular No.	Date	Subject
1	DBOD.BP.BC.37/21.04.048/2001-2002	October 27, 2001	Monetary and Credit Policy Measures - Mid-Term Review for the Year 2001-2002 - Unhedged Foreign Currency Exposures of Corporates
2	DBOD.BP.BC.51/21.04.103/2003-2004	December 5, 2003	Mid-term Review of Monetary and Credit Policy for the year 2003-04 - Unhedged Foreign Currency Exposures of Corporates

3	DBOD.BP.BC.96/21.04.103/2008-09	December 10, 2008	Unhedged Foreign Exchange Exposure of Clients - Monitoring by Banks
4	DBOD.BP.BC.No.76/21.04.103/2011-12	February 2, 2012	Second Quarter Review of Monetary Policy 2011-12 – Unhedged Foreign Currency Exposure of Corporates
5	DBOD.BP.BC.No.61/21.04.103/2012-13	November 21, 2012	Second Quarter Review of Monetary Policy 2012-13 – Unhedged Foreign Currency Exposure of Corporates
6	DBOD.No.BP.BC.85/21.06.200/2013-14	January 15, 2014	Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure
7	DBOD.No.BP.BC.116/21.06.200/2013-14	June 3, 2014	Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure-Clarifications
8	Mailbox Clarification	July 8, 2016	Capital and Provisioning Requirements for Exposures to Entities with Unhedged Foreign Currency Exposure
9	DOR.No.MRG.BC.41/21.06.200/2020-21	February 17, 2021	Capital and provisioning requirements for exposures to entities with Unhedged Foreign Currency Exposure

11.2 All approvals / acknowledgements given under the above circulars shall be deemed as given under these Directions.

11.3 All the repealed circulars are deemed to have been in force prior to the coming into effect of these Directions.

Explanatory Note¹ to Reserve Bank of India (Unhedged Foreign Currency Exposure) Directions, 2022

October 11, 2022

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 of India 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 should 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 through 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.

¹ Explanatory Note is a non-technical description of the rationale / background for introducing the Reserve Bank of India (Unhedged Foreign Currency Exposure) Directions, 2022. The sole purpose of this note is to facilitate better understanding of the Directions by market participants. In case of any conflict between the explanatory note and the Directions, the Directions shall prevail.

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.

Key Changes in the Directions

7. In addition to consolidating all the instructions on the subject at one place, the key changes that have been incorporated in the Directions are as follows:

7.1 *Definition of Entity:* At present, banks are required to assess UFCE of all entities. The term 'entities' is defined as those entities which have borrowed from banks including borrowing in INR and other currencies irrespective of the size of

exposure / entity. On a review, the revised definition of entity states that “Entity” means a counterparty to which bank has exposure in any currency.

7.2 Exemption from UFCE guidelines: At present, banks' exposures to an entity arising from derivative transactions only is excluded from the purview of UFCE guidelines. This exemption has been expanded to include factoring transactions. Accordingly, banks' exposures to an entity arising from derivative transactions and/or factoring transactions only shall be excluded from the purview of UFCE guidelines. In addition, to provide further clarity, the entities exempted from the ambit of these guidelines have been provided separately.

7.3 Alternative method for exposure to smaller entities: At present, banks have the option to follow an alternative method for exposures to ‘smaller entities’ which have a) UFCE; and b) are not in position to provide information on their UFCE to the bank. However, without obtaining information on UFCE from such entities [refer (b) above], banks will not be in position to ascertain whether the entity has UFCE or not [refer (a) above)]. To address this issue, the alternative method has been made applicable for exposure to ‘smaller entities’ which have FCE, instead of UFCE, and are not in position to provide information on their UFCE. Further, the definition of ‘smaller entities’ for this purpose has been revised.

7.4 Incremental Capital Requirement: At present, the incremental capital requirement for exposures falling in the last bucket is provided as 25 per cent increase in risk weight. It is clarified that the incremental requirement is 25 percentage points increase in risk weight. For example, if an entity which otherwise attracts a risk weight of 50% falls in the last bucket, the applicable risk weight would be 75% (50%+25%). This is because the exposures falling in same bucket will have equal increase in their riskiness irrespective of the original risk weight applicable.
