DERIVATIVES UNDER FEMA

What is a Derivative?

A Derivative is a (financial) security or instrument, the value of which depends on underlying asset or group of assets or a benchmark. It is a contract between two or more parties, and its price is determined by fluctuations in the underlying asset. Examples of underlying assets in case of derivatives are shares /stocks, bonds, indexes, currencies, interest rates and commodities.

Derivatives are most commonly used to hedge the risk of abnormal fluctuations, be it price of share or interest rate or exchange rates of currencies. At the same time, derivatives are also used as a speculation tool where the speculators engage in trading them with an objective to gain (arbitrage) from such abnormal fluctuations. Most commonly used derivative contracts as Forward Contracts, Exchange Traded Futures and Options (in stocks and currencies), Interest Rate Swaps, Currency Swaps, etc.

Regulatory environment in India

As a capital market regulator, SEBI is the primary regulator governing derivatives in India. History of derivatives in India dates to 1998, when SEBI accepted the recommendations of Dr. L C Gupta Committee and approved phased implementation of derivatives trading in India, beginning with stock index futures. Necessary infrastructure was created in the form of introducing separate segment on stock exchanges and clearing house therefor, approvals for trading members, putting in place risk containment measures, disclosure requirements, etc. Accordingly, in May 2000, SEBI gave its approval to stock exchanges (BSE and NSE only at that time) to commence derivatives trading. Over a period, multiple derivative products were introduced on stock exchanges for trading.

As a foreign exchange regulator in India, Reserve Bank ("RBI") issued Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations in May 2000 ("Derivative Regulations"). These regulations were amended time to time in line with improvements (at national and international levels) in derivatives market. These regulations provide detailed guidelines, separately for persons resident in India and non-residents, about general permission, limitations, eligible derivative products, exposures that can be covered, etc. As like any other FEMA regulation, prior approval of RBI is required to enter into any derivative contract, unless it is expressly permitted in the derivative regulations or any other FEMA regulation. In addition to Derivative Regulations, RBI's AP (DIR Series) Circulars and FMRD Master Direction No. 1/2016-17 on Risk Management and Inter-Bank Dealings also governs derivation transactions under FEMA.

Derivatives under FEMA

Under FEMA, a Foreign Exchange Derivative Contract ("FEDC") means a financial transaction or an arrangement in whatever form and by whatever name called, whose value is derived from price movement in one or more underlying assets, and includes:

a. a transaction which involves at least one foreign currency other than currency of Nepal or Bhutan, or

b. a transaction which involves at least one interest rate applicable to a foreign currency not being a currency of Nepal or Bhutan, or
c. a forward contract,

but does not include foreign exchange transaction for Cash or Tom or Spot Deliveries.

In case of a Cash Delivery, delivery of foreign exchange, as part of settlement of contract, happens on the same day of transaction. In case of Tom Delivery, it happens on a working day next to the day of transaction and in Spot Delivery, it happens on second working day after the day of transaction.

Exchange Traded Currency Futures and Currency Options (including cross currency options), Interest Rate Swap, Currency Swap (including Cross Currency Swap) and Coupon Swap are the derivative products allowed under Derivative Regulations in addition to Forward Contracts. Any other type of derivative product will be requiring prior approval of RBI.

As explained earlier, derivatives are commonly used to hedge the risk of fluctuations. As such, both persons resident in India (PRI) and non-residents are exposed to risk of foreign exchange rate fluctuations. While a PRI will have exposure to transactions like foreign currency loans taken, investments made abroad, outstanding receivables or payables towards exports and imports, a non-resident will have similar exposure as a counter party to such transactions. Accordingly, Derivative Regulations provide guidelines applicable to transactions by PRIs and non-residents. It may be noted that certain FEMA regulations, like in ECBs, provide for mandatory hedging of such exposures. Any derivative contract under FEMA shall be through authorized dealers only. In case of Exchange Traded Contracts (‘ETC’), delivery of underlying currency is not permitted.

Currency Futures:

As per Derivative Regulations, Currency Futures means a standardised foreign exchange derivative contract traded on a recognized stock exchange to buy or sell one currency against another on a specified future date, at a price specified on the date of contract, but does not include a forward contract.

These exchange traded currency futures were introduced by SEBI in August 2008, and correspondingly RBI issued Currency Futures (Reserve Bank) Directions, 2008 in the same month. Initially trading was allowed only for USD-INR pair futures. Subsequently in Jan 2010, SEBI allowed trading of EUR-INR, JPY-INR and GBP-INR currency futures. Accordingly, RBI vide AP (DIR Series) Circular No. 27, dated 19.01.2010, amended Currency Futures Directions allowing trading in the new currency pairs.

In addition, cross currency futures (i.e., futures not involving rupee as a currency to the contract) were allowed by RBI to be traded vide AP (DIR Series) Circular No. 35, dated 10.12.2015. Such cross-currency futures were allowed in EUR-USD, GBP-USD and JPY-USD currency pairs. Corresponding approval towards trading in such cross-currency futures was given by SEBI to stock exchanges in March 2016.

In case of currency futures contracts, the maturity of the contract shall not exceed 12 months. The membership of the currency futures market of a recognized stock exchange shall be separate from the membership of equity derivative segment and the cash segment. AD Bank can become trading members of currency futures markets subject to fulfilling prudential norms being minimum net worth of INR 5,000 Million, Capital to Risk Assets Ratio (CRAR) of 10%, net NPA not more than 3% and have net profits for last 3 years.

Derivative Contracts permissible to persons resident in India (PRI):

Regulation 4 of Derivative Regulations permits a person resident in India (PRI) to enter in to an FEDC in accordance with provisions contained in Schedule I annexed thereto, to hedge an exposure to risk or otherwise, in respect of a transaction permissible under the Act, or rules or regulations or directions or orders made or issued thereunder. And Regulation 5A of said regulations permit a PRI to enter in to exchange traded currency futures or currency options to hedge their exposures to risk. Such exposure can be either contracted (i.e., already existing) or probable exposure (i.e., futuristic), and it can be out of capital account or current account transactions. For ease of understanding the provisions, we shall discuss them derivative product wise, because the usage of derivative products is restricted to limited purposes.

1. Foreign Currency Forward Contract (FC):

It is a most common derivative product used for hedging. Under an FC, the parties agree to execute the transaction at a pre-determined rate and a pre-determined price. Both the parties must execute the contact on due date mandatorily. Unlike futures and options which are governed by stock exchanges, a forward contract is an over the counter (OTC) derivative product and has higher risk of non-execution by either party.

PRIs can use FCs to hedge exchange rate risk in relation to any transaction for which purchase / sale of foreign exchange is permitted under FEMA and its rules / regulations, which includes overseas direct investment in equity and loans, balances in foreign currency accounts, imports, including transactions denominated in foreign currency but settled in INR.

2. Cross Currency Options

PRIs can use cross currency options to hedge exchange rate risk arising out of trade transactions and to hedge contingent foreign exchange exposure arising out of submission of a tender bid in foreign currency. This is in addition to FCs.

3. Foreign Currency (FCY) – INR Option

As like forward contract, FCY-INR options can be used to hedge the exchange rate risk in relation to any transaction for which purchase / sale of foreign exchange is permitted under FEMA. In addition, it can also be used to hedge the risk arising out of submission of a tender bid in foreign currency. To issue such derivative contracts, AD Banks should meet aforesaid prudential requirements being minimum net worth of INR 5,000 Million, CRAR of 10%, having net profits for past three years and having NPAs not exceeding 3%.

4. Foreign Currency (FCY) – INR Swaps

Using an FCY-INR swap, residents can move from their foreign currency liability to rupee liability. Similarly incorporated resident entities can move from their rupee liability to foreign currency liability (INR-FCY swap). This is done to hedge exchange rate and / or interest rate risk exposures on their long-term borrowings / liabilities (i.e., with period more than one year). No swap transactions involving upfront payment of rupees or its equivalent in any form shall be undertaken.

5. Cost Reduction Structures

This covers cross currency option cost reduction structures and FCY–INR option cost reduction structures. These are permitted only to listed companies and their subsidiaries / joint ventures / associates having a common treasury and consolidated balance sheet or to unlisted companies with a minimum net worth of INR 2,000 Million and the purpose is to hedge foreign exchange rate risk arising out of trade transactions, ECBs and foreign currency loans availed domestically against FCNR(B) deposits. In case of trade transactions being the underlying, the tenor of the structure shall not exceed two years.

<u>General guidelines, terms and conditions in case of transactions by PRI:</u>

a. The maturity and tenor of the hedge / swap shouldn’t exceed the maturity / tenor of the underlying transaction.
b. In case of foreign currency loans or bonds, they will be eligible for hedging only up on final approval RBI and up on allotment of Loan Registration Number (LRN).
c. GDRs and ADRs will be eligible for hedging only upon finalization of issue price.
d. In case of contracted exposures, forward contracts with residual maturity of less than one year can be easily cancelled and rebooked.
e. In case of cross currency options, only plain vanilla European options, both call and put options, can be issued by AD Bank
f. FCY-INR options can be issued by AD Bank who meet additional criteria (like adequate internal control and mark to market mechanism, net worth of INR 3,000 Million etc) set by RBI and that too with its prior approval.
g. In case of all forex derivative transactions other than INR-FCY currency swaps i.e. moving from INR liability to foreign currency liability, AD Bank shall take a declaration from the constituents that the exposure is unhedged and has not been hedged with another AD Bank. However, if a part of exposure is hedged with one AD Bank, the remaining can be hedged with another AD Bank, subject to a declaration in this regard.
h. An annual certificate from the statutory auditors should be submitted in case of contractual exposure to the effect that the contracts outstanding with all AD category I banks at any time during the year did not exceed the value of the underlying exposures at that time

i. Only one hedge transaction can be booked against a particular exposure or part thereof for a given time period.
j. Residents, other than individuals, are permitted to hedge their commodity risk and freight risk using appropriate derivative products (like forwards, swaps, futures, options or a any combination of them.

Special Dispensation:

RBI allowed Small and Medium Enterprises to hedge their direct or indirect exposures to foreign exchange risk through Forward Contracts without production of underlying documents, subject to other conditions specified in this regard.

Similarly, resident individuals, firms and companies can hedge their foreign exchange exposures, arising out of both actual as well as anticipated remittances, inward and outward, without production of underlying documents, up to a limit of USD 1 Mn, based on a declaration. For this purpose, they can use forward contracts and FCY-INR options. The tenor of such instruments shall be up to one year only.

Derivative Products for Probable Exposures:

PRIs are eligible to hedge their probable exposures (i.e., exposures which are not yet contracted) in case of imports and exports of goods and services. Such probable exposure shall be calculated based on past performance. The maximum exposure for derivative product in such case shall be the higher of average turnover of actual exports / imports of past three financial years or the previous year's actual import or export turnover.

The above limits shall be calculated for imports and exports separately. Higher limits, if any, will be permitted by RBI (Chief General Manager, Financial Markets Regulation Department of RBI) based on an application made in this regard. AD Bank while issuing a derivative under this category may insist for an undertaking that supporting documentary evidence will be produced before the maturity of all the contracts booked.

Derivative Contracts permissible to non-residents:

Regulation 5 and 5B read with Schedule II of Derivative Regulations allow non-residents (i.e., person resident outside India) to enter in to a FEDC or ETC to hedge an exposure to risk in respect of a permitted current account transaction, rupee denominated asset held by such non-resident or his rupee denominated rupee liability or any other transaction permissible under the FEMA or rules or regulations or directions or orders made or issued thereunder, subject to such conditions as may be prescribed by RBI.

Foreign Portfolio Investors (FPIs), non-resident Indians (NRIs), investors having FDI in India, non-resident importers and exporters, non-resident lenders having ECB designated in INR are the categories of non-residents who usually have exposure and accordingly hedge them. Below are the guidelines / provisions, as applicable to each category of non-residents.

Foreign Portfolio Investors:

FPIs can use derivative products to hedge currency risk on the market value of investment in equity and / or debt in India, coupon receipts arising out of such investments in debt securities and to hedge transient capital flows in case of IPOs. Derivative products being forward contracts, currency futures and FCY-INR options can be used to hedge their investments, other than IPO related where FCY-INR swaps only can be used.

The FPI should provide a quarterly declaration to the custodian bank that the total amount of derivatives contract booked across all AD Banks is within the market value of its investments. The hedges taken by FPIs with AD banks other than designated AD banks must be settled through the Special Non-Resident Rupee Account (SNRR) maintained with the designated bank through RTGS/NEFT. The cost of hedge should be met out of repatriable funds and /or inward remittance through normal banking channel. All outward remittances incidental to the hedge should be net of applicable taxes.

In case of exchange traded currency futures and options, FPIs can take positions without having to establish underlying exposures up to such limits as may be prescribed by RBI, SEBI or stock exchanges.

Non-Resident Indians (NRIs)

NRIs can use forward contracts, FCY-INR options and exchange traded currency futures to hedge the exchange rate risks on the market value of investments made under portfolio investment scheme (PIS), on amount of dividend due on shares held in Indian companies, on the amounts held in FCNR(B) deposits and on balances held in NRE accounts. Additionally, in case of FCNR(B) accounts, cross currency forward contracts to convert the balances in one foreign currency to other foreign currency are permitted.

One should note that all foreign exchange derivative contracts permissible for a resident outside India other than a FPI, once cancelled, are not eligible to be rebooked.

Other Non-Residents:

A non-resident can enter into a forward contract with an AD Bank in India to hedge currency risk on dividends receivable from him from an Indian company or to hedge the currency risk arising out of his proposed foreign direct investment in India. Similarly, non-resident importer / exporter can enter into a forward contract or FCY-INR option contract to hedge the currency risk in respect of imports from or exports to India invoiced in INR.

A non-resident can enter into a forward contract or FCY-INR option or FCY-INR swap contract with an AD Bank in India to hedge currency risk in respect of ECB denominated in INR.

A non-resident parent company can enter into any FEDC with an AD Bank in India to hedge an exposure of exchange risk of and on behalf of its Indian subsidiary in respect of the said subsidiary's transactions. This facility shall be subject to a tri-partite agreement between the AD Bank, parent company and Indian subsidiary clearly defining the relationship, relative roles and responsibilities and the procedure of transactions including settlement. The non-resident parent should be from FATF compliant country.

Simplified Hedging Facility

RBI, vide AP (DIR Series) Circular No. 11, dated November 12, 2017, brought the scheme of Simplified Hedging Facility with a view to simplify the process for hedging exchange rate risk by reducing documentation requirements, avoiding prescriptive stipulations regarding products, purpose and hedging flexibility, and to encourage a more dynamic and efficient hedging culture. The scheme can be used by both residents and non-residents, other than individuals, to hedge the exchange rate risk on transactions, permissible under FEMA, covering both actual and anticipated exposures. Any OTC derivative or exchange traded currency derivative can be used for this purpose.

Under the said scheme, the cap on total outstanding contracts is USD 30 Mn or its equivalent, on gross basis and the transactions should be routed through an AD Bank designated by such user. If hedging requirement of the user exceeds the limit in course of time, the designated bank may re-assess and, at its discretion, extend the limit up to 150% of the stipulated cap. Users are not required to furnish any documentary evidence for establishing underlying exposure under this facility. Users may, however, provide basic details of the underlying transaction in a standardised format, only in the case of OTC hedge contract.

Facilities to Category I Authorised Dealers (ADs)

a. ADs are permitted to hedge interest rate and currency risks associated to their foreign exchange asset-liability portfolio by using interest rate swap, interest rate cap / collar, currency swap or forward rate agreement including currency options. However, they should have an internal policy approved by their top management in this regard.

b. Similarly, AD Banks authorized by RBI to operate gold deposit schemes or which are authorised to enter into forward gold contracts in India can use any exchange traded or OTC derivative product available overseas to hedge gold prices.

c. Foreign banks operating in India can hedge their capital funds by using forward contracts subject to such other conditions specified by RBI.

d. AD Banks can participate in currency futures and exchange traded currency options market in India subject to aforesaid other prudential norms being minimum net worth of INR 5,000 Million, CRAR of 10%, having net profits for past three years and having NPAs not exceeding 3%.

It may be observed from the above that India has offered diversified and risk reward basis Derivative Structures and one can hedge their Foreign Exchange Risk, without much room for speculative trading. One can judiciously use the available derivative products and hedge the risk