Framework for implementation of new hedging guidelines

Effective from 01 September 2020

I. Preface

Reserve Bank of India has revised guidelines related to hedging of foreign exchange exposures. This is as per the circular - 'Risk Management and Inter-bank Dealings – Hedging of foreign exchange risk' - issued on 07 April 2020 and effective from 01 Sept. 2020 (the effective date).

The key changes in the regulation are

- Classification of Users into Retail and non Retail, and therefore the permissibility of products for each set of users
- Classification of underlying exposure into Contracted Exposure and Anticipated Exposure
- Flexibility to book derivative contracts upto USD 10 mio without the need to establish the existence of underlying exposure
- A simpler definition of "Hedging"
- A greater leeway on what products can be offered

The new guidelines are a shift from a prescriptive approach to principles based approach. They give operational freedom and simpler documentation requirements for Market Makers as well as users. They also provide a wider range of products for most users.

This framework document outlines the way Kotak Mahindra Bank (Bank) would implement the new guidelines for its clients[1] for derivatives[2]. It is intended to provide high level guidance (i) For the Banks internal processes on the implementation of the revised regulations and (ii) For clients of the Bank to understand and adhere to revised guidelines and the terms and conditions of the Bank for all future contracts.

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[1] For the purposes of this note, users who deal or can potentially deal with Kotak Mahindra Bank are referred to as clients.

[2] Derivatives also include forward contracts.

II. <u>User Classification:</u>

1. Bank will classify its clients as either a retail user or non-retail user as per the eligibility criteria given in the regulations. As per the new regulations, the following users shall be eligible to be classified as non-retail users:
    a. *All entities regulated by a financial sector regulator subject to general or special permission of the concerned regulator, Exim Bank, National Bank of Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI)*
    b. *Companies with a minimum net worth of Rs 500 crores*
    c. *Persons resident outside India other than individuals*

    Any user who is not eligible to be classified as a non-retail user shall be classified as a retail user.
2. User classification would apply to all derivatives including contracts not involving INR and Non-deliverable derivative contracts.
3. For the purpose of such user classification, bank would use information available with itself, publicly available information or as provided by the client. The bank will use such information in the best of its judgement to classify the client.
4. In case a client who is eligible to be classified as a non-retail user, choses to classify itself as retail user with the Bank, the client is required to intimate bank to classify itself as a retail user. The client is also required to disclose its user classification status with other banks. Subsequent to any such change, the client shall be eligible only for derivatives permissible for Retail users. Other outstanding contacts prior to change in user classification may be allowed to run until maturity.

III. Contracted Exposure and Anticipated Exposure

Clients of the Bank can avail the facility of the booking the contracts under Anticipated Exposure or Contracted Exposure provided all contracts involving deliverable Rupee are

i. For the purpose of hedging as defined in the regulation
ii. The notional and tenor of the contract does not exceed the value and tenor of the exposure at any point of time
iii. The same exposure has not been hedged using any other derivative contract.

1 Contracted Exposure :

i. A contracted exposure is an exposure to the exchange rate of INR against a foreign currency on account of current and capital account transactions permissible under FEMA, 1999 or any rules or regulations made thereunder, which has already been entered into.
ii. Evidence of underlying exposure shall be submitted within 15 calendar days from the trade date. Authenticated documentation for evidence of underlying shall be submitted either in physical form or electronic form through a mode acceptable to the Bank (e.g. electronic copies, scan through official email)
iii. In the event the evidence of underlying exposure is not provided within the stipulated timelines or is not to the satisfaction of the Bank, the contract would be cancelled. Losses upon such cancellation shall be recovered and gains, if any, shall not be passed on to the client.
iv. If trades are booked against underlying exposure where the value of the exposure is not ascertainable with certainly, such contracts may be booked on the basis of reasonable estimates (such as Master Sales Agreements or Master Procurement Agreement or similar such arrangements). The Bank would make a reasonable estimation of the exposure based on the documents submitted and its assessment of the client's business. Such estimates would also be subject to periodic review.
v. Contracts booked under contracted exposure can be rebooked after cancellation.

2 Anticipated Exposure :

i. A contract booked against an exposure to the exchange rate of INR against a foreign currency on account of current and capital account transactions permissible under FEMA, 1999 or any rules or regulations made thereunder, which are expected to be entered into in future. Therefore the amount of an anticipated exposure and the time by when it would crystalize may not be precisely known at the time of entering into a hedge contract.
ii. When hedging under this facility, the client will have to declare while booking the trade that this is under anticipated exposure. The amount and tenor permissible for such hedges would be based on the Bank's assessment of the reasonableness of such future exposure. The bank could ask for additional details to satisfy itself.
iii. Bank shall need relevant information of exposure at the time of initiating the trade. This information should include, at a minimum, basic details of underlying (for e.g., current account, capital account, etc.).

iv. If such hedging is for capital account transactions, then information of such exposure e.g. anticipated nature of transaction, expected date and amount of agreement.
v. In the event that the bank is not satisfied about such underlying exposure within 15 days of the trade, the Bank retains the right to cancel all or part of the contract. The profits from such cancellations if any would not be passed on to the client while losses would have to be borne by the client.
vi. Contracts under anticipated exposure can be cancelled and rebooked. However for outright cancellations, or cancellation and rolled over as a new contract, the losses on such cancellations would be payable while profits would be withheld. These withheld profits would be passed on to the client on
    a. Satisfying the Bank that the contract has been delivered either through the Bank's counters or through another bank.
    b. The cancellation was for reasons beyond the control of the client. In such cases, the bank would need to satisfy itself with necessary documentary proof.
vii. In case of rollovers or if a trade is booked against previously hedged and cancelled trade, the client should submit the unique reference no of previously hedged/cancelled trade at the time of initiation of the rebooked trade. This will enable linking hedges on the same anticipated exposure, and the client can net losses on cancellations against prior profits on cancellations. The net profits on such trades however would be passed to the client only as per the point above. In absence of any such information of linkages at the time of booking of contract, contract booked would be treated as new exposure. The discretion of linking previous hedges either at the time of booking a new trade or at a future date, and the calculations of the net value of such trades, would be at the sole discretion of the Bank.

IV. Facility to book derivative contracts of outstanding upto USD 10 mio without the need to establish the existence of underlying exposure

1. Proof of underlying exposure need not be provided for trades upto USD 10 mio of outstanding exposure. It is likely to ease documentation burden for clients and the Bank for smaller value trades.
2. This facility is based on client declaration that the limit of USD 10 mio is being adhered to, across all banks. The extent of utilisation within USD 10 mio permitted under this facility shall be at the sole discretion of the Bank.
3. While the client need not provide proof of underlying exposure to the bank under this facility, the client should have an underlying exposure of notional equal to or higher, and of tenor equal to or longer, than the hedge. The exposure could be either contracted or anticipated exposure, and all other relevant guidelines of contracted or anticipated exposure will apply to these contracts also.
4. If booked under contracted exposure, the client can do so only if there is a valid contracted exposure to be hedged before the contract is entered into. The Bank retains the right to seek proof of such exposure at its sole discretion.
5. If booked under anticipated exposure, the bank needs to be satisfied about the likelihood of such an exposure. The bank could seek additional documents as necessary to satisfy itself.
6. In case the bank is not satisfied of the underlying exposure, it retains the right to classify a trade booked under contracted exposure as one against anticipated exposure, cancel the trade or take any other action as it deems reasonable. These could include, but are not limited to, not permitting further trades under anticipated exposure, requiring proof of exposure before booking further trades or withholding some of the profits which may fall due for the client.
7. If a trade is cancelled by the bank because it is not satisfied about the underlying exposure then the profits on such trades would be withheld and losses would have to be borne by the client.
8. When the outstanding notional of the client crosses 10 mio USD equivalent, the client should furnish the underlying documents required for Contracted Exposure contracts as per the norms laid down for Contracted exposure for all outstanding contracts under Contracted Exposure. It may be noted that the underlying should be available as on the date of booking of the respective outstanding Contracted exposure contract. Further, such contracts booked on Contracted Exposure will follow the rules of Contracted Exposure thereafter. In case of Anticipated Exposure contracts, the passing of any net gains upon cancellation will be guided by the norms laid down for Anticipated Exposure where the client will need to evidence cash flows on contract basis for all outstanding contracts.
9. Clients having exceeded the USD 10 mio outstanding notional limit once, will in future not be eligible to again avail of the said documentary relaxation during the same financial year.

V. Transition

1. The new regulations and the revised guidelines of the Bank come into effect from September 1, 2020, the effective date. Existing contracts booked under the provisions of the directions before the effective date may be continued till the date of their expiry.
2. Accordingly, the Bank shall seek associated documents/declarations from clients as was required under the earlier guidelines till the maturity or market action such as cancellation / rollover (whichever is earlier) of these hedge contracts
3. Rollover or rebooking of such contracts, and all new contracts from the effective date onwards shall be governed by the new regulations and these guidelines.
4. Facilities such as Past Performance, Simplified Hedging, Self declaration are withdrawn from the effective date and shall be replaced with only two types of underlying exposure – Contracted Exposure and Anticipated Exposure.

VI. General Terms and Conditions

1. The permissibility of products to clients is defined as per User Classification. However, the bank retains the right at its sole discretion to decide which of the permitted products would be offered to a client, including the currency pairs and interest rate benchmarks in which the derivative products could be offered. The product offering of the Bank shall be guided by the extant guidelines on derivatives, guidelines on suitability and appropriateness, internal policies and procedures of the Bank, and the Bank's assessment of the client.
2. Once a contract is entered into for an underlying exposure, any change in the existence of underlying exposure for which contract has been booked and outstanding will be brought to the notice of the Bank. Outstanding contacts if any for such exposures would be suitably modified, including cancelling part or all of the notional, to comply with regulations and this framework
3. In order to satisfy itself on the applicability of relevant regulations and internal guidelines, the bank could ask for additional information from the client including
    a. Documentary proofs of underlying exposures
    b. Basis of assessments of anticipated exposures
    c. Declarations or certifications from the client or from external parties
    d. Any other aspects related to the exposures and hedges of the client
4. Failure to adhere to such requests, or in cases where the bank is not reasonably satisfied about the underlying exposures, or in case there is a reason for the Bank to believe there has been misuse of the facilities provided or misrepresentations to the Bank, the Bank retains the right to
    a. Reclassify exposures where necessary
    b. Cancel contracts and withhold profits and recover losses from such cancellations
    c. Enter into further transactions only on being convinced of the exposure, if necessary by seeking documents prior to the deal, or
    d. Any other form of action to protect the interest of the bank and ensure conformity with extant regulations
5. Any information, declaration, undertaking or document provided to the Bank (to ensure compliance of the regulation) either in physical or electronic form while availing entering into contracts with the bank or when the bank seeks additional information would be in accordance with client's own constitution.
6. The Bank would have further internal processes which could detail the operational aspects of the new regulatory guidelines and this framework document. The implementation and stand of the bank on particular contracts would be guided by such processes as well. This framework should therefore be treated as a broad guidance note and not as the comprehensive listing of all the processes of the bank guiding transactions with its clients. Both this framework and the processes of the bank are subject to change based on evolving regulations and internal requirements of the bank.
7. By entering into any derivative deal with the bank post the effective date, the client is declaring that the terms of this framework are understood and accepted. All contracts of the bank would be guided by the extant terms and conditions of the bank which are updated on the website of the bank.