FOREIGN EXCHANGE MANAGEMENT

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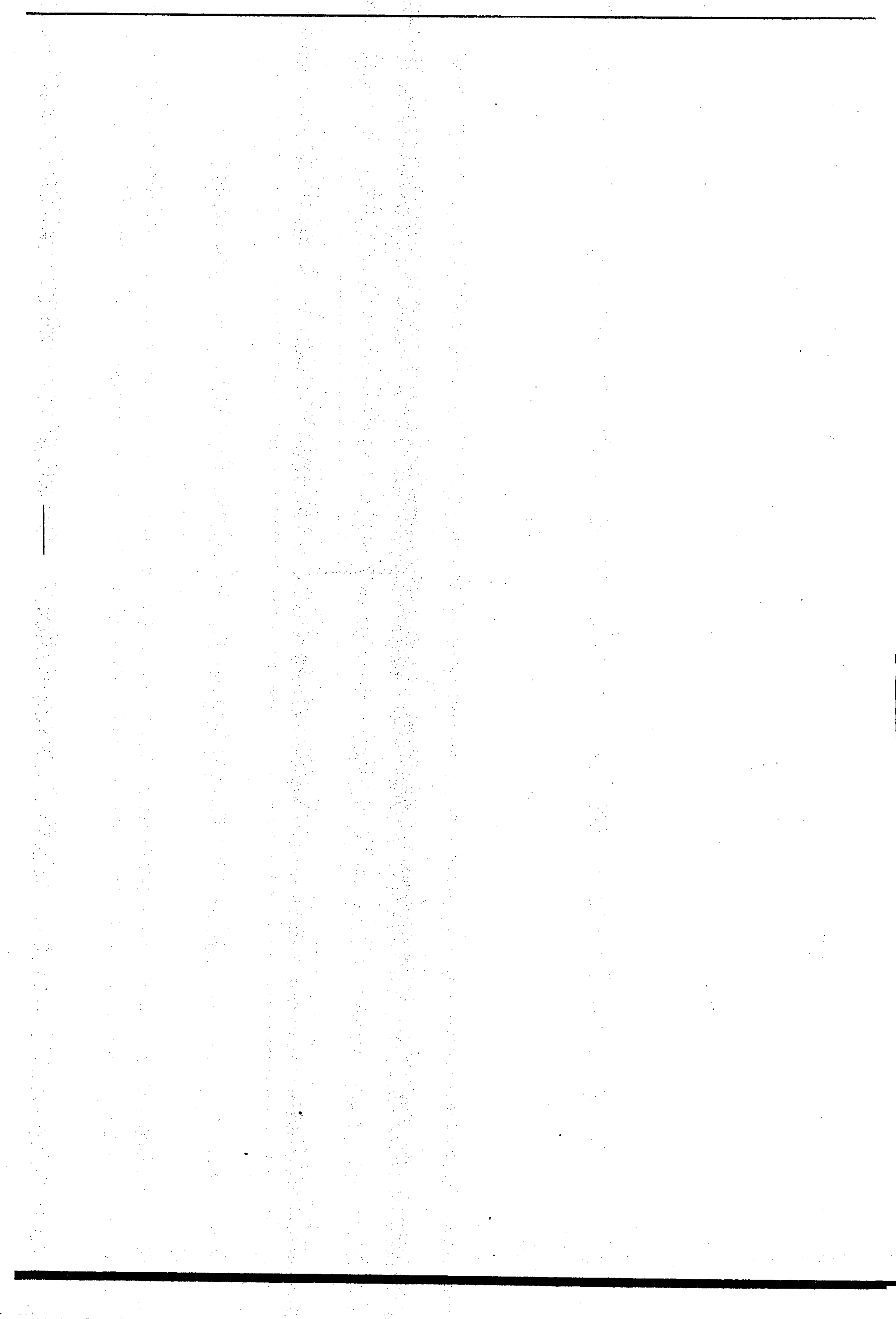

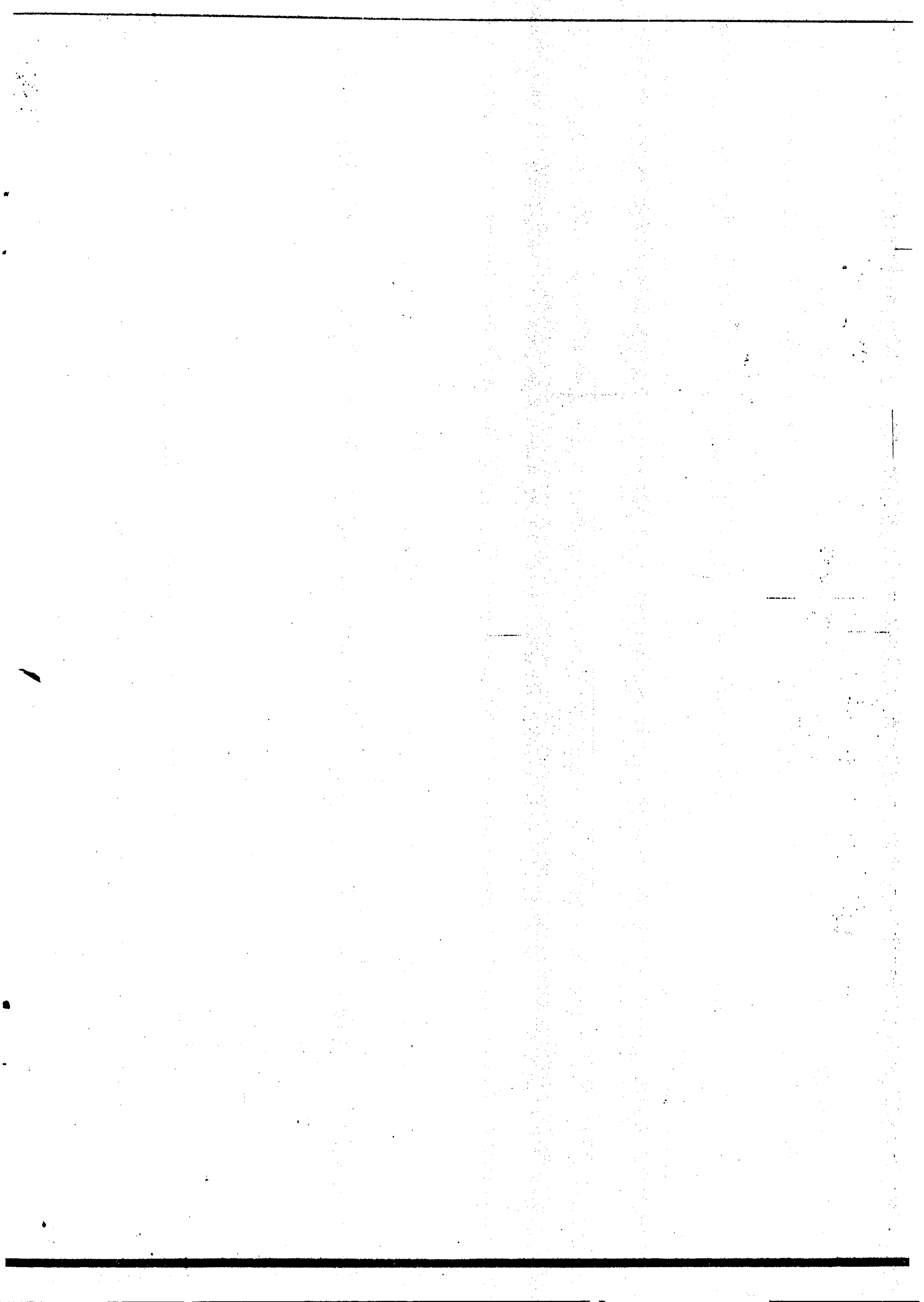

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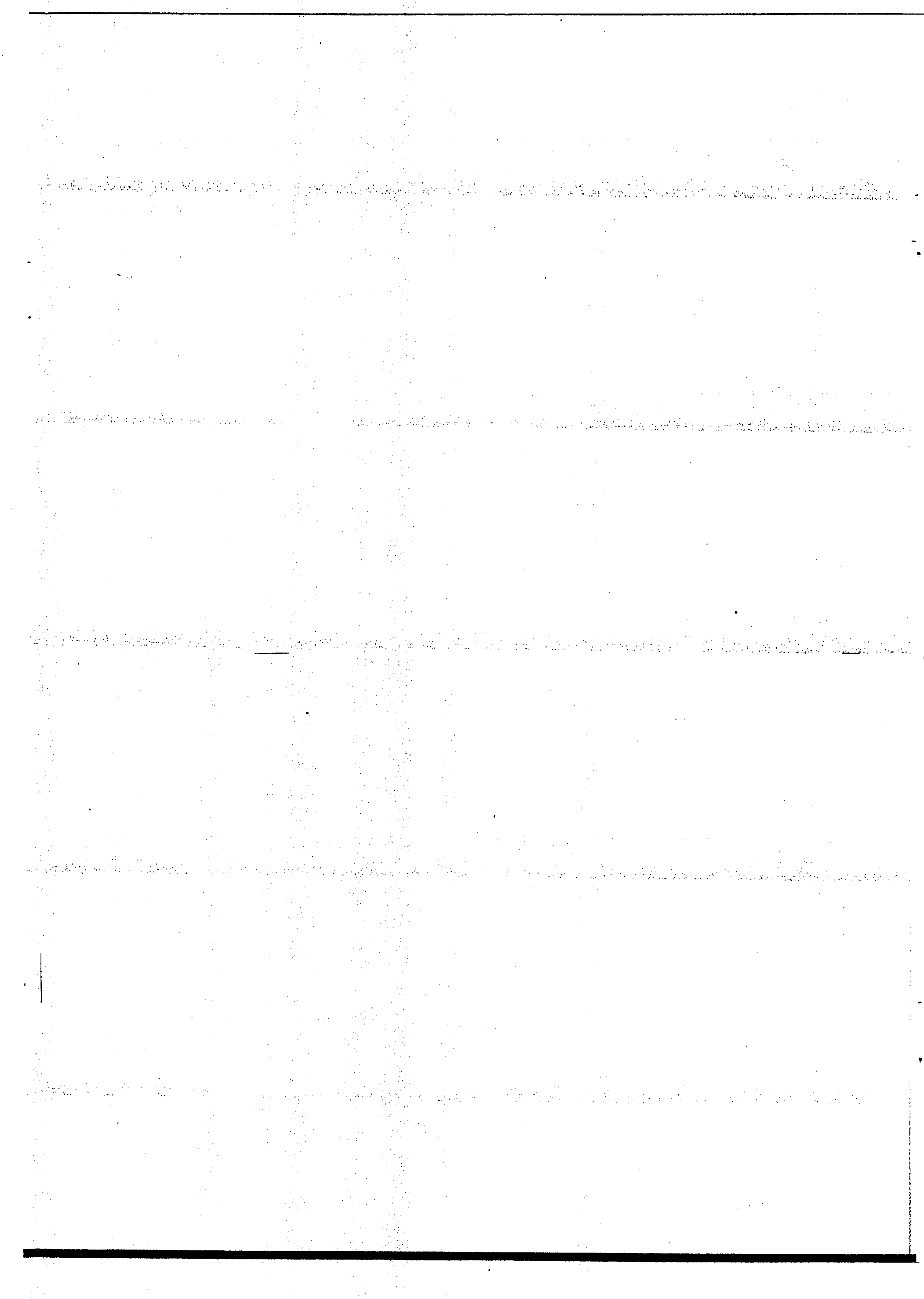

1 Foreign Exchange—Sources and Uses

THE importance of international trade in the economy of a country is too well known to need emphasis. A number of advantages flow from international trade. Many developed nations of the world owe their present status to international trade; many developing countries place their hopes of development on it. A common man, who is not keenly interested in these developments, is still reaping its fruits when he is using many items of common use. A large number of these items are either imported or some components of them are imported. Even if an item is indigenously produced, it may be found that it is made on an imported machine.

1.1 FOREIGN TRADE AND FOREIGN EXCHANGE

International trade refers to trade between the residents of two different countries. Each country functions as a sovereign State with its own set of regulations and currency. The difference in the nationality of the exporter and the importer presents certain peculiar problems in the conduct of international trade and settlement of the transactions arising therefrom. Important among such problems are:

(a) Different countries have different monetary units;
(b) Restrictions imposed by countries on import and export of goods;
(c) Restrictions imposed by nations on payments from and into their countries; and
(d) Differences in legal practices in different countries.

The existence of national monetary units poses a problem in the settlement of international transactions. The exporter would like to get the payment in the currency of his own country. For instance, if Amerexport of New York export machinery to Indimports, Mumbai, the former would like to get the payment in US dollars. Payment in Indian rupees will not serve their purpose because Indian rupee cannot be used as currency in the USA. On the other hand, the importers in India have their savings and borrowings in India in rupees. Thus the exporter requires payment in the currency of the exporter's country whereas the importer can pay only in the currency of the importer's country. A need, therefore, arises for conversion of the currency of the importer's country into that of the exporter's country. Foreign exchange is the mechanism by which the currency of one country gets converted into the currency of another country.

The conversion of currencies is done by banks who deal in foreign exchange. These banks maintain stocks of foreign currencies in the form of balances with banks abroad. For instance, Indian Bank may maintain an account with Bank of America, New York, in which dollar balances are held. In the earlier example, if Indimports pay the equivalent rupees to Indian Bank, it would arrange to pay Amerexport at New York in dollars from the dollar balances held by it with Bank of America.

❑ Exchange Rate

The rate at which one currency is converted into another currency is the rate of exchange between the currencies concerned. In our illustration, if Indian Bank exchanged US dollars for Indian rupees at Rs. 45 a dollar, the exchange rate between rupee and dollar can be expressed as

USD 1 = Rs. 45.

The rate of exchange for a currency is known from the quotation in the foreign exchange market. The banks operating at a financial centre, and dealing in foreign exchange, constitute the foreign exchange market. As in any commodity or stock market, the rates in the foreign exchange market are determined by the interaction of the forces of demand for and supply of the commodity dealt in, viz., foreign exchange. Since the demand and supply are affected by a number of factors, both fundamental and transitory, the rates keep on changing frequently, and violently too.

❑ Foreign Exchange as Stock

In another sense, the term foreign exchange is used to refer to the very balance held abroad. Used in this sense, the term foreign exchange refers to the stock of foreign currencies and other foreign assets. The Foreign Exchange Management Act, 1999, defines:

"Foreign exchange means foreign currency and includes—

(i) deposits, credits and balances payable in any foreign currency,
(ii) drafts, travellers cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency;
(iii) drafts, travellers cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency."

Thus, foreign exchange includes foreign currency, balances kept abroad, instruments payable in foreign currency, and instruments drawn abroad but payable in Indian currency.

1.2 BALANCE OF PAYMENTS

Balance of payments is a record of the value of all transactions between residents of a country with outsiders. It constitutes the result of demand for and supply of foreign exchange for various purposes. Since the rate of exchange between currencies is determined by the forces of demand and supply, balance of payments is the fundamental factor in determining the exchange rates. A change in the balance of payments of a country will affect the exchange rate of its currency.

❑ Definition

Balance of payments is the systematic summary of the economic transactions of the residents of a country with the rest of the world during a specified time period, normally a year. The following features of the balance of payments are implicit in the above definition:

1. Economic Transactions. The statement is a summary of economic transactions of the country with the outsiders. An economic transaction arises when values are exchanged or moved between nations. These may arise from:

(i) movement of goods in the form of exports and imports;
(ii) rendering of services abroad and using foreign services;
(iii) gifts/grants from one country to another;
(iv) investments made abroad or received from abroad;
(v) income on investments received from abroad or remitted abroad;
(vi) increase or decrease in the international reserves of the country.

2. Residents with Non-residents. Generally transactions which take place between the residents of the country with residents of other countries are recorded in the balance of payments. Residents may mean the individuals, institutions, corporate bodies, government departments etc., domiciled in the

country. Units or branches of multinational companies domiciled in the country are also residents and their transactions with their parent or branches abroad also are reflected in the balance of payments. If the economic transaction is between residents only, it is not included in the balance of payments. For instance sale of gold in the domestic market will not find a place in the balance of payments. There are, however, certain exceptions to the resident/non-resident basis of balance of payments. If the gold was sold to the central bank of the country and thus the monetary gold of the country increases, it will appear in the balance of payments. Similarly, foreign assets exchanged between residents may be included in the balance of payments.

3. A Flow Statement. A balance of payments is compilation of the flow of economic transactions of the country during the period and not a statement of the position as on a date. It is more like a funds flow of a company, rather than a balance sheet. For instance, if the balance of payments shows USD 300 million as plus in non-resident deposits, it means the balances held by the non-residents of the country with banks in India has changed during the period by USD 300 million; it does not mean the aggregate of such balances is USD 300 million.

4. Periodicity. Normally balance of payments statement is prepared covering a period of one year. However depending upon the requirement of the government the statement may be prepared for shorter periods also, such as six months, a quarter or even a month.

❑ Balance of Payments Accounting

If we look at the economic transactions listed earlier, we can discern that they involve either real resources (goods, services and income) or financial claims. For instance, when exports are made from India, goods move out of India (real asset). The export proceeds are realised and kept in the name of the bank in India which handled the export bill. In other words, the country has a claim on the foreign bank, which is a financial asset. When an import is made, there is an addition to the real assets of the country, but it involves outflow of money from India or reduction in financial asset held abroad (reduction in bank balance abroad).

Accounting, used for recording business transactions, recognises, that every transaction has two aspects. A sale, for instance, results in the inflow of cash and outflow of goods for the business concern. In accounting inflow of value is recorded as debit and outflow as credit. In the above example, cash account will be debited and goods account will be credited. This is known as double entry system in accounting.

In the compilation of the balance of payments also, the same double entry principle of accounting is used.

(i) Credit is indicated by the arithmetic sign (+) and represents outflow of real assets (exports) from the country or incurring liability abroad or decrease in the foreign assets.

(ii) Debit is indicated by the arithmetic sign (−) and represents inflow of real assets (imports) into the country or decrease in foreign liability or increase in foreign assets.

(The plus sign and minus sign indicate respectively the earning and spending of foreign exchange by the country.)

We try to understand the balance of payments accounting with the help of five illustrative transactions.

Transaction 1

Export of goods USD 200 million; realisation deposited in bank abroad.

As a result of the transaction, goods leave the country. Therefore export is a credit in the balance of payments. The bank deposit abroad is a debit.

	Credit (+) USD	Debit (–) USD
Export of Goods	200 million	
Bank balances abroad		200 million

Transaction 2

Import of goods USD 150 million; payment made from bank account maintained abroad.

Import of goods increases the real resources of the country and is a debit entry. In payment of imports the bank balance held abroad is used. The country's foreign asset is reduced. So, it is a credit.

	Credit (+) USD	Debit (–) USD
Import of Goods		150 million
Bank balances abroad	150 million	

Transaction 3

Amount spent by foreign tourists in the country USD 40 million.

When foreigners come on tour or other trips and enjoy the hospitality in the country, it amounts to exporting of services and is credited. The amount received from them in foreign exchange in the form of travellers cheques etc. will ultimately be realised and deposited in banks abroad. This will increase the bank balances abroad and will be debited.

	Credit (+) USD	Debit (–) USD
Export of Services	40 million	
Bank balances abroad		40 million

Transaction 4

Received goods as gift from another country USD 60 million.

A good received into the country increases its resources and is debited. This transaction does not have any effect on the foreign assets or liabilities of the country since gift is a *unilateral transfer* without any obligation of *quid pro quo*. Nevertheless, the gift received is treated as *donation* and credited.

	Credit (+) USD	Debit (–) USD
Import of Goods		60 million
Unilateral transfers	60 million	

Transaction 5

Exports of commodities for USD 80 million on a government deal; payment in gold by the importing country's government.

Export of commodities is a credit item. Payment received in gold will go to replenish the official reserves of the country, which is similar to increase in foreign assets of the country. Hence it is debited.

	Credit (+) USD	Debit (-) USD
Export of Goods	80 million	
Official reserves		80 million

When all the above transactions are reported as a statement of balance of payments, it may appear as follows:

Balance of Payments *(USD million)*

	Credit (+)	Debit (-)	Balance
A. CURRENT ACCOUNT			
1. Merchandise Trade	280	210	+ 70
2. Trade in Services	40		+ 40
3. Unilateral Transfers	60		+ 60
Current Account Balance			+ 170
B. CAPITAL ACCOUNT			
Bank balances abroad	150	240	- 90
C. OFFICIAL RESERVES ACCOUNT		80	- 80

It may be seen that the total plus balances agree with the total of minus balances. This is in keeping with the accounting principle that the total of debits equals total of credits.

Components of Balance of Payments

From the example in the previous section, it would have been observed that the balance of payments statement is presented with three major components:

(i) Current account;
(ii) Capital account; and
(iii) Official reserves account.

Earlier balance of payments used to be divided into two accounts — current account and capital account. The present trend is to divide the capital account further into two accounts and show separately the details of official reserves account.

To draw an analogy with the final accounts of a business entity, the current account is similar to the profit and loss account which shows the income and expenses of the entity during a year. The capital account (including the official reserves account) is the balance sheet, or to be more precise, the funds flow statement, the first part showing the changes in the assets and liabilities of the entity and the second part revealing changes in its equity.

As an illustration of the full statement, the balance of payments of India for the year 200X–200Y is reproduced in Table 1.

Current Account

The current account of the balance of payments refers to transactions in goods and services, income and current transfers. In other words, it covers all transactions between residents and non-residents, other than financial items.

Table 1.1. India's Overall Balance of Payments—200X-200Y

(*USD million*)

Items	*Credit*	*Debit*	*Net*
A. CURRENT ACCOUNT			
I. MERCHANDISE	33764	48063	-14299
II. INVISIBLES (a + b + c)	21250	10612	10638
a) Services	8615	6208	2407
i) Travel	2878	858	2020
ii) Transportation	1939	2394	-455
iii) Insurance	216	153	63
iv) Government not indicated elsewhere	72	178	-106
v) Miscellaneous	3510	2625	885
b) Transfers	11562	81	11481
i) Official	423	13	410
ii) Private	11139	68	11051
c) Investment Income	1073	4323	-3250
Total Current Account (I + II)	**55014**	**58675**	**-3661**
B. CAPITAL ACCOUNT			
1. Foreign Investment (a + b)	**7695**	**1861**	**5834**
a) In India	7685	1663	6024
i) Direct	2736	22	2714
ii) Portfolio	4951	1641	3310
b) Abroad	8	198	-190
2. Loans (a + b + c)	**15881**	**12925**	**2956**
a) External Assistance	3056	1955	1101
i) By India	-	8	-8
ii) To India	3056	1947	1109
b) Commercial Borrowings (MT & LT)	5740	4723	1017
i) By India	8	-	8
ii) To India	5732	4723	1009
c) Short-term			
To India	5085	6245	838
3. Banking Capital (a + b)	**7718**	**5303**	**2415**
a) Commercial Banks	7332	4921	2411
i) Assets	755	1625	-870
ii) Liabilities	102	357	-255
iii) Non-Resident Deposits	6475	2939	3536
b) Others	386	382	4
4. Rupee Debt Service	-	**727**	**-727**
5. Other Capital	**2949**	**2379**	**570**
Total Capital Account (1 to 5)	**34243**	**23195**	**11048**
C. Errors & Omissions	-	**594**	**-594**
D. Overall Balance (A + B + C)	**89257**	**82464**	**6793**
E. Monetary Movements (i + ii)	-	**6793**	**-6793**
i) IMF	-	975	-975
ii) Foreign Exchange Reserves	-	5818	-5818

Merchandise Trade. Item (I) in the statement, *merchandise*, represents exports and import of commodities from/into India. The credit in the item represents exports and debit represents imports. The net balance, being the difference between exports and imports is known as the *balance of trade.*

The values of exports are shown at FOB prices, *i.e.*, excluding the cost of transportation from abroad. Imports represent CIF payment, *i.e.*, including freight and insurance paid for imports. However, where freight and insurance on imports are paid separately to foreigners, these are included under 'transportation' and 'insurance'.

Invisibles. Item (II) of the statement includes services, transfers and investment income. It is titled invisibles to distinguish from merchandise trade, also known as visible trade.

Travel covers expenditure incurred by non-resident travellers during their stay in the country. It excludes international passenger services, which are included in 'transportation'. Debit entries represent exchange sold for private and official travel.

Transportation covers all receipts and payments on account of international transportation services except for the freight on imports invoiced CIF/CFR included under import payments. The credits include expenses of foreign transport companies in India, receipt of foreign earnings of Indian transport companies and other receipts. The debits include expenses of Indian companies abroad, payments to foreign transport companies, etc.

Insurance covers all receipts and payments relating to all types of insurance as well as reinsurance.

Government, not included elsewhere, relates to receipts and payments on government account not included elsewhere as well as receipts and payments on account of maintenance of embassies and diplomatic missions and offices of international institutions such as UNO, WHO, etc. Credits include allocations made for the US embassy expenditure in India out of the rupee proceeds of sales in India of US surplus agricultural commodities under PL 480 agreements.

Miscellaneous items cover receipts and payments in respect of all other services such as agency services, technicians, and professional services, technical know-how, royalties, subscriptions for periodicals, etc.

Transfer payments or unilateral transfers represent all receipts and payments without a quid pro quo. They include items like aid and grants received from/extended to foreign governments, migrants' transfer, repatriation of savings, remittances for family maintenance, contributions and donations to religious organisations and charitable institutions etc.

Investment income relates to remittances, receipts and payments on account of profits, dividends, interest and discounts including interest charges and commitment charges on foreign loans including those on purchase from the International Monetary Fund.

Balance on Current Account. What is important for decision making is not the absolute figures of exports/receipts and imports/payments, but their difference which shows whether the country has earned or lost foreign exchange. Two important measures in this regard are (*i*) balance of trade and (*ii*) balance of payments.

Balance of trade refers to the net difference between the value of export and import of merchandise or the visible trade. When the aggregate exports of goods from the country during the period exceed its aggregate import, the balance of trade is said to be 'favourable', or 'surplus' or 'positive'. If the imports exceed exports, the balance of trade is 'unfavourable' or 'deficit' or 'negative'. Since imports and exports of a country seldom equal, the balance of trade will not ordinarily balance. During any given period, the balance of trade will show either a favourable or an unfavourable balance.

Balance of payments includes the foreign trade in its broad sense and includes not only visible trade but invisible items also. Thus this term is more comprehensive than balance of trade. In other words, balance of payments represents balance of trade plus balance on invisibles. It would be more appropriate to call this balance of payments on current account as it includes the net balance of all items included in the current account. As in the case of balance of trade, the total amounts receivable and payable on current account do not balance and the balance of payments for a given period ends up in a favourable (surplus) or unfavourable (deficit) balance.

Capital Account

The capital account represents transfer of money and other capital items and changes in the country's foreign assets and liabilities resulting from the transactions recorded in the current account.

Foreign investment in India is the amount invested by non-residents in the equity of entities in India. The difference between direct and portfolio investment is one of intention of the investor. *Direct investment* reflects a lasting interest of the investor in the entity and his intention to take active role in the management of the company. Investment in equity by the direct investor and the amounts accruing on the original investment but retained in the country fall under the category of direct investment. *Portfolio investment* covers transactions in equity securities other than direct investment. The investor does not intend to take part in the management of the company. Foreign investment abroad is the amount invested by residents in entities abroad.

Loans comprise external assistance, commercial borrowings and short term loans. External assistance is borrowings from multilateral organisations like World Bank and from bilateral sources, mainly on concessional terms.

Commercial borrowings are debts owed to international banks, borrowings in bond markets, credits from export credit agencies and loans provided on commercial terms by specialised multilateral or bilateral institutions like International Finance Corporation.

Short term credit are those repayable within one year.

Banking capital covers the assets and liabilities of commercial banks, non-resident deposit accounts and other financial institutions.

Rupee debt service is the payments under rupee/rouble agreement with Russia.

Other capital includes any capital transaction not included in the above.

Balance on Capital Account. Balance on capital account is the net of inflows and outflows on capital transactions. It is also appropriate to call this balance on private capital account as this excludes movement in official reserves.

Overall Balance

Overall balance is the total of balance on current account and balance on capital account. It is also called official settlements balance since it must be financed by official reserves or by other non-reserve transactions that are substitute for reserve transactions. This is a very important measure because it reflects a country's overall competitive position in terms of all private transactions and exerts pressure on the exchange rate of the currency of the country.

Basic Balance. This is the total of balance on current account and balance on the long-term items in the capital account. In other words, it is overall balance of payments, less short-term capital movements. This balance is sometimes worked out to evaluate the long-term trends in the balance of payments devoid of the effect of volatile short-term capital flows. Basic balance is considered a true indicator of the 'autonomous' movement in balance of payments, i.e., those transactions that take place due to market forces, without being managed or manipulated by government. Transactions in the current account and the long-term capital movements are presumed to be autonomous.

Errors and Omissions

It was mentioned earlier that debits and credits recorded under the balance of payments should agree. In case of business accounting, if these figures do not agree, it is indicative of an inaccuracy that should be found out and rectified. This is possible in the case of business accounting because debit and credit for a transaction emanate from the same source.

In the case of balance of payments account, the sources of debit and credit may vary. For instance, information on payments for imports not passing through the banking channels is obtained from other sources, primarily government records. The time of recording for each leg of the transaction may also vary. Because of these, generally difference would arise and such difference is shown separately as errors and omissions. Transactions that escape the official machinery are also recorded under this head.

Monetary Movements

Monetary movements measure the effect of the transactions on current and capital accounts on the official reserves of the country. This is similar to the equity account in the balance sheet of a business enterprise. The change in the monetary movement will be equal to the overall balance, as adjusted for errors and omissions, but on the opposite side.

1.3 BALANCE OF PAYMENTS OF INDIA

The following table gives the balance of payments position of India during the current decade :

Table 1.2. Balance of Payments of India **(USD million)**

Year	*Exports*	*Imports*	*Balance of Trade*	*Invisibles*	*Balance of Payments*
1995-96	32311	43670	-11359	5449	-5910
1996-97	34133	48948	-14815	10916	-4619
1997-98	35680	51187	-15507	10007	-5500
1998-99	34298	47544	-13246	9208	-4038
1999-00	37542	55383	-17841	13143	-4698
2000-01	44894	59264	-14370	11791	-2579
2001-02	44618	57618	-12703	14054	1351

Source: *CMIE.*

☐ Balance of Trade

One striking feature that emerges from the data given in the table is the continuous deficit in balance of trade. This has been the trend even in 1950's and 60's and for the most part of 70's. In the initial years of planning, the situation could be justified as they involved establishing of many heavy industries aimed at achieving self-sufficiency through import substitution. This meant large-scale import of intermediary and capital goods. But now the country has reached certain level of development and the massive liberalisation programmes mean that effort should be to meet the imports only by exports.

Another aspect is the share of India in the world trade. From about 2% in early 50's India's share in world trade had declined to 1.1% in 1960 and further to a dismal figure of around 0.5% since 80's. This has improved slightly to about 0.7% in 1995-96. The subsequent years saw dismal performance in exports front and the share in world trade further declined. The situation in the current year is somewhat promising.

The conditionalities attached to SDR 5 billion loan availed by India from IMF in early 1980's have compelled the authorities to liberalise imports to a large extent. A large chunk of these imports were of capital goods and equipment and were expected to bear fruit in the form of increased exports in the long run. But the immediate effect of the policy was felt in the large imports.

The rate of growth of exports could not keep pace with the growth rate of imports. The sluggish growth in exports was due to protectionist policies adopted and recessionary conditions prevailing in the importing countries. On the domestic

front, transport and power bottlenecks have affected the supply of exportable goods. The unremunerative prices that prevailed in international markets for our traditional commodities like tea, hides and skin and gunnies have also been contributing to this state of affairs.

Till the launching of economic reforms, the policy of the government had been one of import restriction and export promotion. Efforts were also made to reduce imports and encourage import substitution. One commendable achievement is seen in the field of oil. Efforts at exploration of oil in the country, both on-shore and off-shore, have borne fruit. Between 1980 and 1987, domestic production of crude oil rose from about 11 million tonnes to 30 million tonnes. The saving in crude oil import was of the order of nearly USD 2.7 billion annually. Frantic efforts are also being made to develop alternative sources of energy, especially, renewable sources like solar energy and biogas.

Post Liberalisation Scenario

The year 1990-91 was the most difficult one for India on the external trade front. The global slowdown in world trade following the recessionary conditions in industrialised countries and the economic disruption in Eastern Europe including the USSR affected India's exports. The Gulf crisis emerging in August 1990 caused sharp increase in the oil import bill due to steep increase in prices and also volume growth in the wake of relative stagnation in domestic output of crude petroleum. All these factors led to widening of the trade deficit. A number of measures were taken by the Government and Reserve Bank to curb imports and expedite repatriation of export proceeds. These measures include :

(*i*) Raising the margin requirements for import letters of credit ;
(*ii*) Restrictions on foreign exchange allocations for imports ;
(*iii*) Hiking the interest rate for imports ;
(*iv*) Restriction of import of capital goods only under foreign currency line of credit available with financial institutions ; and
(*v*) Differential interest for export advances charging higher rates for longer periods.

As a result of the above measures taken, the trade deficit during the first six months of 1991-92 showed a substantial decline to Rs. 2,356 crores from Rs. 4,234 crores during the same period the previous year. The success was achieved mainly through compression of imports but at the same time it hampered the growth of exports too.

Devaluation

To revive the exports growth the Reserve Bank devalued rupee in July 1991 against major international currencies by about 20%.

Devaluation of a currency is expected to boost exports and curb imports. By devaluation the exports from the country would become cheaper in terms of foreign currencies. This is expected to increase the demand for the country's products in the international markets and hence increase exports. At the same time imports into the country would become costly in terms of domestic currency. This would act as a disincentive to imports leading to a reduction in imports.

The expected results from devaluation will realise only when the exports and imports of the country are price elastic. It is possible that exports from country may not increase in quantity terms because the demand for the products from the country depends also upon many other factors like quality, etc. Therefore, if there is no quantity increase in exports the result would be lesser realisation in foreign exchange. On the import front, if the items imported are essential goods, there may not be any reduction in the quantity imported and the amount paid may increase instead of declining.

An analysis of the foreign trade statistics of India reveals that the expected benefits did not accrue in the immediate post-devaluation period. In dollar terms exports during April-November 1991 were lower by five per cent at USD 10,951 million as against USD 11,531 millions during the corresponding period, the previous year. Imports too were lower showing a decline by 20.7% to USD 12,381 millions from USD 15,610 millions, but this was the combined effect of devaluation and curbs on imports. The deficit came down to USD 1,430 millions from USD 4,079 millions mainly due to a lower level of imports.

The effect of devaluation was seen inflated figures of foreign trade in rupee terms. In rupee terms exports increased by 28.1% from Rs. 20,303 crores to Rs. 26,012 crores. The trade deficit too showed a drop to Rs. 3,398 crores from Rs. 7,181 crores. It may be noted that a surplus in foreign exchange terms is more important as it is the true indicator of accretion to foreign exchange assets of the country.

Along with devaluation, the other methods introduced were : (*i*) introduction of Exim scrips to replace replenishment licences. These licences are intended ultimately to replace the import licences entirely barring few exceptions; (*ii*) abolition of cash compensatory support. Their impact on foreign trade balance has been only marginal.

The structural reform of the trade policy is continuing and the government has brought out a new Export Import policy on 1st April 1992 valid for five years ending March 1997. Along with this the rupee was made fully convertible on current account. The exporters now realise their export proceeds fully at the market value. The measures taken by the government were expected to yield results in the form of smaller deficit in balance of trade. But as could be seen from the data given in the beginning, the trade deficit continues to cause concern. With stagnating exports the balance of trade increased from USD 11,359 million in 1995-96 to USD 15,507 million by 1997-98. The general recession world over and the Asian currency crisis were the immediate excuses available to justify the poor performance on export front. The situation improved somewhat to a deficit of USD 13,246 in 1998-99. The improvement was not due to increase in exports, which in fact registered a negative growth. The fall in the world price of oil was the relieving factor. Though the trade deficit is on the declining trend since 1999-2000, the magnitude is still large.

Current Scenario

The performance during the first 8 months of the current year (2002-03) has been promising. Between April and October 2002, exports registered a growth of 13.8% as compared to decline of 1.1% during the same period last year. The contribution to the higher growth in exports has come mainly from exports of ores and minerals, engineering goods, gems and jewellery, readymade garments, handicrafts, chemicals, rubber manufacturing products, glass and non-basmati rice.

On the import front, the growth rate was 3.3% as against a decline of 1.4% during the same period the previous year. The first four of the fiscal had a negative growth rate in imports. A healthy growth in imports was seen during August-September. The petroleum bill showed an increase of 18.5% due to rise in international prices. Increase was also seen in the import of capital goods, especially transport equipment.

The trade deficit was USD 5 billion marginally down from USD 5.2 billion during the previous year. Sustained effort is needed to maintain the progress and achieve the avowed goal of achieving trade surplus.

❑ Balance of Payments

In the past despite continuous balance of trade deficits, India could manage its balance of payments due to net receipt from invisible trade. But the balance of payments position remained under pressure throughout the Seventh Five-Year Plan mainly due to large-trade deficits and fall in the surpluses on invisible account. Between 1995-96 and 1997-98 invisibles showed an increase the positive balance from USD 5,449 million to USD 10,007 million.

The balance of payments of India continued to face strain in 1990-91. In fact the position challenged the clean record of India in repayment of external borrowings. Doubts about possible default in repayments were triggered by down grading of credit rating by international agencies. The foreign exchange reserves declined sharply from Rs. 5,480 crores at the end of August 1990 to Rs. 2,152 crores in December 1990. The Gulf crisis beginning in August 1990 with consequent increase in import bill of oil and reduction in inward remittances was a major factor contributing to the situation.

In January 1991, India obtained two loans from IMF amounting to SDR 1,269 million. As a result of the borrowing, reserves increased to Rs. 4,719 crores by the end of January 1991. Simultaneously the Reserve Bank also imposed severe curbs on imports through a steep hike in cash margins for import. However, between April and June 1991, the reserve declined again with complete stoppage of commercial funds from abroad. Besides, there was also a large outflow of funds from the NRI deposits. In July 1991 a second drawal of SDR 166.18 million was made from IMF. In the same month Reserve Bank borrowed USD 400 million by pledging 46.9 tonnes of gold. As a result of these efforts, the reserves increased to Rs. 3,313 crores by the end of July 1991.

Between September 1991 and January 1992, India received large inflow of capital in the form of IMF loans, India Development Bonds floated for NRIs and Amnesty Scheme for NRIs. Total inflow of foreign capital during this period amounted to Rs. 5,900 crores, India Development Bonds and Amnesty schemes accounting for Rs. 4,000 crores. Resurgent India Bonds issued in 1998 could get Rs 4,000 crores. By January 2000, the foreign exchange reserves showed a comfortable figure of USD 34 billion.

The year ending March 2002 saw after a lapse of long years a positive balance of payments position, though on a modest scale. Since there has been a surge in foreign exchange reserves contributed by lower trade deficit, foreign direct investment and other inward remittances. The foreign exchange reserves of the country stood at all time high of USD 68.4 billion by December 2002. In fact the size of the reserves has given rise to the question whether the country could afford such a huge balance in foreign exchange. The inward remittances, not matched by an increase in domestic production, are expected to have an inflationary effect on the domestic economy through increased money supply. The Reserve Bank has been sterilising the inflows through open market operations. It is issuing government securities to absorb the liquidity and at the same time reduce the interest cost on government borrowings.

2 International Exchange Systems

IN Chapter 1 we saw that the exchange rate between currencies in a foreign exchange market is affected by a number of factors. The extent to which these fluctuations are allowed is vastly dependent on the monetary systems adopted by the countries concerned.

When countries were under gold standard the value of currency of a country was fixed as the value of gold of definite weight and fineness. The exchange rate between the currencies was determined on the relative value of gold content of currencies concerned. For example, if the gold content of Indian rupee was 5 grains of standard purity, and that of US dollar 60 grains of standard purity, the rate of exchange between Indian rupee and US dollar could be determined as under :

1 Rupee = 5/60 = USD 0.0833

or, 1 USD = 60/5 = Rs. 12.

This rate of exchange was known as the *mint par of exchange* because, at the Indian mint one rupee would get 5 grains of gold and in the USA USD 0.0833 would get the same quantity of 5 grains of gold. Exchange rates were stable under gold standard because any deviation in the exchange rate would be set right automatically by the movement of gold between the countries that such deviation caused.

When the paper currency system replaced the gold standard, the exchange rate was determined by relative purchasing power of the currencies. The stability in exchange rates gave way to fluctuations with dynamic situation prevailing all round.

2.1 FIXED AND FLOATING EXCHANGE RATES

❑ Fixed Exchange Rates

Fixed exchange rates refer to the system under the gold standard where the rate of exchange tends to stabilise around the mint par value. Any large variation of the rate of exchange from the mint par value would entail flow of gold into or from the country. This would have the effect of bringing the exchange rate back to the mint par value.

In present-day situation where gold standard no longer exists, fixed rates of exchange refer to maintenance of external value of the currency at a predetermined level. Whenever the exchange rate differs from this level it is corrected through official intervention. For example, when IMF was instituted, every member-country was required to declare the value of the currency in terms of gold and US dollars (known as the par value). The actual market rates were allowed to fluctuate only within a narrow band of margin from this level.

The par value system was abolished with the second amendment to the Articles of IMF in 1978. Still the system of fixed rates continues in many countries in the form of pegging their currencies to a major currency. For instance, countries like Chile, Egypt, Iraq and Pakistan have pegged the value of their currencies to US dollar. That is, the values of these national currencies are fixed in terms of US dollar and are allowed to vary in the exchange markets only within a narrow band.

If the exports of the country exceed imports, the demand for the local currency in the exchange market will rise. This will raise the value of the currency in the market. Where the increase in value is beyond the support point, the central

bank of the country intervenes in the market to sell local currency and thus the foreign exchange reserves of the country increase. The sale of local currency in the market leads to increase in money supply in the country causing inflation. Revaluation may be resorted to allow for more imports and contain inflation.

If the country is facing balance of payments deficits due to higher imports, it would have the effect of increase in supply of local currency in the foreign exchange markets. The price of local currency may go below the support point and the central bank may have to intervene by buying local currency at a higher price. In the process, the foreign reserves of the country are depleted because the foreign currencies are exchanged in the market for buying local currency. To make up for the deficit, the country may be compelled to devalue the currency. The large-scale buying of local currency will reduce the domestic money supply and may help fight inflation.

Under fixed rates, the compulsion to devalue the currency may be postponed or avoided by mopping up additional reserves. One such way is exchange of currency reserves between the central banks of countries. For instance, if India is in deficit, Reserve Bank may sell rupees to Bank of England against purchase of pound-sterling. The sale will be reversed after a number of years when India has corrected its balance of payments.

❑ Floating/Flexible Exchange Rates

Free or floating rates refer to the system where the exchange rates are determined by the conditions of demand for and supply of foreign exchange in the market. The rates are free to fluctuate according to the changes in demand and supply forces with no restrictions on buying and selling of foreign currencies in the exchange market.

Flexible rates of exchange refer to the system where the exchange rate is fixed, but is subject to frequent adjustments depending upon the market conditions. Thus, it is not a free or floating rate with cent per cent flexibility, but is any system providing for adjustments as and when required.

However, in practice, often the above difference is ignored and both the terms are used interchangeably. The term 'managed float' or 'dirty float' is used to refer to the system where the central bank intervenes only where the market forces cause violent fluctuations, to bring some order in the market.

Under floating rates no par value is declared and the central bank does not intervene in the market. Any disparity in the balance of payments is adjusted through the changes in exchange rate that take place automatically in the market. Because the central bank does not intervene in the market there is no change in the exchange reserves of the country.

A lively debate on the advisability of adopting fixed or floating rates of exchange has always been engaging the attention of economists. Forceful agreements have been put forward in favour of both systems.

❑ Case for Fixed Rates

(1) ***Promotion of International Trade*** Stable exchange rates encourage international trade by providing certainty and confidence. Exporters and importers know in advance how much they will receive or they will have to pay in terms of home currency.

Advocates of floating rates point out that the post-war experiences do not support the view that stable exchange rates are required for smooth flow of international trade. Even under flexible rates of exchange international trade will flourish. So long as the balance of payments is at equilibrium, no change in the rate of exchange is expected. When the balance of payments is in disequilibrium, the rate of exchange will change but the change expected can be assessed. Further, the importers and exporters can guard themselves against the changes by entering into forward

contracts. The facility of forward contracts imparts the necessary certainty as far as the traders are concerned.

(2) ***Promotion of International Investment*** Stable exchange rates promote international investments which are essential for economic development and progress of the underdeveloped countries. Lenders on long-term would be prompted to invest in other countries only when the return in terms of home currency is ensured by stable exchange rates.

The claim that stable exchange rates promote international investment is not borne out by facts. Even under fixed exchange rates it cannot be ensured that the rates will not change over a long period running into decades. The impending fear of the possibility of devaluation of the currency may act as a deterrent factor in international investments. On the other hand, flexible exchange rates adjust the external value of the currency and prevent recurrence of balance of payments crises more effectively. As a result, their effect on the international lending is likely to be beneficial.

(3) ***Facility of Long-range Planning*** Firms and the government can draw out long-range plans and work towards economic stability and prosperity easily under conditions of stable exchange rates. The stable exchange rates provide the necessary framework for drafting out such plans. Under flexible exchange rates, the frequent changes in exchange rates would render determination of the outlay of the plans difficult because with every change in exchange rates the outlay would vary.

Proponents of flexible rates argue that under flexible exchange rates, the adjustment of balance of payments is done painlessly through changes in the rate of exchange without affecting the domestic prices and income. This helps planning by firms. Further, flexible rates allow freedom to the country in its monetary arrangements. Under fixed rates the monetary policy adopted should be such as to facilitate maintenance of the fixed rates.

(4) ***Development of Currency Areas*** Proper functioning of regional arrangements like sterling area or dollar area would be facilitated with the stable exchange rates. In such arrangements, if flexible rates prevail, especially for the major currency like pound-sterling or dollar with which the other currencies are linked, it will have serious repercussions on many other currencies.

The argument that stable rates of exchange are required for development of regional arrangements does not stand the test of proof. The case of sterling area is a good illustration in this regard. The sterling area was promoted in 1930s at which time the pound-sterling was free to fluctuate under market conditions. Therefore, it is clear that the strength of the sterling area lies in certain economic, political and social factors which have bound them rather than the exchange rates. Allowing the pound-sterling to fluctuate freely would not weaken the area if the decision is taken after consultation with member-countries.

(5) ***Prevention of Speculation*** Stable exchange rates avoid the dangerous possibilities of speculation and thus help in orderly growth of international markets.

The claim that stable exchange rates prevent speculation is not correct. By keeping the value of the currency at an artificial level, it encourages speculation of devaluation of the currency. The suspicion of devaluation will ultimately make devaluation inevitable and result in the destruction of the stability of the currency.

(6) ***Small Open Economies*** It is argued that flexible rates will not work for small open economies, *i.e.*, a country which trades extensively with others. Such economies may be depending upon imports to a large extent for many of its consumption goods. An adverse balance of payments, under flexible rates, will lead to depreciation of the currency of the country. This is supposed to stimulate exports due to reduction in the price of domestic products and thus adjust the deficit in

the balance of payments. But, the depreciation of the currency will raise the price of imports. If the import is inelastic, it will raise the cost of living leading to rise in wages. The prices of domestic products increase offsetting of the benefit of depreciation. Thus the increase in exports may not realise. It would be better for such economies to fix the value of their currencies to the currency of the country which supplies most of their imports.

(7) ***Inflation*** Under the fixed rate system, where rates are strictly on gold or dollar standard, there was need for the central bank to keep a close watch on the money supply and keep the inflation under control. Poor performance on this front was immediately reflected in the dwindling of foreign exchange reserves. This provided a good reason for taking strong remedial measures by the central bank. Under flexible exchange rates, the foreign exchange reserves are not affected and therefore no evidence of the deterioration in the situation is available. This may allow inflation to creep in. However, it should be noted that under flexible rates, the change in exchange rate itself provides the needed evidence. Therefore, it may not be true to say that flexible rates are more inflationary than fixed rates.

(8) ***Terms of Trade*** Many countries maintain their currencies pegged through trade and exchange controls at a level higher than that would prevail in a free market. The introduction of flexible rate system would substantially deteriorate their terms of trade. The loss from deterioration of terms of trade would far exceed gain, if any, that accrues from introduction of flexible exchange rates.

(9) ***Competitive Exchange Depreciation*** Under the flexible exchange rate system there is a possibility of countries engaging in competitive depreciation of their currencies in order to capture world markets. Such unhealthy practices are eliminated in the case of stable exchange rates.

❑ Case for Flexible Rates

A strong case for flexible exchange rates is made by refuting many of the arguments made in favour of fixed exchange rates as discussed above. In addition, flexible exchange rates offer other advantages also.

(1) ***Adjustment of Balance of Payments*** A deficit in balance of payments can be corrected under fixed exchange rates by such measures as reduction in prices or income of the people of the country. A reduction in prices will help boost exports but will affect payments made to the factors of production, including wages for labourers. These measures will receive resistance from workers. Similarly measures to bring down the disposable income with the people so as to restrict the imports will earn the displeasure of the people. Under flexible exchange rates there is no need for taking these hard measures to correct a balance of payments disequilibrium. Flexible exchange rates provide a smoother adjustment mechanism through changes in exchange rates. Changes in exchange rates affect only the external value of the currency but does not affect its domestic value.

However, it should be noted that flexible exchange rates carry out the adjustment by ultimately reducing the real income. A depreciation in the value of the currency makes imports costlier which raises the cost of living and thereby reduces the purchasing power of given local income. Thus the effect of both fixed exchange rates and flexible exchange rates is same. The merit of flexible rates lies in the fact that the adjustment carried out averts adverse reaction from people.

(2) ***Better Confidence*** Any adverse balance in the country's balance of payments situation is corrected immediately and automatically under flexible rates. It thereby prevents the country from having persistent deficits and inspires confidence in the international financial system. The confidence created leads to fewer attempts by individual or central banks to readjust currency portfolios, and this gives rise to calmer foreign exchange markets.

(3) ***Better Liquidity*** Flexible exchange rates do not require central banks to hold foreign exchange reserves, since there is no need to intervene in the foreign exchange market. This means that the problem of having insufficient liquidity does not exist with truly flexible rates. Thus competitive devaluations of currencies aimed at securing a larger share of inadequate total stock of reserves will not take place.

(4) ***Gains from Free Trade*** Under fixed rates, the balance of payments deficit can be corrected through monetary, fiscal or exchange control measures. Exchange control measures such as restrictions on free flow of goods and capital and imposition of tariffs are often resorted to because of their immediate and visible effects. The imposition of restrictions is not conducive for the growth of multinational trade and costs the country in the form of loss of potential gains from the international trade and investments. Flexible rates avoid the need for such restrictions.

(5) ***Independence of Policy*** Under fixed exchange rates the country may be compelled to follow the same economic policy as its major trading partners. For example, let us suppose that rupee has a parity with pound-sterling. If England increases its money supply, it will push up prices in England ultimately leading to deficit in balance of payments. Because rupee is fixed to sterling, a deficit in England is likely to bring surplus in India. In the exchange market, it will have the effect to putting up the price of rupee. Reserve Bank may have to sell rupee in the market to peg down the price. This will increase the money supply in India. Thus the economic policies of India are closely tied to that of England. Under flexible exchange rates all that will happen is that value of sterling will decrease against other currencies. Thus the economic sovereignty of individual countries is maintained.

(6) ***Cost-price Relationship*** Stable exchange rates do not reflect the present and true cost-price relationship between two countries; they are based on past rates. When countries follow different economic policies the cost-price relationship alters frequently. Flexible exchange rates take care of these. They provide automatic adjustment for the balance of payments disequilibria which in the process establishes the true cost-price relationship.

Both the systems of exchange rates have their own merits and demerits. *Neither of the system in the extreme form is good.* What is required is a system which is fairly stable but at the same time flexible enough to accommodate small changes in accordance with the needs. The system now prevalent under IMF (detailed later in this chapter) is a managed float in which exchange rates of major currencies are floating but subject to exchange control regulations to keep the exchange rate movements within limits.

2.2 EXCHANGE RATE SYSTEM PRIOR TO IMF

Prior to the institution of International Monetary Fund, the international monetary system was following the fixed exchange rate system based on international gold standard. Under the gold standard the value of the currency was kept equal to the value of a fixed weight of gold. Over the years the gold standard took three forms: (*a*) gold currency standard, (*b*) gold bullion standard, and (*c*) gold exchange standard.

❑ Gold Currency Standard

Gold standard or *gold currency standard* or *gold coin standard* was the monetary system where gold coins of a definite weight and fineness circulated as the standard unit of currency. To a small extent paper currencies and coins of other metals like nickel and silver also circulated but they were freely convertible into gold. Gold coins could be melted and used for industrial or other purposes. Any person could mint coins of gold bullion. There was free flow of gold between countries. There were no restrictions on import or export of gold. Besides, the monetary authorities were always prepared to buy or sell gold in unlimited quantities at fixed prices.

The exchange rate between two currencies were determined on mint parity, *i.e.*, the relative value of gold content of each currency. For instance, if one US dollar was worth 5 grains of fine gold and Indian rupee was worth 0.5 grains of fine gold, then one US dollar was equal to ten Indian rupees. So long as the market rate for currencies fluctuated within a reasonable limit from the mint par value (the cost of physical transfer of gold), the export and import transactions were financed by credit instruments rather than import and export of gold. Thus, even though there was no restriction on the movement of gold from and into the country, the actual gold flow was much less. Secondly, the working of the gold standard required that any inflow or outflow of gold should result simultaneously in increase or decrease in money supply in the country. If exports of a country exceed its imports, there would be net inflow of gold. This should result in increase in money supply in the country. The increase in money supply would lead to inflation in the country. Due to increase in costs, the exports become less competitive and dwindle and thereby adjust the balance of payments position. Reversely, if imports exceed exports the sequence would be decrease in money supply, reduced imports and higher exports (at lower prices) and adjustment of balance of payments. Any deliberate attempt by the government to interfere with the mechanism would mean malfunctioning of the system.

The gold currency standard could survive up to 1914 because of many facilitating factors that prevailed up to that period. Countries believed that the best policy was to keep the value of the currency constant in relation to the value of gold. They were prepared to freely allow movement of gold, even though at times it meant large scale unemployment in the country. Free trade policy adopted by the countries helped free functioning of the mechanism. Disequilibrium in balance of payments was small in magnitude. Even such deficiencies were financed by surplus countries by lending on short term to the deficit countries. Movement of gold on government account was not large. There were no 'hot-money' movements chasing higher interest rates. But the scene changed with the advent of the First World War. European governments ceased to allow their currencies to be convertible either into gold or other currencies, causing the collapse of the gold standard.

❑ Gold Bullion Standard

Mounting expenditure during the First World War brought out the inherent weakness of the gold standard. If the imports into it were met by export of gold, the entire gold reserves of any country would have been depleted. Fearing this, gold was withdrawn from circulation and paper money was introduced. Thus the war expenses were financed by currency expansion leading to inflation.

After the War, an International Conference at Brussels, in 1922, decided to reintroduce gold standard in a modified form. The result was the *gold bullion standard.*

Under the gold bullion standard, paper currency replaced gold coins. But the paper currency was expressed as a definite quantity of gold of a certain fineness. Gold bullions were not converted into coins. Gold acted as the reserve for the currency in circulation, but the reserve formed only a portion of the total money in circulation. Paper currency and other forms of money were redeemable into gold at the fixed rate, but only for relatively large quantities. As between countries, gold was freely imported and exported. In short, paper currency was used for internal requirements of the country and gold was used for international settlements.

With the introduction of paper money, the purchasing power of money was divorced from the value of gold. The hyperinflation resulting from the war led to uneven price relationship between different countries. The parity between currencies became a farce.

The interwar period witnessed rampant nationalism, price rigidities, volatile capital movements and other impediments to international trade. Countries indulged in open market operations to offset gold movements, thereby not allowing the gold-money relationship to function. They also indulged in exchange rate wars by resorting to competitive depreciation of currencies. Hot money movements characterised this period due to changes in banking policies and use of bank rate by the central banks. Rigidity developed in the economic structure with unions refusing wage cuts. High tariffs were imposed on imports. Many countries faced difficulty in repayment of war debts.

Because of the above factors, the gold bullion standard had to be given up. England which adopted this system in 1925 suspended it in 1931. America followed with the same decision in 1933 and France in 1936.

❑ Gold Exchange Standard

The Great Depression of 1930s showed the weakness of the gold standard. The British return to the gold standard from 1925 to 1931 was widely held responsible for the contraction of the British economy over this period, which in turn aggravated the Great depression. Experiment with floating rates in 1920s failed miserably to help revive the post War II European economy. The Geneva conference suggested Gold Exchange Standard to conserve gold reserves. Under this standard the currency of the country consisted of paper currency and subsidiary coins. They were not expressed in terms of gold but in terms of foreign currency which was on gold standard. Gold coins did not circulate in the country nor was gold kept as reserve for money in circulation. The monetary authorities undertook to convert in unlimited quantity the currency of the country into that of the foreign country which was on gold standard. For that purpose, the monetary authorities maintained foreign asset reserves, bank accounts and other liquid assets in the foreign country concerned. Gold exchange standard was not new; it had existed even earlier. For instance, India adopted this standard before 1914. The value of rupee was maintained fixed in relation to pound-sterling at 1s. 4d. per rupee.

As we shall see presently, gold exchange standard formed the basis of the exchange rate policies of the International Monetary Fund as it was originally implemented.

2.3 EXCHANGE RATE SYSTEMS UNDER IMF

❑ Original Scheme under IMF

The International Monetary Fund was instituted soon after the Second World War with the avowed objective of facilitating smooth running of international trade and betterment of all nations of the world. It was thought that a system of fixed exchange rates would be necessary for the smooth functioning of international finance. The original scheme of the IMF, therefore, provided that :

(*a*) Each member-country should declare the external value of its currency in terms of gold and a currency pegged to gold. Most countries declared values of their currencies in terms of gold and US dollar. This was known as the 'par value' of the currency.

(*b*) The value of US dollar was fixed at USD 35 per ounce of fine gold. The USA committed itself to convert dollars into gold at the above official price.

(*c*) Following the above, the monetary reserves of member-countries came to consist of gold and US dollars. Thus US dollar got the position of a reserve asset.

(*d*) Each country agreed to maintain the market value of its currency within a margin of 1% of the par value. Where the variation in the market is more

than the permitted level, the country should take steps to devalue the currency to correct the position.

(*e*) Members were free to devalue their currencies. But, if the devaluation exceeded 10% of the par value, approval of the IMF should be obtained. The IMF might approve it or advise a lower rate. However, it had no power to reject the proposal.

(*f*) The IMF granted short-term financial assistance to its members to tide over their temporary balance of payments problems. For chronic problems the members were expected to use permanent solutions like devaluation.

❑ Working of the System

For the smooth running of the system, the major industrialised countries, other than the USA, endeavoured to keep exchange rate changes to the minimum and maintain a common price level for tradable goods. Since other countries were endeavouring to maintain the exchange rate, USA had to remain passive in foreign exchange markets so as to lend support to such efforts. On the other hand, it had to follow a monetary policy that could provide a stable price level for tradable goods. Europe and Japan found it convenient to rely upon the USA to supply a stable price environment, and support US dollar as unit of account and means of settlement of international transactions.

The system provided a distinct advantage to the USA, *viz.*, the *seigniorage* gains. It means that USA could obtain goods and services from abroad by merely printing US dollar, so long as the other countries were willing to accept dollar as the key currency. The acceptance of dollar depended on the confidence the other countries had that their US dollar reserves could be used for settlement of their international debts or that they could convert their reserves into gold. This aspect proved to be both a strength and weakness of the system. It was a strength because dollar became a reserve asset, in addition to gold, providing additional base for creation of money supply to keep pace with increase in international trade. It was a weakness in the sense, the system depended excessively on a single currency. This dependence ultimately brought the fall of the system.

❑ Collapse of the System

For about two decades the system worked smoothly. Slowly during the late sixties, the deficiencies of the system began to surface themselves up. One of the major difficulties was that the growth of means of settlement of international debts (international liquidity) did not keep pace with the increase in the volume of international trade. Many countries began to experience balance of payments problems. The reason can be attributed to the fact that increase in international liquidity depended upon the availability of gold. The supply of gold did not increase because its official price was fixed at USD 35 per ounce. With inflation and increased cost of mining, many countries found it uneconomical to mine gold.

The other reason was the undue importance given to a single currency, *viz.*, the US dollar. As early as 1960, Robert Triffin pointed out the paradox in the situation, which has come to be known as the *Triffin paradox* or Triffin dilemma. As we have seen, the system depended on the confidence other countries had in the US dollar. To facilitate other countries to accumulate reserves, USA had to run deficits in its balance of payments. So long as deficit was moderate, the system could work well. However, when every country began accumulating as much dollars as possible, which meant huge deficits in US balance of payments, the dollar could not hold its value in the foreign exchange market. If the faith in the dollar was lost due to pressure in the market and if only a portion of the balance outside was required to be converted into gold the Federal Reserve System of the USA would

have collapsed because the gold reserve constituted only a little portion of the dollar balances abroad.

The events in 1960s followed the predictions. The USA experienced heavy deficits in the balance of payments. The supply of dollars in the foreign exchange markets increased to greater extent leading to sharp fall in the value of dollar in the market. The speculative forces further complicated the issue rendering it difficult to maintain the exchange value of dollars. As a corrective measure the USA was advised to devalue its currency. But the USA did not heed to the advice because it was thought the prestige enjoyed by the dollar as a reserve currency would thereby suffer. Further, it was thought that devaluation of the dollar would affect many other countries which had accumulated huge dollar balances. Instead of resorting to devaluation the USA took a unilateral and unexpected step on August 15,1971. The convertibility of dollar into gold was suspended and further a surcharge of 10% was imposed on imports into the USA. These measures completely destabilised the exchange markets. Some major countries like Japan and West Germany took steps to rescue the dollar by purchasing it in huge amounts. This action could not, however, stabilise the exchange market. Therefore, some western countries decided to float their currencies in exchange markets.

❑ Smithsonian Agreement (Snake in the Tunnel)

This state of instability and confusion led the other countries to devote immediate attention to the issue. Ten major industrialised countries of the world (the USA, Canada, Britain, West Germany, France, Italy, Holland, Belgium, Sweden and Japan) which came to be known as the 'Group of Ten' met at the Smithsonian building in Washington during December 1971 to solve the dollar crisis and to decide about the realignment of the currencies. Under the agreement, known as the 'Smithsonian Agreement', which came into effect from December 20, 1971, the US dollar was devalued by 7.87% and the new dollar-gold parity was fixed at USD 38 per ounce instead of USD 35 fixed earlier. But this devaluation was not enough to set right the situation completely. The other major countries therefore decided to revalue their currencies. Japan revalued its currency in relation to dollar by 7.66% and West Germany by 4.61%. This meant, that in relation to gold, the Japanese yen was revalued by 16.88% and the Deutsche Mark by 12.6%. The Smithsonian Agreement also provided for a wider band of fluctuation in exchange rates. The exchange rates were allowed to fluctuate within 2.25% on either side instead of 1% existing previously. This step was taken with a view to affording greater flexibility to exchange rates in the market. The USA removed the 10% surcharge on its imports, but the non-convertibility of dollar into gold continued.

The fact that the Smithsonian Agreement was not a panacea for the ills was proved soon. The USA faced unprecedented balance of payments deficit for the year 1971 characterised by increased imports due to domestic boom. Dollar continued to fall in the exchange market. A number of countries tried to save the situation by purchasing dollar in large quantities. The situation was beyond repair by these methods and hence the USA devalued dollar for the second time on February 13,1973. The extent of devaluation this time was 10% with the gold value increasing from USD 38 to USD 42.22 per ounce. Following the second devaluation of US dollar, many countries, including Japan, West Germany and UK, started floating their currencies. Thus the Smithsonian Agreement came to an end.

❑ Abolition of Gold and Emergence of SDR

The turmoil in the exchange market continued. The dollar continued to fall and Japanese Yen and Deutsche Mark emerged strong. Major currencies of the world continued to float. The Committee of 20—which had 20 principal members both from developed and developing countries—made a number of far-reaching

recommendations on reforming the IMF system. The major recommendations relate to the place of gold in the IMF system and the use of SDR.

The official price of gold was abolished in November 1975, putting an end to the gold era. The countries were free to purchase or sell for monetary reserve gold at the prevailing market price. SDR emerged as the international currency. No agreement could, however, be reached on a new system of exchange rates. The USA advocated floating rates, while France was for fixed rates and return to par values.

❑ Second Amendment of IMF Articles

A major change in the IMF system was noticed with the second amendment to its Articles of Agreement which came into effect from April 1, 1978. Under the present arrangement every member is free to choose its own exchange rate system. But every member should endeavour along with IMF and other members to ensure general stability of exchange rate system and orderly conditions in exchange markets. Manipulation of exchange rates by a member to gain an unfair advantage over others is prohibited. The IMF has surveillance over the exchange rate policies of the members and is free to put forward its frank opinion on such policies. Subject to these provisions each country can have its own exchange rate system.

❑ Plaza-Lourve Intervention Accords

Even though floating rate has become the order of the day, the events in 1980s have lent legitimacy to official intervention in the exchange markets to regulate exchange rates. Between 1981 and 1985 the US dollar appreciated by over 50% supported by expansive fiscal policy and tight monetary controls followed by the US government. The appreciation of dollar resulted in the country losing its export competitiveness resulting in trade balance deficits. European countries had to adopt stricter monetary policies to arrest fall of their currencies, but these measures were at the cost of lowering domestic economic performance. They could not take advantage of the situation to increase exports to USA, due to import restrictions placed by the latter to protect its industries. The situation brought out the importance of exchange rates on the economies, and the need for active management of the exchange rate system. On September 22, 1985 officials from Group of Five countries (G-5 — Britain, France, West Germany, Japan and USA) met at Plaza Hotel in New York. After the meeting the officials from G-5 countries announced that they would intervene jointly to reverse the dollar appreciation. The announcement is considered historic for the reason that for the first time the policy of intervention gained legitimacy and was undertaken in coordinated manner by different central banks with transparency about such measures. As an immediate reaction to the decision, the dollar fell sharply and continued to decline through 1986.

The continued depreciation of dollar needed some corrective measure as the competitiveness of other countries were getting affected. This resulted in another effort at exchange rate cooperation by G-5 countries. At the meeting held at Lourve in Paris on February 22, 1987, G-5 countries along with Canada, agreed to foster stability of exchange rates around the then existing levels. The central banks agreed for a set of *target zones*, or exchange rate ranges, that they would defend using active foreign exchange intervention.

❑ Present System

The present system can be termed as a 'managed float' under which the major currencies are floating but subject to exchange control regulations to keep the rate movements within limits. The different methods adopted at present by countries for exchange rates are as follows :

(a) The major currencies like US dollar, Japanese yen, pound-sterling, are floating, *i.e.*, their exchange rates are determined by market conditions.
(b) Some currencies are pegged to SDR ; their values move with change in the value of SDR, *e.g.*, Burmese kyat.
(c) Some currencies are pegged to a major currency, *e.g.*, Sri Lankan rupee is pegged to pound-sterling.
(d) For some currencies, rates are based on a basket of currencies.
(e) For some currencies, rates are subject to mutual intervention arrangements.

2.4 EUROPEAN UNION

The European Union (EU) is a sterling example of successful economic integration among the countries of a region. Formerly known as the European Economic Community (EEC), the Union was born out of the 'Treaty of Rome' entered into among six European countries—Belgium, Netherlands, Luxembourg, France, Germany and Italy—who are also its founder-members. It came into operation on January 1, 1958.

Under the Treaty of Rome the member-countries agreed to: (*i*) gradual liberalisation of trade among the members with a view of achieving zero tariff level as early as possible; (*ii*) evolving a common external tariff among the member-countries for inter-regional trade; (*iii*) evolving a common agricultural and transport policy; (*iv*) removal of obstacles to the free movement of persons, services and capital; (*v*) establishing the European Common Market (ECM) with a view to reducing intra-regional income disparities and promote trade among the members; and (*vi*) evolving common fiscal and economic policies to the extent possible for the functioning of the ECM and to remedy disequilibria in their balance of payments.

The member-countries agreed to abolish in a phased manner all the tariffs among themselves and adopt a uniform tariff for trade with other countries. This was achieved by 1968. The next step was to integrate the European Community into a single market with single set of laws, tariffs and fiscal barriers. This was to be achieved by 1992. In June 1985, the European Commission issued the White Paper listing various legislative proposals on 'completing the internal market'. The proposals essentially centre on abolishing existing physical, technical and fiscal barriers. These include border controls, technical standards and regulations and disparities in tax regulations. The Single European Act, which became effective in July 1987, provided the legal basis necessary to implement the integration of European market.

The European Union is operating as a single market with effect from 1st January, 1993 with the elimination of barriers to the movement of goods, services, capital, manpower and skills within the bloc. At present the membership includes 15 countries with the addition of England, Ireland, Denmark, Greece, Spain, Portugal, Austria, Finland and Sweden. It now constitutes the world's largest and prosperous market with a share of 40% in the world trade.

One of India's major trade partners is the EU which accounts for 25% of its exports. While the scope for exports has been enlarged by the mere size of the market and flexibility of the quota for different items, the Indian industry has to survive the severe competition arising from throwing open the market to all. India has signed a trade and economic cooperation agreement with the EU. This provides for preferential trade between EU and India and mutual cooperation in economic and agricultural and industrial development. It is expected that in course of time India may be assigned an associate member status.

❑ European Monetary System

On the monetary front, the European Monetary System (EMS) was conceived to pave the way for European monetary integration. The main objective of EMS was

to establish a zone of monetary stability in Europe and to achieve a greater convergence of financial and economic policies among member-countries. It was thought of as a protection to the European countries from the instabilities of US dollar.

The EMS became operative from March 1979 with the members of EEC except Britain which opted to remain outside the system. Each member-country of the EMS agreed to maintain exchange rates within certain margins through concerted intervention policies. It also provided for mutual credit facilities to implement the policy of stability of exchange rates.

An innovation of the EMS was the creation of European Currency Unit (ECU). The ECU occupied the central position in the system. ECU was the unit of account for mutual monetary assistance. It also served as an indicator of divergence in exchange rates of currencies of member-countries. In addition, it was used as a measure of settlement among the central banks of the members. In short, ECU was the unit of account of the EMS and occupied the same position that is occupied by SDR in IMF.

Exchange Rate Mechanism (ERM) ECU was a basket of fixed amount of EEC currencies. The parities of all EMS currencies were declared against the ECU. As the parity of all EMS currencies was fixed in terms of ECU, each pair of these currencies had a fixed cross parity. The central bank of a member was required to keep the market rate for its national currency against each other participating currency within 2.25% above and below its cross parity. The central bank of each participating country declared selling and buying rates for each other participating currency at 2.25% above and below the cross parity, at which rates it will deal in unlimited amounts. The willingness of the central bank to deal at these rates was to ensure that the market rates do not go beyond the limits.

In addition to maintaining the cross parity with other currencies, each currency was allocated a maximum percentage deviation against its ECU central rate, known as the *divergence indicator*. When this divergence was reached, there was a presumption (but not an obligation) that corrective action will be taken by the country concerned. The maximum divergence indicator against a currency's ECU central rate varied from currency to currency.

Although among themselves the EMS currencies had fixed parity, the currencies were floating as a bloc against other currencies.

❑ Economic and Monetary Union

The integration of the European Union was complete only with the evolving of a single currency for all EU countries. At a summit meeting of the EC heads of government held in Maastricht in the Netherlands in December 1991, it was decided to achieve the economic and monetary union in three stages. Stage I began on July 1, 1990 (earlier to Maastricht) with free movement of capital in the EC. Stage II began on January 1, 1994 with the establishment of European Monetary Institute as a precursor to the eventual formation of Central Bank for Europe. At Stage III, commencing from 1997 and not later than January 1, 1999, the members would irrevocably fix *inter se* exchange rates and proceed towards a single currency. Under Maastricht, Britain has retained the right not to join the monetary union.

The European political leaders who met in Madrid in December, 1995 took final decision to implement the economic and monetary union (EMU), commencing from January 1, 1999. The single currency for Europe is named 'Euro'.

The members of the EMS are eligible to join the EMU subject to fulfilment of the following conditions:

(*i*) The yearly average inflation of the country not to exceed by more than 1.5% the inflation levels of three of the best performing member countries;
(*ii*) The yearly average long-term interest rates not to exceed by more than 2% that prevailing in the three best performing member countries;
(*iii*) The government deficit not to exceed 3% of the GDP or should be falling substantially towards this figure;
(*iv*) The gross government debt not to exceed 60% of GDP or must show a satisfactory fall towards this figure;
(*v*) The exchange rate of the country's currency must have moved for at least two years within the normal EMS margin.

❑ Launching of Euro

Euro was launched on January 1, 1999 in line with the schedule set out by the Maastricht Treaty. Eleven out of fifteen member countries in the European Economic and Monetary Union (EMU) which achieved the Maastricht convergence criteria irrevocably linked their domestic currencies to Euro on December 31, 1998.

The conversion rates between Euro and the currencies of the member states opting the Euro which came into effect since January 1, 1999 are as follows: 1 Euro = 40.3399 Belgian francs; 1.95583 German marks; 166.386 Spanish pesetas; 6.55957 French francs; 0.787564 Irish pounds; 1936.27 Italian lire; 40.3399 Luxembourg francs; 2.20371 Dutch guilders; 13.7603 Austrian schillings; 200.482 Portuguese escudos; 5.94573 Finnish markkas.

The Euro is issued and administered by an European System of Central Banks (ESCB) which comprises of the European Central Bank (ECB) and 11 national central banks (NCBs) which sets the monetary policy and can alone authorise the issuance of Euro notes. The Euro was initially transacted in the form of electronic currency. Euro notes and coins were put in circulation on January 1, 2002 and circulated along with the erstwhile national currencies (legacy currencies). Euro became the sole legal tender in the eleven countries on July 1, 2002.

2.5 EXTERNAL VALUE OF RUPEE

When India joined the IMF value of the rupee was declared as the equivalent of 0.268601 grams of fine gold. In terms of pound-sterling the parity was fixed at Rs. 1 = 1 sh. 6 p. In September 1949, the pound-sterling was devalued and the rupee was also devalued to the same extent. Although the parity of 1 sh. 6 p. per rupee was continued to be maintained, the gold content of the rupee was reduced to 0.186621 grams.

Rupee was devalued in June 1966 by 37.5% and the parity rate of rupee was fixed at US $ 0.133333, equivalent to a gold parity of 0.118489 grams of fine gold per rupee. The fixed parity system broke down in August, 1971, when the USA suspended the convertibility of the US dollar into gold. In view of the uncertainties in the international situation prevailing then, it was decided that the Indian rupee should be pegged to the US dollar at the rate of $ 0.133333 per rupee. The pound-sterling continued to remain the intervention currency and Reserve Bank's rates for buying and selling the pound-sterling were determined daily on basis of the rate for the dollar in the London Market.

In December 1971, the Smithsonian Agreement brought some order in the turmoil and new system of central rates with a wider margin of 2.25% on either side of the fluctuation was introduced. Along with this development, the rupee was pegged to sterling at the central rate of Rs. 18.9677 per pound-sterling.

The fact that majority of exports from India were invoiced in pound-sterling and also the historical link between the two countries led to this decision.

However, with the failure of the Smithsonian Agreement the pound-sterling began to float in the market. With the floating of the pound-sterling the rupee also floated. This led to a continuous depreciation of the rupee in the exchange markets. To correct the situation the Government of India delinked rupee from pound-sterling in September 1975 and linked it with the 'basket of currencies'. The value of rupee was determined by the values of currencies that constituted the basket. However, sterling was retained as the intervention currency in terms of which the external value of rupee was fixed. The rupee-sterling middle rate was so fixed that the value of the rupee in terms of the basket was within a band of 5% of the base rate, *i.e.*, rate announced for rupee on switching over to this system. The composition of the basket as well as the weight assigned to each currency was kept confidential and was determined by Reserve Bank of India in consultation with the Government of India. However, the currencies were presumed to be pound-sterling, US dollar, Japanese yen, Deutsche mark, Swiss franc and a currency of one oil exporting country—the currencies in terms of which the majority of the country's exports are invoiced.

Linking of the rupee to a basket of currencies was done to moderate the fluctuations in the exchange rates and further moderate the depreciation of rupee in the international market.

With effect from March 1992, US dollar was adopted as the intervention currency in place of sterling and rupee was partially floated. 40% of the inward remittances, other than of capital account, including remittances on account of exports, was converted at the *official rate* which was the rate based on the Reserve Bank rate for the foreign currency concerned. 60% of the remittance was converted at *market rate* which was derived on the basis of market forces of demand and supply for the currency concerned. That portion of the remittance which was converted at the official rate was to be sold by the authorised dealer to Reserve Bank. That portion converted at the market rate could be retained by the authorised dealer to meet the demand for foreign exchange for import customers and others. Certain imports by the Government and import of life-saving drugs were allowed at the official rate by the Reserve Bank making available the foreign exchange at the official rate. All other imports were to be met at the market rates.

The external value of rupee was made fully dependent on market forces with effect from March 1993. The official rate has now been abolished. The exchange rate for rupee is calculated based on the market rates. Even the Reserve Bank rates are based on market rates.

2.6 CONVERTIBILITY OF RUPEE

In the present context, convertibility of a currency refers to its convertibility into a foreign currency as desired by its holder. The currency is fully convertible if the holder can convert it into any other currency at rates determined by the forces of demand and supply and without any interference from the government. The convertibility therefore involves two aspects:

(*i*) The rate of exchange should be determined by the market and not by the regulatory authority and thus the holder does not incur any loss on conversion; and

(*ii*) There should not be any quantitative restrictions on the repatriation of the currency.

Earlier the exchange rate of rupee was subject to the condition that the rate quoted by a bank to its customer should not be worse than the rate based on RBI rate. Rupee was made partially convertible when dual exchange rate was introduced and 60% of the remittance into India was converted at the market determined rates. Now the value of rupee is fully determined by the market

forces. Thus rupee now fulfils the first condition of convertibility, *viz.*, the exchange rate should be determined by market forces.

A currency is converted to effect remittances, either from the country or into the country from abroad. Remittances are broadly classified into two categories: (*i*) those on current account and (*ii*) those on capital account. This classification is based on the current and capital accounts in the balance of payments. Remittances on current account represents transactions relating to trade in goods and services. For such remittances no reverse flow of funds in the future is anticipated. Remittances on capital account relates to investments, loans etc. These represent the external debt of the country and reverse flow in the form of interest/ dividend and repatriation of capital is expected.

❑ Current Account Convertibility

Rupee is now fully convertible on current account fulfilling also the second condition for convertibility, *viz.*, no quantitative ceiling on remittances abroad, through subject to certain regulations. As a part of liberalisation of foreign exchange transactions, the Reserve Bank has enhanced the discretionary powers for authorised dealers for making various remittances abroad. The limits on remittances for various purposes like travel, studies, medical treatments, gifts, services etc., have become indicative. In certain cases authorised dealers themselves can permit remittance beyond the indicated limits. In certain other cases, the requests for remittances over the limits shall be referred to Reserve Bank, who will favourably consider the request.

As an affirmation of the convertibility of rupee on current account, with effect from August 20, 1994. India moved over to Article VIII status in the IMF. IMF members accepting the obligations of Article VIII undertake to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval.

❑ Capital Account Convertibility

The next logical step in the direction is the convertibility of rupee on capital account. In his Budget Speech for 1997-98, the Union Finance Minister described capital account convertibility as the cherished goal of the government. As a follow-up measure, the Reserve Bank of India appointed in February 1997 a committee on Capital Account Convertibility (CAC) under the Chairmanship of Sri S.S. Tarapore, then Deputy Governor of Reserve Bank. The committee submitted its report on May 30, 1997.

❑ Benefits of CAC

The Committee has put forward the following as the advantages flowing from CAC:

(*i*) It makes available a large capital stock to supplement domestic resources and thereby enables the economy to register higher growth, reduce the cost of capital and improve access to international financial markets.

(*ii*) It allows residents to hold an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic stocks, lower funding costs for borrowers land prospects of higher yields for savers.

(*iii*) Allocative efficiency improves as a result of financial integration arising from CAC. This can stimulate innovation and improve productivity.

(*iv*) It provides impetus for domestic tax regimes to rationalise land converge to international tax structures. This removes inducements for domestic agents towards evasion and capital flight.

(*v*) The capital controls turn progressively ineffective, costly and even distortive. On the other hand, an open account would bring the weakness of the Indian financial system under a sharper focus. It would impose a strong discipline.

upon the financial system and expedite the early rectification of infirmities in the system and lead to widening/deepening of markets to enable the spreading/distribution of risks.

❑ International Experience

The Committee made a survey of the international experience in capital account convertibility. The countries which initiated the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shift in a stance of macro-economic policies. Also, these countries were less vulnerable to backtracking and the reimposition of controls. Countries with weak initial conditions were constrained to adopt drastic macro-economic policies to facilitate the move to CAC.

The following are considered important preconditions for CAC:

(*i*) A strong balance of payments position.
(*ii*) The strengthening of the financial system.
(*iii*) Fiscal consolidation.
(*iv*) Conduct of an appropriate exchange rate policy.

In the implementation of CAC, restriction on inflows and related outflows by non-residents and residents, corporates and non-banks usually received preferential treatment, followed by banks and individuals. Some restriction on capital inflows were imposed during the transition period.

❑ Preconditions for CAC in India

The Committee stipulated preconditions in three important areas for implementation of CAC. They are:

(*i*) *Fiscal consolidation*. The ratio of Centre's gross fiscal deficit to gross domestic production to be reduced from a budgeted 4.5% in 1997-98 to 4% in 1998-99 and further to 3.5% in 1999-2000, accompanied by a reduction in the States deficit.
(*ii*) *Mandated inflation rate*. The inflation for the three-year period (1997-2000) should be an average of 3-5 per cent.
(*iii*) *Strengthening of Financial System*. Interest rates should be fully deregulated in 1997-98. The average effective CRR should be reduced to 8% in 1997-98, 6% in 1998-99 and further to 3% in 1999-2000. Gross non-performing assets to be brought down to 12% in 1997-98, 9% in 1998-99 and 5% in 1999-2000.

Implementation CAC should be implemented in three phases over three years: Phase I—1997-98, Phase II—1998-99 and Phase III—1999-2000. The implementation of measures contemplated for each phase should be based on a careful and continuous monitoring of the preconditions.

Exchange Rate Policy On the exchange rate policy, the Reserve Bank should have a monitoring band of 5% around the neutral Real Effective Exchange Rate (REER). (REER is the exchange rate for the currency adjusted for inflation rate differential.) Reserve Bank should ordinarily intervene as and when the REER is outside the band.

Adequacy of Reserves The following four indicators should be for evaluating the adequacy of reserves:

(*i*) Reserves should not be less than six months of imports.
(*ii*) Reserves should not be less than three months of imports plus 50% of debt service payments plus one month's exports and imports.
(*iii*) The short term debt and portfolio stock should be lowered to 60%.
(*iv*) The net foreign exchange assets to currency ratio should be prescribed by law at not less than 40 per cent.

Narrow Banks The weak banks should be converted into 'narrow banks' and the incremental resources of these narrow banks should be deployed only in Government securities.

Risks of Convertibility

Those who oppose convertibility offer the following arguments against its implementations:

(*i*) Credit rating institutions will play a vital role in decision making by the investors. The changed view of these institutions or changes in the interest/ exchange rates may have a destabilising effect on the portfolio flows.

(*ii*) It exposes banks' liabilities and assets to more price and exchange risks. The effect of increased volatility of exchange rate will be felt on the banks' open foreign currency positions.

(*iii*) Banks may supplement their domestic deposit base with borrowings from off-shore markets. The volatility in interest and exchange rates can be dangerous to weak and fragile banks.

(*iv*) Fluctuation in interest rate may affect the cost of borrowing for emerging markets and alter the relative attractiveness of investing in these markets. Real exchange rate volatility may cause currency and maturity mismatches, creating large losses for bank borrowers.

(*v*) Due to increased competition, the margins for the banks may be reduced.

Implementation in India

India is already moving towards capital convertibility, though not at the speed envisaged by the Committee. The recent Asian currency crisis has moderated the tone of the staunch advocates of CAC. The Reserve Bank and the Government are progressively relaxing the conditions attached to such areas as investments abroad, investments into India and maintenance of foreign currency accounts by banks. Thus India is cautiously moving towards convertibility of its currency on capital account.

Provisions under FEMA The Foreign Exchange Management Act, 1999, which came into force with effect from June 2000, continues restrictions on capital account transactions. Section 6(2) provides that the Reserve Bank may, in consultation with the Central Government specify the permissible classes of capital account transactions and the limit up to which foreign exchange shall admissible for such transactions. Only such transactions which are permitted under specific or general permission of the Reserve Bank can be carried out. Thus rupee remains only partially convertible for capital account transactions.

2.7 SOUTH EAST ASIAN CURRENCY CRISIS

The group of South East Asian countries came to be known as Asian Tigers due to phenomenal economic progress made by them within a short period. Low inflation rates, sustained high economic growth and high savings rate attracted the attention of the entire globe. In comparison, the growth achieved by India was dubbed lethargic and the country was advised to liberalise the economy at a faster pace to match the achievements of its neighbours.

❑ The Crisis

Then came the bolt from the blue in the form of currency crisis which has shaken the financial system of the entire globe. It started with the downward adjustment of the value of Thai Baht, (for a long time pegged to dollar) in July 1997, as the authorities decided that it was overvalued. This initiated a run on Thai Baht. The market perception changed and soon the currencies of the neighbouring countries came under speculative attack. Between end June 1997 and third week of January 1998, the Thai Baht fell by 120%, the Philippine peso by 62%, the Korean won by 97%, the Malaysian ringgit by 79% and the Indonesian rupiah by 120%.

Causes

The postmortem conducted on the crisis point to both market forces and wrong management of the economy to share the blame.

(i) Thai Baht was pegged to US dollar for a long time which meant that it appreciated in value when dollar appreciated, despite the country posting a persistent current account deficit of 8.7% of GDP. The pegging gave the investors from abroad an environment of stability in exchange rates and freedom from exchange risks.

(ii) The private sector indulged in excessive short term borrowing as money was flowing easy from the international financial markets. The country received large inflow of short term portfolio investments. A large number of bank and non-banking financial companies mushroomed to handle these inflows.

(iii) Foreigners were allowed to hold domestic currency deposits. In the absence of adjustment of exchange rate, it offered arbitrage opportunity in interest by borrowing in international markets and investing in local currency.

(iv) Huge investments had already been made in sectors like automobiles and electronics leading to overcapacity. In the absence of suitable investment opportunities, the excess liquidity with the banking system found outlet in lending for property deals and shares leading to boom in property and share prices. The borrowings of the banks were in US dollars, but the lendings were in Baht. When the cash flow dried up, these loans could not be repaid but were allowed to be rolled over. In the absence of stringent prudential norms, the banks were not revealing the non-performing assets.

(v) On the external front, it was seen that glut in manufactures produced in the region lead to decline in export prices and exports. Combined with declining exports and increased imports of luxury consumer items, the country faced a steep increase in current account deficit. This lead to a speculative attack on the currency. The central bank lost more than USD 1.5 billion trying to defend the parity, but was ultimately forced to float the Baht on July 2, 1997.

(vi) With the sharp drop in currency value, the value of the securities of bank advances fell leading to large scale losses. The stock markets also crashed. As the investors started to look closely at the countries in the region and take steps to protect their interest, it resulted in pressures on other currencies as well. Philippines too put the peso on float. Indonesian rupiah and Malaysian ringgit were put on wider pegging. The overseas investors suffered losses and the sentiment was reflected in the worldwide fall in the stock prices.

Recovery

Most of the economies are on the path of recovery. IMF came out with rescue package of more than USD 100 million with the terms and conditions of restructuring their weak banking and financial systems and following sound macro economic policies. The time has been seen as opportune by the multinationals to acquire business interest, through acquisitions or otherwise, when the currencies of the countries are at low ebb. After the debacle, the currencies are showing some semblance of stability, but it will take a long time to regain the past glory. It is also felt that the crisis is only temporary as the economies are fundamentally strong. This region now accounts for one-third of world output as against 20% 15 years ago.

❑ Impact on India

The effect of the Asian crisis was felt in India, though not to the same extent, in the depreciation of Indian rupee and downward slide in investments from abroad. In January 1998, the rupee crossed the psychological level of Rs. 40 per dollar. The period also witnessed net outflow of foreign investments from India. The Reserve Bank responded to the situation with a package of measures announced on January 16, 1998, aiming at tightening the liquidity in the banking system. The measures included raising the bank rate by 2%, hike in cash reserve ratio by 1/2 %, reduction in refinance limits of banks and doubling the interest rate surcharge from 15% to 30% on import finance. These measures were considered by many as more stringent than warranted. However, they had the desired effect of allaying the speculative forces and the rupee regained some lost ground and steadied at about Rs. 39.50 per dollar, which is considered reasonable considering the fundamental factors. Having achieved the objective, subsequently the Reserve Bank relaxed some of the restrictions imposed.

On the international trade front, the effect of the crisis depends upon two factors. First, the trade between Indian and South East Asian countries. These countries accounted for 15% of India's total exports and 11.5% of its total imports in 1995-96. Trade balance of India with these countries has been a deficit of about 7% of its total exports. To some extent, therefore, the fall in exchange rates should benefit India in the from of lower import costs.

The second aspect is the exports from the country for which the South East Asian countries are competitors. These include items like tea, coffee, marine products, engineering goods and textiles. In all these cases, exports from India have become costly due to fall in the exchange rates of the currencies of the competing countries.

❑ Lessons for India

The important question is what lessons do we learn from the debacle to avoid such a situation threatening India?

(*i*) No country can afford to have high deficit in the current account for a long time. Such deficits should not be covered by volatile short-term forms. India's position in this regard is not alarming because the current deficit is less than 1.5% of the GDP (as against 8% of Thailand). However, it should not be forgotten that the same comfortable position may not sustain once India is forced to remove the quantitative restrictions on imports yielding to pressures from WTO.

(*ii*) It is not the size, but the quality of foreign exchange reserves that is important. Thailand which has a reserve of USD 38.7 billion at the end of 1996 lost around USD 13 billion in less than months in 1997. India as in a better position with low ratio of short term debt to reserves. However, these short term debts and foreign institutional investment, constitute about 50% foreign exchange reserves of the country. These are considered potential 'hot money'. Therefore more discretion is required in relaxing restrictions on capital transfers and maturity pattern of external commercial borrowings.

(*iii*) There is need for keeping the exchange rate of the currency aligned to the fundamentals in the long run. If this is not done, the currency will be subject to speculative attacks. Once the speculative attack is launched on any currency, the effect is bound to spread to the neighbouring countries as well. The effort of the central bank to defend the currency in such a situation will not only be fruitless, but also cost the exchequer heavily.

(*iv*) The banking system should be regulated and subject to prudential norms. There should be transperancy in their operations. Especially the use of

bank funds for speculative activities like real estate business and share deals should be discouraged. The banking system in India is functioning under reasonably effective regulation by the Reserve Bank. The high level of non-performing assets is getting reduced gradually. Thus the situation overall is satisfactory. But it should be ensured that granting of autonomy for the banks that is on the cards should not result in dilution of the present prudential regulations.

(v) The capital convertibility cannot be introduced unless the fundamental factors are strong enough. The recommendations of the Tarapore Committee on the preconditions for introducing capital convertibility in India gets a favourable endorsement by the events that led to the Asian currency crisis.

❑ Conclusion

The Asian crisis has shown timely warning signals to India in its march towards liberalisation. India should continue to follow the path of progressive liberalisation with continuous assessment and judicious monitoring.

3 International Financial Institutions

For the smooth functioning of international monetary system, certain international institutions have been established with membership of majority of the nations of the globe. We take a brief look at some such institutions.

3.1. INTERNATIONAL MONETARY FUND

Even before the Second World War ended, the Allied countries began to devote serious thought and efforts in developing a system that would end the chaotic conditions prevailing and pave the way for an orderly conduct of international trade and promote good monetary relations among the countries. They worked with the objectives of finding a system which would (*a*) help remove the restrictions on trade, (*b*) ensure free convertibility of currencies (which was suspended during the inter-war period due to multitude of exchange controls) and maintain stability in exchange rates among the currencies. In these efforts, the USA (represented by Mr. H.D. White) and the UK (represented by Lord Keynes) had a greater role to play.

In June 1944, representatives of 44 Allied powers met at Brettonwoods, New Hampshire, USA, to give concrete shape to their ideas. The agreement reached at this meeting provided for establishing two institutions which came to be known as the 'Brettonwoods twins'. The institutions set up were the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank).

❑ Objectives

The Articles of Agreement of the IMF set out the following as the objectives of the Fund :

1. To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
2. To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
3. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
4. To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
5. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive to national or international prosperity.
6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

Thus the role of the IMF is mainly twofold : It is an organisation to monitor the proper conduct of the international monetary system. Second, it is a source of liquidity for countries in need of foreign exchange to finance temporary balance of payments deficits.

❑ Structure

The central office of the IMF is in Washington. The IMF is an autonomous body with 184 countries as members. It is affiliated to the UNO. The highest authority of the IMF is the *Board of Governors* in which each member-country is represented by a governor and an alternate governor. The Board of Governors is the policy-making body. It meets normally every year.

The International Monetary and Financial Committee consists of 24 Governors representing constituencies or groups of countries, corresponding to those of the Executive Board. It meets twice a year, on the occasion of the IMF-World Bank Annual and Spring Meetings, to advise the IMF on the functioning of the international monetary system.

The administrative responsibilities and detailed functioning of the IMF are vested with the *Executive Board*. At present there are 24 executive directors—eight Executive Directors represent individual countries: China, France, Germany, Japan, Russia, Saudi Arabia, the United Kingdom, and the United States. The 16 other Executive Directors each represent groupings of the remaining countries. The Executive Board rarely makes its decisions on the basis of formal voting, but relies instead on the formation of consensus among its members.

The Executive Directors have substantial powers. Decisions regarding lending, changes in exchange rates and appointment of Managing Director are taken by the Executive Directors. Executive Directors meet frequently, even on alternate days, to decide on problems that crop up.

❑ Resources

The main resources for IMF is the members' quotas. Quota represents the subscription by a member-country to the capital fund of the IMF. Quotas are fixed for each country fixed broadly on its economic size. Apart from representing the subscription of a country to the IMF, the quota also forms the basis for determining its drawing right from the IMF, its voting power and share in allocation of SDRs. All these rights are available to a member in proportion to the quota allotted to it.

Initially, it was stipulated that 25% of a country's quota should be paid in the form of gold or US dollars and the other 75% in the country's own currency. At present, instead of contribution in gold, the 25% of the quota is to be contributed in the form of SDRs or widely accepted foreign currency, such as US Dollar, Euro, Yen or Pound-Sterling.

Since the quotas were fixed in proportion to the relative importance of each country, economically more powerful countries had the largest quotas. This was beneficial in a way because the IMF came to possess proportionately greater amounts of currencies of the larger and stronger economies. These funds are available to member-countries to draw upon when additional foreign exchange is needed to finance temporary balance of payments deficits. But it also meant confining the voting rights and thereby the decision-making to a handful to industrially advanced countries.

Quotas are reviewed by the IMF at intervals of not more than five years. Over the years quotas have been increased. Initially the quotas totalled about USD 7 billion. The last review was made in November 1997, increasing the allocation to SDR 213 billion.

General Arrangements to Borrow IMF can supplement its resources by borrowing. A significant achievement made in this direction is the entering into 'General Arrangement to Borrow' (GAB) in 1962. Under this agreement ten industrialised countries agreed to lend to IMF their own currencies up to the limit agreed. The ten countries, known as the Group of Ten, include Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, UK and USA. Switzerland

joined later making it a Group of Eleven. IMF can borrow under this arrangement only when the funds are needed for a participant in the arrangement. The original agreement was for a period of four years. It was subsequently renewed periodically. At present under this arrangement, lending commitments by 11 industrialised countries stand at SDR 17 billion, plus SDR 1.5 billion through an associated agreement with Saudi Arabia.

New Arrangement to Borrow Similar to GAB, IMF entered into a new arrangement to borrow (NAB) in 1998, under which 25 countries have agreed to lend SDR 34 billion. The stipulation for IMF is that the borrowing under GAB and NAB cannot exceed SDR 34 billion.

Trust Funds The IMF provides financial assistance to low-income countries through concessional lending under the Poverty Reduction and Growth Facility (PRGF), and debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. These resources are financed through bilateral contributions and by the IMF itself. They are separate from the quota subscriptions and are administered under the PRGF and PRGF-HIPC Trusts, for which the IMF acts as Trustee.

❑ Drawings from IMF

IMF provides temporary assistance to members to tide over balance of payments deficits. When the country requires foreign exchange, it tenders its own currency to the IMF and gets the required foreign exchange. This is known as 'drawing' from the Fund. When the balance of payments position of the country improves, it should 'repurchase' its currency from the IMF and repay the foreign exchange.

Ordinarily, a member-country should not borrow more than 25% of its quota in a twelve-month period. The total borrowing of a country can go up to a level where the IMF's holding of the country's currency reaches 200% of the quota. For example, if India's quota is SDR 1,000 million of which SDR 750 million were contributed by her in the form of Indian rupees, the maximum amount that India can borrow from the IMF would be SDR 1,250 million so that the total holding of Indian rupees by the IMF does not exceed SDR 2,000 million. However, Article 5 of the Articles of Agreement allows for waiver of this condition at the discretion of the IMF. The Fund can waive the condition considering periodic or exceptional requirements of the member requesting the waiver. There are a number of occasions on which IMF exercised the discretion and allowed the accumulation of member's currency with it to exceed 200%.

Tranche Policies The drawing of resources from the IMF by the member-countries is subject to the Fund's 'Tranche polices'. The word 'tranche' means slice in French. Under this policy, the member's right to draw from the fund is divided into five tiers or tranches. The borrowing that takes the IMF's holding of the currency up to 100% of the country's quota is known as the 'reserve tranche' (formerly, gold tranche). Borrowing in addition to the reserve tranche is divided into four tranches, known as the 'credit tranches', each equal to 25% of the country's quota. Drawing from the reserve tranche is without any restriction. A country should first draw against the reserve tranche and subsequently the first, second, third and fourth credit tranches, in that order. The IMF may be quite liberal in the first credit tranche, but drawings from higher tranches receive greater scrutiny by IMF, the severity of scrutiny increasing with successive tranches. The borrowing country has to justify its action by giving a programme of action in the fiscal, monetary and exchange fields. IMF may decline to allow the drawing if it is not satisfied with the plans.

❑ Loan Instruments[1]

Over the years, the IMF has developed a number of loan instruments, or facilities, that are tailored to address the specific circumstances of its diverse membership. Low-income countries may borrow at a concessional interest rate through the Poverty Reduction and Growth Facility (PRGF). They can also avail the debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. Non-concessional loans are provided through five main facilities: Stand-By Arrangements (SBA), the Extended Fund Facility (EFF), the Supplemental Reserve Facility (SRF), the Contingent Credit Lines (CCL), and the Compensatory Financing Facility (CFF).

Except for the PRGF, all facilities are subject to the IMF's market-related interest rate, known as the rate of charge (which includes an adjustment for deferred charges and arrears) and some carry an interest rate premium, a surcharge. The rate of charge is based on the SDR interest rate, which is revised weekly to take account of changes in short-term interest rates in the major international money markets. The rate of charge is currently about 2.9 per cent. The IMF discourages excessive use of its resources by imposing a surcharge on large loans, and countries are expected to repay loans early if their external position allows them to do so.

Heavily Indebted Poor Countries Initiative Launched in 1996, the HIPC Initiative is designed to reduce the external debt burden of eligible countries to sustainable levels, enabling them to service their external debts without the need for further debt relief and without compromising growth. For the first time multilateral, Paris Club, and other official and bilateral creditors united to take this kind of comprehensive approach to debt relief. Assistance under the HIPC Initiative is limited to countries that are eligible for PRGF and International Development Association (IDA) loans and that have established strong track records of policy performance under PRGF- and IDA-supported programs but are not expected to achieve a sustainable debt situation after full use of traditional debt relief mechanisms.

Poverty Reduction and Growth Facility (***PRGF***) The IMF for many years provided assistance to low-income countries through the Enhanced Structural Adjustment Facility (ESAF). In 1999, however, a decision was made to strengthen the focus on poverty, and the ESAF was replaced by the PRGF. Loans under the PRGF are based on a Poverty Reduction Strategy Paper (PRSP), which is prepared by the country in co-operation with civil society and other development partners, in particular the World Bank. The interest rate levied on PRGF loans is only 0.5 per cent, and loans are to be repaid over a period of 5½–10 years. The PRGF is designed to make poverty reduction programs a key element of a growth-oriented strategy. Programs supported by the PRGF are framed around a comprehensive, nationally-owned poverty reduction strategy, the costs of which are fully incorporated into the macroeconomic framework. For countries that receive HIPC Initiative assistance, this strengthens the link between debt relief and poverty reduction. Concessional lending under the current PRGF is provided by the PRGF Trust, established in December 1987, which borrows resources at market-related interest rates from central banks, governments, and government institutions and lends them on a pass-through basis to PRGF-eligible countries receives contributions to subsidise the interest rate on PRGF loans, and, maintains a Reserve Account that provides security to lenders to the PRGF Trust in the event of non-payment by PRGF borrowers.

Standby Arrangements Under standby arrangements entered into between the IMF and a member-country, the member is allowed to draw upon the resources of the IMF up to specific limits and within an agreed period. Similar to an overdraft facility being extended by a bank to its customer, here the IMF extends to its member-country the facility of drawing funds as and when required.

1. Based on information at IMF website.

Such standby arrangements are to be negotiated between the IMF and individual members. In considering requests for standby arrangements, IMF applies the same appraisal norms as are applicable to its other facilities. Once the arrangement has been agreed, the request of a member for accommodation should be allowed by IMF without reconsideration of the member's position at the time of drawing. The advantage under the facility is that the countries which have availed of this arrangement can know for certain and in advance that assistance would be forthcoming from the Fund. They can, therefore, desist from imposing strict exchange and trade controls. The length of a SBA is typically 12–18 months. Repayment is normally expected within 2¼–4 years unless an extension is approved. Surcharges apply to high levels of access.

Extended Fund Facility (***EFF***) This facility was established in 1974 to help countries address more protracted balance-of-payments problems. The facility is available for longer periods (3 years) and in large amounts than authorised under the tranche policies. It is especially designed to help countries suffering serious payments imbalance due to structural maladjustments in production, trade and prices. The country should be prepared to implement a comprehensive set of corrective policies covering a period of two or three years. Repayment is normally expected within 4½–7 years unless an extension is approved. Surcharges apply to high levels of access.

Supplemental Reserve Facility (***SRF***) The SRF was introduced in 1997 to meet a need for very short-term financing on a large scale. The sudden loss of market confidence experienced by emerging market economies in the 1990s led to massive outflows of capital, which required loans on a much larger scale than anything the IMF had previously been asked to provide. Countries are expected to repay loans within 1–1½ years, but may request an extension by up to 1 year. All SRF loans carry a substantial surcharge of 3–5 percentage points.

Contingent Credit Lines (***CCL***) The CCL differs from other IMF facilities in that it aims to help members prevent crises. Established in 1999, it is designed for countries implementing sound economic policies, which may find themselves threatened by a crisis elsewhere in the world economy—a phenomenon known as "financial contagion." The CCL is subject to the same repayment conditions as the SRF but carries a smaller surcharge of 1½–3½ percentage points.

Compensatory Financing Facility (***CFF***) The CFF was established in the 1960s to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports caused by fluctuating world commodity prices. The financial terms are the same as those applying to the SBA, except that CFF loans carry no surcharge.

Emergency Assistance The IMF provides emergency assistance to countries that have experienced a natural disaster or are emerging from conflict. Emergency loans are subject to the basic rate of charge and must be repaid within 3¼–5 years.

❑ Exchange Rate Arrangement

The most important feature of IMF system, as originally conceived, was the exchange rate arrangements of its member-countries. The original plan of IMF tried to incorporate the features of the gold exchange standard. The basic structure of exchange rates was that of fixed exchange rates, with flexibility built into it to a certain extent.

Under gold exchange standard, one or two major countries remain on gold standard and their currencies are convertible into gold. Other countries make their currencies convertible into the currency which remains on gold standard. The same arrangement was retained in the IMF plan, with dollar taking the place of the convertible currency. An account of the functioning of the exchange rate arrangement under IMF, its collapse in 1970s and the emergence of the floating rates era has been given in Chapter 2, which may please be referred to.

3.2. SPECIAL DRAWING RIGHTS

During the late sixties the growth in world resources did not keep pace with the growth in international trade. During 1963-68, the monetary reserves in the form of gold and US dollars increased by about 16% while for the same period the growth in the international trade was of the order of 70%. The slackness in the growth of resources was mainly due to dependence on the accretion of gold to monetary reserves. It was foreboding that the slow growth of monetary reserve would result in hampering the growth of international trade and in serious balance of payments difficulties to many countries. The need to increase the international liquidity, *i.e.*, resources for settlement of international debts, was felt and after much thought on the subject, it resulted in the introduction of Special Drawing Rights (SDRs) in 1970.

❑ Nature of SDRs

SDRs are entitlements granted to member-countries enabling them to draw from the IMF apart from their quotas. The arrangement is similar to a bank granting credit limit to its customer. When SDRs are allocated the country's Special Drawing Account with the IMF is credited with the amount of the allotment. When the country experiences need for foreign exchange it can sell SDRs to another country and get foreign exchange. Thus, if India is in need of foreign exchange and UK agrees to meet this need to the extent of SDR 100 million the arrangement can be made as follows. India would inform IMF that it is selling SDR 100 million to UK. IMF would debit this amount in the India's Special Drawing Account and credit the same to the account of UK. India would receive from UK pound-sterling or any other currency as agreed between them.

As can be observed from the above, SDR is not a currency and has no backing of any security. Nor is the IMF liable on the SDRs allocated. It is merely an asset created out of book entries. It is an independent reserve asset, supplementing other reserve assets, the volume of which could be increased or decreased according to the reserve needs of the international community. The real strength of the SDR lies in the undertaking by the member-countries to abide by the Articles of Agreement of the IMF and exchange SDRs for currencies. Every member participating in the SDR scheme is required to accept up to 200% of its allocation of the SDRs when offered by other countries and exchange with currency of its own or other countries. On its own, a member can hold SDRs above this statutory obligation.

❑ Allocation

Allocation of SDRs is made to member-countries in proportion to their quotas. The decision to allocate SDRs is taken periodically by the Board of Governors taking into account the requirements of international liquidity. A majority of 85% of the voting power is required for decisions involving allocation or cancelling of SDRs. Starting from 1970, when SDRs were first allocated, the quantum of SDRs allocated has increased over the period and as at the end of April 1990 the total amount of SDRs allocated stood at SDR 21.4 billion.

❑ Valuation and Interest

It may be remembered that SDR was introduced before the dollar crisis of August 1971. Keeping with the monetary environment prevalent at the time of its introduction, initially the value of one SDR was equal to a specific quantity of gold (which was equal to the value of 1 US dollar) and was provided with an absolute gold value guarantee. That is why SDRs were popularly known as 'Paper Gold'. After the dollar debacle when the major currencies began to float, the link the SDR had with the gold value was snapped. Effective from 1974, the value of

SDR was linked to a basket of 16 principal currencies. In 1981, the composition of the basket was simplified by replacing the 16 currencies with those of the 5 major trading nations. The currencies and the weightage given in the valuation revised with effect from 1.1.1991 are : US Dollar (40%), Deutsche Marks (21%), Japanese Yen (17%), French Franc (11%), and Pound-sterling (11%). Since January 1, 1999, the share of Deutsche Mark and French Franc has been replaced by equivalent Euro. The IMF values SDRs in terms of the composition of the basket every day and announces the value of SDR in terms of US dollars.

When a member-country utilises SDRs, interest at 100% of the weighted average of the short-term rates prevailing in the above five countries is charged. The interest rate is revised every quarter. Similarly, for those with additional holdings of SDRs, than the allotment, interest at the same rate is paid.

❑ Utilisation

For the sake of convenience, with the establishment of SDRs, the accounts of the IMF are kept in two sets, the General Account and Special Drawing Account. The ordinary transactions of the IMF relating to quota subscriptions, repurchases and payment of charges are conducted through the General Account. Transactions related to SDRs are routed through the Special Drawing Account.

Originally SDRs were to be used only for meeting balance of payments deficits. It could be used only in any of the three ways prescribed. The *first* was transactions with designation. That is, when a country experiences a balance of payments deficit and requires other currencies it had to apply to the IMF. On receipt of such application, the IMF would designate another country with strong balance of payments and reserve position to accept SDRs from the deficit country and pay in exchange some currency. As already noted, participants were obliged to accept SDRs in this way as long as their holdings were less than three times their total allocations.

The *second* was the sales of SDRs for currency by arrangement with another participant, *i.e.*, without designation by the IMF. Such transactions by agreement were permitted only if the user of SDRs was redeeming balances of his own currency held by the other participant or if the Fund authorised the particular transaction or had made a general authorisation of that particular type of transaction. Generally, the country selling SDRs was subject to the requirement of a balance of payments deficit.

Thirdly, SDRs could be used in transactions with the Fund, for instance, in payment of charges to the Fund.

Due to later developments and as a consequence of endeavours to make SDRs an international unit of account, their use has been liberalised. Now SDRs can be used directly among the members without the approval of the IMF and without restriction relating to the balance of payments requirements. A country may swap SDRs with another country to acquire a currency it desires. SDRs can also be used to make and repay loans among governments and to serve as security for the performance of financial obligations. Besides, the IMF has authorised certain international institutions such as the Bank for International Settlements, International Bank for Reconstruction and Development, to hold SDRs. Currently, such institutional holders number 16.

SDR has gained importance both as a reserve asset and as means of settlement of international transactions. While SDRs cannot be transferred among private individuals, private parties do sometimes use the SDR as a standard of value. Few international banks accept time deposits designated in SDR. Fifteen member countries have pegged their currencies to SDR.

3.3. INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

Also known as World Bank, the IBRD is an offshoot of the Brettonwoods Conference of 1944. Its main function is to provide long-term capital assistance to its member-countries for their reconstruction and development. In its initial days, the World Bank concentrated on reconstruction of the war shattered European economies. Later the Bank shifted its focus and 'development' of the backward countries began to receive prime importance. As an inter-governmental agency for lending for development, the bank is mobilizing large-scale resources of private investors of the world's capital markets for investment in the developing countries.

❑ Functions

The main functions of the Bank are :

1. To assist in reconstruction and development of the territories of its member-governments by facilitating investment of capital for productive purposes ;
2. To promote foreign private investment by guarantees of or through participation in loans and other investments of capital for productive purposes ;
3. Where private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or out of the funds borrowed by it ; and
4. To promote the long-range growth of international trade and the maintenance of equilibrium in the balance of payments of members by encouraging international investment for the development of the productive resources of members.

The bank has adopted as its principal objective lending for productive projects which will lead to economic growth in its less developed member-countries.

❑ Lending Activities

The Bank can make or facilitate loans in any of the following ways :

(*i*) By making or participating in direct loans out of its own fund ;
(*ii*) By making or participating in direct loans out of funds raised in the market of a member, or otherwise borrowed by the bank ; and
(*iii*) By guaranteeing in whole or in part loans made by private investors through the usual investment channels.

In short, the Bank may make loans directly to member-countries or it may guarantee loans granted to member-countries. The Bank normally makes loans for productive purposes like agriculture and rural development, power, industry, transport, etc. The total amount of the loan granted by the Bank should not exceed 100% of its total subscribed capital and surplus. The interest rate charged by the bank is the estimated cost to the Bank of borrowing money for a comparable term in the market and is uniform without distinction being made among borrowers. In addition to interest, commission of 1% for the purpose of creating a special reserve against loss and 1/2% for administrative expenses are charged.

In guaranteeing loans, the Bank acts as a bridge between the donors and recipients of foreign aid for development. The Bank is continuously involved in the assessment of the creditworthiness of the recipients of aid and convinces the foreign investors that the political and economic climate for investment is favourable. It coordinates aid-giving activities of the Western countries. It has organised 'consortia' for centralising the flow of foreign aid so that the recipients of aid do not play one aid giver against the other. At the same time, it is actively involved in helping the developing countries to identify appropriate projects for development which can be financed by the world investors.

The Bank adopts the following policies in respect of its loans and guarantees :

(i) All loans are made to governments or they must be guaranteed by governments;
(ii) Repayment is to be made within ten to thirty-five years;
(iii) Loans are made only in circumstances in which other sources are not readily available;
(iv) Investigations are made of the probability of repayment, considering both the soundness of the project and the financial responsibility of the government;
(v) Sufficient surveillance is maintained by the Bank over the carrying out of the project to assure that it is relatively well executed and managed;
(vi) Loans are sanctioned on economic and not political considerations;
(vii) The loan is meant to finance the foreign exchange requirements of specific projects: normally the borrowing country should mobilise its domestic resources.

Two aspects of lending activities of the Bank deserve to be highlighted. *First*, since the Bank has to finance high-priority productive sectors of economies and determine 'creditworthiness' of the borrowers, it makes detailed studies through its Missions and Resident Representatives of the economy of the recipients of aid. The Bank's comprehensive and limited pre-investment surveys, which are financed either by the Bank or the UNDP, have created a situation where the headquarters of the Bank has become a 'monitoring' centre of the economies of the borrowing countries.

Secondly, the Bank's dependence for resources on capital markets of the world influences its economic and social philosophy which is based on the doctrine of 'free enterprise'.

❑ Organisation

IBRD is an inter-governmental organisation. Only governments of various countries can become its members. The total membership of the Bank at the end of June 2001 was 184. The management of Bank is on the same lines as that of IMF, with a Board of Governors, Executive Directors and a President. Of the 22 Executive Directors, 5 are nominated by the 5 biggest shareholders—USA, UK, FRG, Japan and France. Remaining directors are responsible for general operations of the Bank and meet every month. The President acts as the Chairman of the Board of Directors. The ultimate authority is the Board of governors in which all member-States are represented. Voting rights of the Governors and Executive Directors are proportionate to the share capital of the member-country which they represent. Therefore, the policies of the Bank tend to get influenced by the opinions of the largest shareholders.

❑ Resources

Resources of the Bank consist of the capital and borrowings. Initially the authorised capital of the World Bank was $ 10,000 million, divided into 100,000 shares of $ 100,000 each. Of the share capital—

(a) 2% is payable by the member-country in gold or US dollars. This portion is freely available for lending;
(b) 18% is payable in member's own currency. This portion is available for lending with the consent of the member whose currency is involved; and
(c) 80% is kept in reserve to be paid by the member when called.

Thus only 20% of each member's subscription is available to the Bank for lending activities. The balance 80% is serving as guarantee resources backing up the Bank's borrowing operations in international markets.

Besides lending activities, the Bank renders a variety of technical assistance involving full-scale economic survey of the development potential of member-countries or advice on particular projects. It has done a useful function in settlement of international economic problems such as nationalisation of the Suez Canal. Most of its lendings have gone to developing countries, India being the single largest borrower. But, it is pointed out that difficulties are faced by developing countries in obtaining finance from it. The Bank's policy of requiring guarantee from the government or the central bank of the country for loans granted to private enterprises has also been hindering large-scale assistance to private enterprises.

The interest rate charged is said to be high in comparison with the returns from the projects for which the loans are made. However, it cannot be denied that the Bank has been rendering a useful service especially for the economic development of developing countries.

3.4. INTERNATIONAL FINANCE CORPORATION

The IBRD loans are available only to member-country governments or with the guarantee of member-country governments. Further, IBRD can only make a loan but it cannot participate in the equity of the project finance. The International Finance Corporation (IFC) was established in 1956 with the specific purpose of financing private enterprise. It is an affiliate of the IBRD.

❑ Organisation

Only members of the World Bank can become members of IFC. The Board of Governors of the IBRD also constitutes the Board of Governors of the IFC. But it is a separate entity with funds kept separate from those of the IBRD.

The powers of IFC are vested in the Board of Governors which normally meets once in a year. The 22 Executive Directors of the World Bank constitute the Board of Directors of the IFC, responsible for its general operations. The president of IBRD is the Ex-officio chairman of the Board of Directors of IFC. The day-to-day operations are conducted under the direction of the Executive Vice-President.

❑ *Functions*

The purpose of the IFC is to further the economic development by encouraging growth of private enterprise in member-countries, particularly in the less developed areas, thus supplementing the activities of the IBRD. The IFC, therefore,

1. invests in private enterprise in member-countries, in association with private investors and without government guarantee, in cases where sufficient private capital is not available on reasonable terms;
2. seeks to bring together investment opportunities, private capital of both foreign and domestic origin, and experienced management ; and
3. stimulates conditions conducive to the flow of private capital, domestic and foreign, into productive investments in member-countries.

The IFC makes advances in the form of long-term loans or invests in the equity shares in a wide variety of productive private enterprises in developing countries. It particularly encourages joint ventures between developed and developing countries, the technical skill available with the former combining with the resources available with the latter. The project which IFC proposes to assist should be an economically viable unit and beneficial to the economy of the member-country. Normally the financial assistance from the IFC for a unit would not be less than $ 1 million and not more than $ 100 million. Further, IFC's investment normally does not exceed 50% of the total investment of the enterprise. In case of its investment by equity contribution, it does not exceed 25% of the share capital. The interest charged on advances varies depending upon the proposal and stature of the borrower.

Besides direct lending and participation in equity capital, IFC also undertakes certain developmental activities. The activities include :

(i) Project identification and promotion. IFC undertakes country-sector studies to identify the types of business which have the potential to develop the economy of a country and promotes such sectors identified by the countries themselves. It also helps the individual entrepreneurs in preparation of feasibility studies for projects identified by them.
(ii) It helps the member-countries to establish and improve privately owned development finance companies and other institutions which are themselves engaged in promoting and financing private enterprise.
(iii) Encouraging the growth of capital markets in the developing countries. This it does by (a) providing support to financial institutions in developing countries to meet their investment needs, and (b) by promoting the investors in developed countries to participate in these capital markets.
(iv) Giving advice and technical counsel to developing countries in measures that will create a climate conducive to the growth of private investment.

❑ Resources

The resources of IFC consist of capital contributed by its members and accumulated reserves. It can also borrow from the World Bank for the purpose of lending an amount equal to four times its unimpaired subscribed capital and surplus.

❑ Evaluation

The IFC had a slow beginning and much of its assistance was concentrated in Latin and Central American countries. But in recent years it has diversified its area of operations and many developing countries stand benefited. India has also received substantial assistance from IFC.

3.5. INTERNATIONAL DEVELOPMENT ASSOCIATION

The International Development Association (IDA) is an affiliate of the IBRD. It was established in 1960 to provide 'soft loans' to economically sound projects which create 'social capital' such as the construction of roads and bridges, slum clearance and urban development. The projects taken up by the IDA are such that fall under the category of 'high development priority' due to their benefit on the development on the area concerned, but the returns from the projects are not sufficient to pay the high rates of interest on borrowings. The IDA provides loans for such projects interest free and for longer periods. Therefore, IDA, is often referred to as the 'soft loan window' of the World Bank.

❑ Functions

The IDA extends assistance to high priority projects in the member-countries. The finance may be made available to the member-governments or to the private enterprise. Advances to private enterprises may be made without government guarantees. It also co-operates with other international institutions and member-countries in providing financial and technical assistance to the less developed countries.

The financial assistance of the IDA has some special features :

(a) The credit is interest free. Only a small service charge of 0.75% per annum is payable on the amount withdrawn and outstanding to cover administrative expenses.
(b) Repayment period is long extending over 50 years. There is an initial moratorium for 10 years and the amount borrowed is repayable in the next 40 years.
(c) IDA finances not only the foreign exchange component but also a part of the domestic cost.
(d) The credit can also be repaid in the local currencies of borrowing countries. Thus the repayment of loan does not burden the balance of payments of the country.

❑ Organisation and Resources

All the members of the IBRD are eligible to become members of IDA. The Board of Governors and Executive Director of the IBRD are also ex-officio Board of Governors and Executive Directors of IDA. However, IDA is a separate entity distinct from the IBRD.

The members of the Association are grouped into two. Part I list consists of *industrially developed countries whose subscriptions can be freely used or who are required to contribute 10% of their subscription in the form of other currencies and the rest in their own currencies. Contributions in the form of* national currencies by these countries are not to be used by the IDA for conversion to other currencies or for financing exports from these countries without the consent of the country concerned.

❑ Evaluation

IDA has been a blessing for the developing countries to whom the credit from the IDA has largely gone. In keeping with the objectives, most of the assistance has gone to high development priority projects which could not get finance from other sources. India has immensely benefited from the IDA ; it has been receiving a series of loans, almost continuously.

3.6. MULTILATERAL INVESTMENT GUARANTEE AGENCY

The World Bank established the Multilateral Investment Guarantee Agency (MIGA) in 1988 as its affiliate aimed at encouraging foreign investment in developing countries by issuing guarantees against non-commercial risks. The membership is open to all World Bank members. Current membership is 157.

MIGA provides guarantee to private investors against the risk of transfer restriction (including inconvertibility), expropriation, war and civil disturbance and breach of contract.

Generally, investors from member country, other than the host country[2] are eligible for guarantees. However, MIGA may insure an investment made by a national of a host country if the funds to be invested come from outside the country and the application of coverage is made jointly by the investor and the host country. MIGA also insures investments made by state-owned enterprises if they operate on a commercial basis. The guarantee is available for periods up to 15 years, and occasionally up to 20 years. The guarantee coverage requires investors to adhere to social and environmental standards that are considered to be the world's best.

Since inception MIGA has issued more than 500 guarantees for projects in 78 developing countries. As of June 2001, total coverage issued exceeded USD 9 billion.

3.7. ASIAN DEVELOPMENT BANK

Asian Development Bank (ADB) is a development bank started in 1966 under the aegis of ECAFE (United Nations Economic Commission for Asia and Far East). Its membership consists of countries from Asian region as well as from other regions. There are 61 members of which 44 countries are from Asia-Pacific region and 17 countries are from Europe and North America.

❑ Functions

The main purposes and functions of ADB are to :

1. promote investment in the ECAFE region of public and private capital for development purposes ;
2. utilise the available resources for financing development, giving priority to those regional and sub-regional as well as national projects and programmes which will contribute most effectively to the harmonious economic growth of

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2 The country where the investment is made.

the region as a whole, and having special regard to the needs of the smaller or less developed member-countries in the region ;

3. meet requests from members in the region to assist them in coordination of their development policies and plans with a view to achieving better utilisation of their resources making their economies more complementary, and promoting the orderly expansion of their foreign trade, in particular, intra regional trade ;
4. provide technical assistance for preparation, financing and execution of development projects and programmes, including the formulation of specific proposals ;
5. to co-operate with the United Nations and its organs and subsidiary bodies, including, in particular, ECAFE and with public international organisations and other international institutions, as well as national entities whether public or private, and to interest such institutions and entities in new opportunities for investment and assistance ; and
6. undertake such other activities and to provide such other services as may advance its purpose.

ADB finances principally specific projects in the region. It also provides programme, sector and multi-project loans. It may make loans to or invest in the project concerned. It may also guarantee loans granted to the projects. Most of the loans granted are hard loans or tied loans. However, loans from special funds set aside by the ADB up to 10% of its paid-up-capital are granted under soft loan terms. Soft loans are normally granted to projects of high development priority and requiring longer periods of repayment with lower rates of interest. ADB normally finances foreign exchange cost of the project and the loan is repayable in the currency in which it is made.

❑ Organisation

The Bank's highest policy-making body is the Board of Governors which meets annually. The direction of the Bank's general operations is the responsibility of the Board of Directors composed of 12 directors—eight representing regional countries and four representing non-regional countries. The President of the Bank, elected by the Board of Governors, is also the Chairperson of the Board of Directors.

❑ Resources

The financial resources of ADB consist of ordinary capital resources, comprising subscribed capital, reserves and funds raised through borrowings; and Special Funds, comprising contributions made by member-countries and amounts previously set aside from the paid-up capital. Loans from ordinary capital resources, which account for almost 69 per cent of Bank lending, are generally made to member-countries which have attained a somewhat higher level of economic development. Loans from Special Funds, which are administered in the Asian Development Fund, are made almost exclusively to the poorest borrowing countries on highly concessional terms.

❑ Evaluation

ADB has become a major catalyst in promoting the development of the most populous and fastest growing region in the world today. With the growing need for larger and more diversified inflows of capital to the region, the Bank is actively expanding its co-financing activities, with official as well as commercial and export credit sources. The Bank has also entered into equity investment operations. India is the second largest subscriber, after Japan, among the regional members and third largest among all members, after Japan and USA.

4 Administration of Foreign Exchange

Foreign exchange was considered a rare commodity and was subject to strict control in almost all countries of the world till 1970s. Exchange control was the order of the day. Today we talk of exchange management and not exchange control. But the fact is that foreign exchange management from the national point of view is only exchange control or regulation, though in a diluted form.

The term 'exchange control' refers to the control, by the Government or a centralised agency of transactions involving foreign exchange. In a broad sense, any stipulation or regulation which restricts the free play of forces in the exchange market can be termed exercise of exchange control. The rate of exchange under exchange control regime tends to be different from the one that would exist in the absence of such control.

The origin of exchange control can be traced to nineteen-thirties. After the First World War, many countries of Europe found themselves with depleted gold reserves and foreign exchange. They imposed payment restrictions to prevent massive capital withdrawals and instil stability in the domestic economy. Since then exchange control has been adopted by a large number of countries and for different purposes.

With the onset of globalisation and liberalisation beginning at the commencement of 1990s, the tendency throughout the world has been that of relaxing exchange control. Even earlier, some countries like USA proclaimed that they had no exchange control. But the fact is even today exchange control exists in all countries, with varying intensity.

4.1. HISTORY OF EXCHANGE CONTROL IN INDIA

Exchange control was introduced in India on September 3, 1939 on the outbreak of the Second World War by virtue of the emergency powers derived under the financial provisions of the Defence of India Rules, mainly to conserve the non-sterling area currencies and utilise them for essential purposes. In the closing stages of the War, it became clear that control over foreign exchange transactions would have to continue in some form or the other in the post-war period in the interest of making the most prudent use of the foreign exchange resources. It was, therefore, decided to place the control on a statutory basis and the Foreign Exchange Regulation Act of 1947 was enacted.

It was found necessary to continue exchange control introduced during the Second World War on a systematic and long-term basis, in view of the substantial requirements of foreign exchange for the planned developmental efforts undertaken. Over the years, the scope of exchange control in India has steadily widened and the regulations have become progressively more elaborate with the increasing foreign exchange outlays under successive Five-Year Plans and the relatively inadequate earnings of foreign exchange. Periodically, appraisals and reviews of policies and procedures have been undertaken and such modifications made as are warranted by changes in the national policies and priorities, and fluctuations in the level of foreign exchange reserves caused by both national and international economic and other developments. Under these circumstances the Foreign Exchange Regulation Act, 1973 was passed to replace the Act of 1947. *The purpose of the enactment was to consolidate and amend the law regulating certain payments, dealings in foreign exchange and securities, transactions indirectly affecting foreign exchange and the import and export*

of currency and bullion, for the conservation of the foreign exchange resources of the country and the proper utilisation thereof in the interest of the economic development of the country.

The Foreign Exchange Regulation Act, 1973 (FERA) was reviewed in 1993 and several amendments were enacted as part of the on-going process of economic liberalisation relating to foreign investments and foreign trade for closer interaction with the world economy. At that stage, the Central Government decided that a further review of the Foreign Exchange Regulation Act would be undertaken in the light of subsequent developments and experience in relation to foreign trade and investment. It was subsequently felt that a better course would be to repeal the existing Foreign Exchange Regulation Act and enact a new legislation. Reserve Bank of India was accordingly asked to undertake a fresh exercise and suggest a new legislation. A Task Force constituted for this purpose submitted its report in 1994 recommending substantial changes in the existing Act.

Significant developments took place after 1993 such as substantial increase in our foreign exchange reserves, growth in foreign trade, rationalisation of tariffs, current account convertibility, liberalisation of Indian investments abroad, increased access to external commercial borrowings by Indian corporates and participation of foreign institutional investors in our stock markets. This needed a change in the outlook of the statute governing the foreign exchange transactions from one of control and conservation to that of encouragement and promotion. The Foreign Exchange Management Act, 1999 was introduced to provide the necessary change.

4.2. FOREIGN EXCHANGE MANAGEMENT ACT, 1999

The Foreign Exchange Management Act, 1999 (FEMA) seeks to bring the law on the subject up to date keeping in view the changed environment. This Act *aims at consolidating and amending the law relating to Foreign Exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange markets in India.* The important features noticed in the new Act as compared with the previous one are:

1. The seriousness of non-compliance with the regulation is diluted. It is only of civil and no criminal consequence.
2. The nature of current account and capital account transactions has been clearly defined.
3. The new enactment is positive in the sense that all current account transactions not otherwise restricted can be freely carried on.
4. The definition of residents and non-residents take into account the duration of their stay in India, as in the case of Income Tax Act.

❑ An Overview of Provisions

Important provisions of the Foreign Exchange Management Act (the Act) are summarised below:

Section 2 defines the various expressions used in the Act.

Section 3 seeks to prohibit dealings in foreign exchange except through an authorised person.

Section 4 describes the provisions in relation to acquisition, holdings, etc., of foreign exchange, foreign security or immovable property situated outside India.

Section 5 stipulates that sale or drawal of all current account transactions shall qualify for drawal of foreign exchange from authorised persons. It also empowers the Central Government to prescribe, in public interest and in

consultation with the Reserve Bank, the restrictions for such transactions as may be considered reasonable.

Sub-section (1) of *Section 6* provides that subject to certain conditions and limitations any person may sell or draw foreign exchange to or from any authorised person for capital account transaction. Sub-section (2) thereof enables the Reserve Bank in consultation with the Central Government to specify the permissible class of such transactions and the limits up to which foreign exchange shall be admissible for such transactions. Sub-section (3) further enables the Reserve Bank to prohibit, restrict or regulate the specific transactions mentioned therein by regulations framed under the Act.

Sub-sections (4) and (5) incorporate the existing policy with respect to the person resident in India acquiring, etc., foreign assets outside India and a non-resident acquiring, etc., assets in India while he was resident in India.

Sub-section (6) empowers the Reserve Bank to regulate the setting up of branches or offices in India by foreign firms.

Section 7 provides for control over repatriation of sale proceeds of exported goods. The section preserves the Reserve Bank's existing powers to direct and exporter to comply with the requirements as deemed fit for the purpose of ensuring that the export value of the goods is received without any delay.

Section 8 casts certain obligations on persons resident in India having any amount of foreign exchange due to accrued in his favour.

Section 9 seeks to provide for exemptions in respect of realisation and repatriation in the cases specified therein. Most of the transactions specified therein are at present exempted in terms of various notifications of the Reserve Bank.

Section 10 empowers the Reserve Bank to authorise persons to deal in foreign exchange or in foreign securities. The authorisation can also be granted top dealing in foreign securities besides foreign exchange. The Reserve Bank specify the conditions in the authorisation and may also revoke the same in the public interest in the case of any contravention of the provisions of this Act or failure to comply with the conditions in the authorisation.

Section 11 empowers the Reserve Bank to issue directions to authorised persons and impose penalty if the direction given by the Reserve Bank is contravened by any authorised person.

Section 12 empowers the Reserve Bank to inspect the authorised person who shall have to produce such books, accounts and other documents, etc., as may be required by the officer making the inspection.

Section 13 deals with the contraventions as civil offences and the adjudicating officers are empowered to impose penalties.

Section 14 lays down the procedure for payment of penalty and the consequences of civil imprisonment for failure to make full payment of the penalty within the specified period. It provides that the detention order shall be executed like a warrant of arrest.

Section 15 seeks to vest in the Directorate of Enforcement the powers to compound offences. This power is to be exercised in accordance with the rules framed by the Central Government.

Section 16 provides for appointment of Central Government officers as Adjudicating Authorities for holding an enquiry for the purpose of imposing any penalty. It also provides for the procedure for taking cognisance by the Adjudicating Authority and confers powers of a civil court on the said authority.

Section 17 provides for establishment of one or more Special Directors (Appeals) to hear appeals against the orders of Adjudicating Authorities.

Section 18 provides for establishment of an Appellate Tribunal to hear appeals against the orders of the Adjudicating Authorities and Special Director (Appeals).

Section 34 bars the jurisdiction of the civil court in respect of matters to be dealt with by Adjudicating Authority or by the Appellate Tribunal.

Section 35 provides for filing an appeal to the High Court against the decision or order of the Appellate Tribunal on a question of law arising out of such decision or order.

Section 36 provides foe establishment of a Directorate of Enforcement.

Sub-section (2) of *Section 38* provides that a Director of Enforcement and other officers of the enforcement shall have the powers of investigation conferred in Income tax authorities under the Income-tax Act, 1961.

Section 46 empowers the Central Government to frame the rules and *Section 47* empowers the Reserve Bank to make regulations to carry out the provisions of this enactment.

Section 49 provides for repeal of the Foreign Exchange Regulation Act, 1973 and for dissolution of the Appellate Board constituted under section 52 of the said Act.

❑ Rules and Regulations Notified under FEMA

For the implementation of various provisions of FEMA the Central Government have issued notifications notifying various rules formed under the Act. They are listed below:

1. Foreign Exchange Management (Encashment of Draft, Cheque, Instrument and Payment of Interest) Rules, 2000.
2. Foreign Exchange (Authentication of Documents) Rules, 2000.
3. Foreign Exchange Management (Current Account Transactions) Rules, 2000.
4. Foreign Exchange Management (Adjudication Proceedings and Appeals) Rules, 2000.
5. Foreign Exchange (Compounding Proceedings) Rules, 2000.

The Reserve Bank of India issued several regulations relating to FEMA, most of them relating to capital account transactions:

1. Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000.
2. Foreign Exchange Management (Issue of Security in India by a Branch, Office or Agency of a Person Resident Outside India) Regulations, 2000.
3. Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000.
4. Foreign Exchange Management (Borrowing and Lending in Rupees) Regulations, 2000.
5. Foreign Exchange Management (Deposit) Regulations, 2000.
6. Foreign Exchange Management (Export and Import of Currency) Regulations, 2000.
7. Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2000.
8. Foreign Exchange Management (Guarantees) Regulations, 2000.
9. Foreign Exchange Management (Realisation, Repatriation and Surrender of Foreign Exchange) Regulations, 2000.
10. Foreign Exchange Management (Foreign Currency Accounts by a Person Resident in India) Regulations, 2000.
11. Foreign Exchange Management (Possession and Retention of Foreign Currency) Regulations, 2000.
12. Foreign Exchange Management (Insurance) Regulations, 2000.
13. Foreign Exchange Management (Remittance of Assets) Regulations, 2000.
14. Foreign Exchange Management (Manner of Receipt and Payment) Regulations, 2000.

15. Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2000.
16. Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.
17. Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000.
18. Foreign Exchange Management (Establishment in India of Branch or Office or other Place of Business) Regulations, 2000.
19. Foreign Exchange Management (Investment in Firm or Proprietary Concern in India) Regulations, 2000.
20. Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000.

❑ Current Account Transactions

The terms 'current account' and 'capital account' are used in the context of balance of payments of a country. Current account transactions are those relating to export and import of services, income on investments and unilateral payments (gifts, remittances for family maintenance etc.). Capital account transactions relate to changes in assets and liabilities abroad held by residents and changes in assets and liabilities in India of non-residents.

According to FEMA, current account transaction means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transactions includes:

(i) payments due in connection with foreign trade, other current business, services and short term banking and credit facilities in the ordinary course of business;
(ii) payments due as interest on loans and as net income from investments;
(iii) remittances for living expenses of parents, spouses and children residing abroad, and
(iv) expenses in connection with foreign travel, education and medical care of parents, spouse and children.

Under section 5 of FEMA, the Government of India, in public interest and in consultation with Reserve Bank is empowered to impose reasonable restrictions on certain current account transactions. Subject to these restrictions, any person may sell or draw foreign exchange to or from an authorised dealer if such sale or withdrawal is a current account transaction.

Government of India have framed the Foreign Exchange Management (Current Account Transactions) Rules, 2000 in terms of which drawal of exchange for certain transactions has been prohibited and restrictions have been placed on certain transactions.

Prohibited Transactions

The following transactions are prohibited in terms of Rule 3:

1. Travel to Nepal or Bhutan.
2. Transactions with a person resident in Nepal or Bhutan (Unless specifically exempted by Reserve Bank by general or special order).
3. Remittance out of lottery winnings.
4. Remittance of income from racing/riding etc. or any other hobby.
5. Remittance for purchase of lottery tickets, banned/proscribed magazines, football pools, sweepstakes etc.
6. Payment of commission on exports made towards equity investment in Joint Ventures/Wholly owned Subsidiaries abroad of Indian companies.
7. Remittance of dividend by any company to which the requirement of dividend balancing is applicable.

8. Payment of commission on exports under Rupee State Credit Route.
9. Payment related to "call back services" of telephones.
10. Remittance of interest income on funds held in Non-resident Special Rupee Scheme account.

Approval of Central Government. Prior approval of Government of India is required in the following cases. However, no such approval is required if the payment is made out of funds held in Resident Foreign Currency or Exchange Earners Foreign Currency account of the remitter:

Purpose of remittance	*Ministry/Department of Government of India whose approval is required*
1. Cultural Tours	Ministry of Human Resources Development (Department of Education and Culture)
2. Advertisement in foreign print media for the purpose other than promotion of tourism, foreign investment and international bidding exceeding (USD 10,000) by any State Government or its PSU	Ministry of Finance (Department of Economic Affairs)
3. Remittance of freight of vessel chartered by a PSU	Ministry of Surface Transport (Chartering Wing)
4. Payment of import by a Govt. department or a PSU on CIF basis (i.e., other than FOB and FAS basis)	Ministry of Surface Transport (Chartering Wing)
5. Multi-modal transport operators making remittance to their agencies abroad	Registration certificate from the Director General of Shipping
6. Remittance of hiring charges of transponders	Ministry of Finance (Department of Economic Affairs)
7. Remittance of container detention charges exceeding the rate prescribed by Director General of Shipping	Ministry of Surface Transport (Director General of Shipping)
8. Remittances under technical collaboration agreements where payment of royalty exceeds 5% on local sales and 8% on exports and lump sum payment exceeds USD 2 million.	Ministry of Industry and Commerce
9. Remittance of prize money/ sponsorship of sports activity abroad by a person other than Inter-national/National/State Level sports bodies, if the amount involved exceeds USD 1,00,000	Ministry of Human Resource Development (Department of Youth Affairs and Sports)
10. Payment for securing insurance for health from a company abroad	Ministry of Finance (Insurance Division)
11. Remittance for membership of P & I Club	Ministry of Finance (Insurance Division)

Prior Approval of Reserve Bank

In respect of the following transactions prior approval of the Reserve Bank should be obtained. The restriction is not applicable if the payment is made out of funds held in Resident Foreign Currency Account or Exchange Earners Foreign Currency Account of the remitter:

1. Remittance by artiste, e.g., wrestler, dancer, entertainer etc. (This restriction is not applicable to artistes engaged by tourism related organisations in India like ITDC, State Tourism Development Corporations etc. during special festivals or those artistes engaged by hotels in five star categories, provided the expenditure is met out of EEFC account).
2. Release of exchange exceeding USD 5,000 or its equivalent in one calendar year, for one or more private visits to any country (except Nepal and Bhutan).
3. Gift remittance exceeding USD 5,000 per remitter/donor per annum.
4. Donation exceeding USD 5,000 per remitter/donor per annum.
5. Exchange facilities exceeding USD 5,000 for persons going abroad for employment.
6. Exchange facilities for emigration exceeding USD 5,000 or amount prescribed by country of emigration.
7. Remittance for maintenance of close relatives abroad exceeding USD 5,000 per annum per recipient.
8. Release of foreign exchange exceeding USD 25,000 to a person, irrespective of period of stay, for business travel, or attending a Conference or specialised training or for maintenance expenses of a patient going abroad for medical treatment or check-up abroad, or for accompanying as attendant to a patient going abroad for medical treatment/check-up.
9. Release of exchange for meeting expenses for medical treatment abroad exceeding the estimate from the doctor in India or hospital/doctor abroad.
10. Release of exchange for studies abroad exceeding the estimates from the institution abroad or USD 30,000, whichever is higher.
11. Commission to agents abroad for sale of residential flats/commercial plots in India, exceeding 5% of the inward remittance.
12. Short term credit to overseas offices of Indian companies.
13. Remittance for advertisement on foreign television by a person whose export earnings are less than Rs. 10 lakhs during each of the preceding two years.
14. Remittances of royalty and payment of lump sum fee under the technical collaboration agreement which has not been registered with Reserve Bank.
15. Remittances exceeding USD 1,00,000 per project for any consultancy service procured from abroad.
16. Remittance for use and/or purchase of trade mark/franchise in India.
17. Remittance exceeding USD 1,00,000 by an entity in India by way of reimbursement of pre-incorporation expenses.

Clarifications by Reserve Bank Reserve Bank clarified that:

(i) The existing procedure to be followed by Indian companies for entering into collaboration arrangements with overseas collaborators would continue.

(ii) There would be no restriction regarding receipt of advance payment or back to back letter of credit for merchanting trade transactions.

(iii) Approval of Reserve Bank would be required for importers availing of supplier's credit beyond 180 days and buyer's credit irrespective of the period of credit.

❑ Capital Account Transactions

As against the liberal provisions for current account transactions, the capital account transactions are still restricted. Section 6 provides that Reserve Bank may, in consultation with the Central Government, specify the classes of and the limits for capital account transactions which are permissible. Reserve Bank has been empowered to frame regulations in respect of:

(a) transfer or issue of any foreign security by a resident;
(b) transfer or issue of any security by a non-resident;
(c) transfer or issue of any security or foreign security by any branch, office or agency in India of a non-resident;
(d) any borrowing or lending in foreign exchange;
(e) any borrowing or lending in rupees between a resident and non-resident;
(f) deposits between residents and non-residents;
(g) export, import or holding of currency or currency notes;
(h) transfer of immovable property outside India, other than by lease up to 5 years, by a resident;
(i) acquisition or transfer of immovable property in India, other than a lease not exceeding 5 years, by a non-resident;
(j) giving of a guarantee in respect of any debt, obligation or other liability incurred (*i*) by a resident and owed to a non-resident, or (*ii*) by a non-resident.

Reserve Bank has issued regulations specifying the capital transactions permitted. The transactions permitted generally fall under the categories of non-resident deposits and non-resident investments, which are discussed in a subsequent chapter.

4.3. ADMINISTRATIVE SET-UP

The Central Government has been empowered under Section 46 of the Foreign Exchange Management Act to make rules to carry out the provisions of the Act. Similarly, Section 47 empowers the Reserve Bank to make regulations to carry out the provisions of the Act and the rules made thereunder. Further, Section 41 provides that the Central Government may, from time to time, give to the Reserve Bank such general or special directions as it thinks fit, and the Reserve Bank shall comply with such directions. Thus, ultimately the Reserve Bank has been charged with the powers as well as the responsibility to administer foreign exchange in India.

❑ Authorised Persons

While the Reserve Bank has the authority to administer foreign exchange in India, it is recognised that it cannot do so by itself. Foreign exchange is received or required by a large number of exporters and importers in the country spread over a vast geographical area. It would be impossible for the Reserve Bank to deal with them individually. Therefore, provision has been made in the Act (Section 10), enabling the Reserve Bank to authorise any person to be known as authorised person to deal in foreign exchange or in foreign securities, as an authorised dealer, money changer or off-shore banking unit or in any other manner as it deems fit.

An authorised person should comply with the general or special directions or orders of the Reserve Bank in all his foreign exchange dealings. Before undertaking any transaction in foreign exchange, he should obtain from his customer such declaration and information as to ensure that the provisions of the Act are not violated. Where the authorised person is not satisfied he should refuse in writing to undertake the transaction. If he has a reason to believe that any contravention

or evasion of the regulations is contemplated, he should report the matter to Reserve Bank.

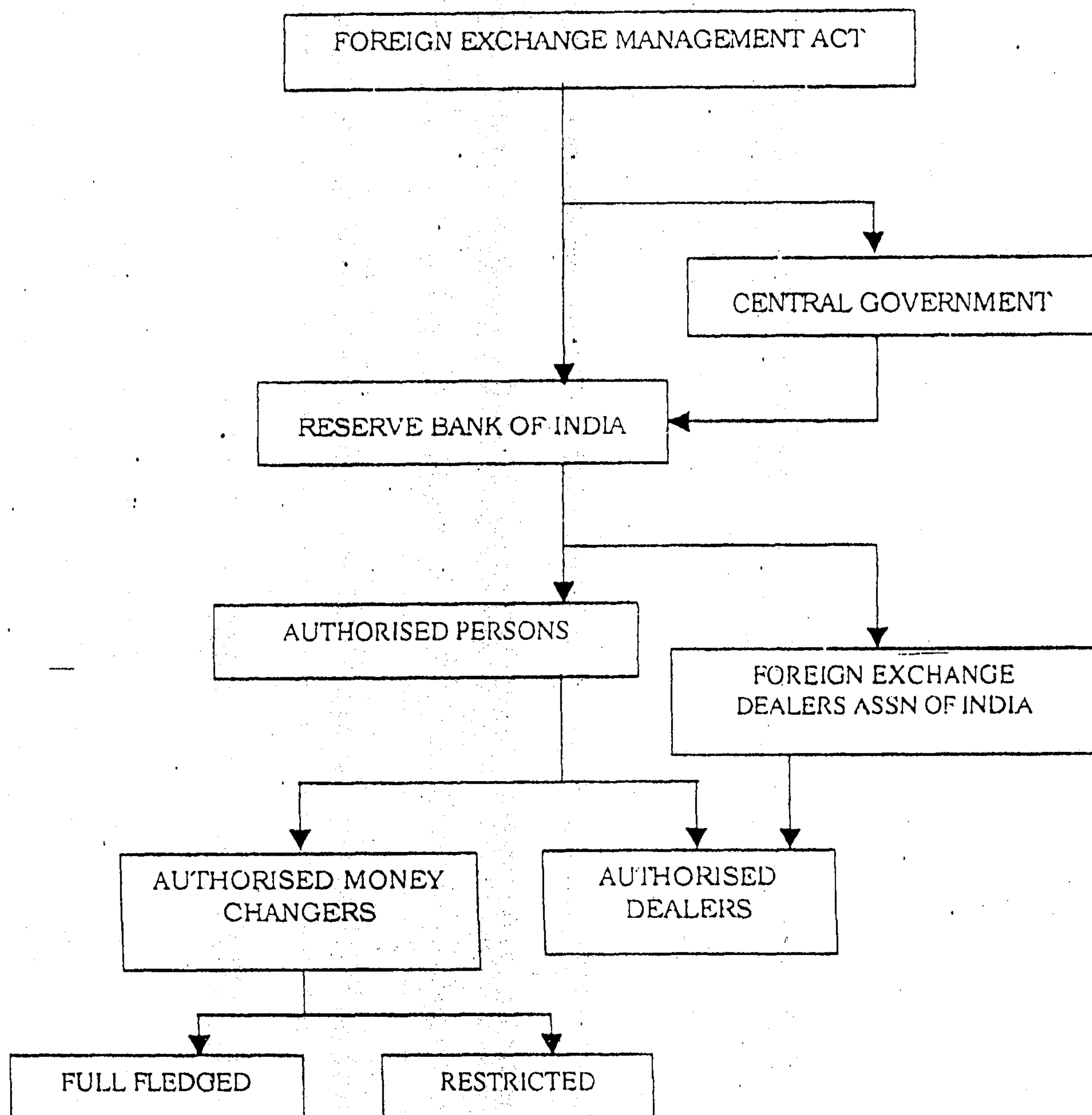

Fig. 4.1. Administration of Foreign Exchange in India.

❑ Authorised Dealers

A major portion of actual dealing in foreign exchange from the customers (importers, exporters and others receiving or making personal remittances) is dealt with by such of the banks in India which have been authorised by the Reserve Bank to deal in foreign exchange. Such of the banks and select financial institutions who have been authorised to deal in foreign exchange by the Reserve Bank are known as authorised dealers.

An authorised dealer should comply with the directions and instructions of the Reserve Bank given from time to time. While FERA was in force, such directions of standing nature were available in the Exchange Control Manual (latest 1993 edition)

issued by the Reserve Bank. All amendments to the Exchange Control Manual were being intimated to authorised dealers by the Reserve Bank in the form of its AD (MA Series) circulars. Further, general and procedural directions were given in the form of its AD (GP Series) circulars. With the coming into effect of the FEMA, the Reserve Bank has issued a series of regulations under the Act. For the time being, the Reserve Bank has also indicated certain provisions in the Exchange Control Manual which will continue to be effective. Amendments to the extant provisions are now communicated in the form of AP (DIR Series) Circulars.

Section 10 of FEMA requires the authorised dealer to obtain declarations and information from the customers as to ensure that the provisions of the Act are not violated. The provision is similar to the one under FERA. Under FERA regime, Reserve Bank has specified the respective documents to be obtained by authorised dealers for various requirements of the Act. These documents are incorporated in the Exchange Control Manual. Now Reserve Bank has advised the authorised dealers to keep on record any information/documentation on the basis of which the transaction was undertaken for verification by Reserve Bank. Authorised dealers are to devise their own formats for these. For some time to come, banks will continue to use the forms prescribed by Reserve Bank earlier.

With regard to charging of commission, quotation of rates, etc., the authorised dealer should also comply with the rules of Foreign Exchange Dealers Association of India (FEDAI).

❑ Foreign Exchange Dealers' Association of India

FEDAI was established in 1958 as an association of all authorised dealers in India. All authorised dealers, currently numbering over 70, are its members. It has its headquarters at Mumbai and local offices at Bangalore, Kolkata, Chennai and New Delhi. The affairs of FEDAI are managed by a Managing Committee at the Head Office and respective Local Committees at local offices. The Committees are represented equally by banks incorporated in India and outside India. The principal functions of FEDAI are:

(a) To frame rules for the conduct of foreign exchange business in India. These rules cover various aspects like hours of business, charges for foreign exchange transactions, quotation of rates to customers, interbank dealings, etc. All authorised dealers have given undertakings to the Reserve Bank to abide by these rules. Provisions of FEDAI rules have been considered at appropriate places in the relevant chapters of this book.

(b) To coordinate with Reserve Bank of India in proper administration of exchange control.

(c) To circulate information likely to be of interest to its members. (Information of international trade received from organisations like the International Chamber of Commerce is passed to the members. It also acts as a clearing house for exchange of information among members.)

Thus, FEDAI provides a vital link in the administrative set-up of foreign exchange in India. It is the mouthpiece of the authorised dealers, representing their views to the Reserve Bank and other international agencies.

❑ Authorised Money Changers

To provide facilities for encashment of foreign currency for tourists, etc., Reserve Bank has granted limited licences to certain established firms, hotels and other organisations permitting them to deal in foreign currency notes, coins and travellers' cheques subject to directions issued to them from time to time. These firms and organisations are called 'authorised money changers'. An authorised money changer may be a 'full-fledged money changer' or a 'restricted money changer'. A full-fledged money changer is authorised to undertake both purchase and sale

transactions with the public. A restricted money changer is authorised only to purchase foreign currency notes, coins and travellers' cheques subject to the condition that all such collections are surrendered by him in turn to an authorised dealer in foreign exchange. The current thinking of the Reserve Bank is to authorise more establishments as authorised money changers in order to facilitate easy conversion facilities.

4.4. ORGANISATION OF AN AUTHORISED DEALER

Foreign exchange is a highly specialised business and is, therefore, concentrated in selected branches of the bank. In most banks, the decision-making is done at the corporate level. The Foreign Exchange Department, also called the International Banking Division or International Division, is headed by a senior executive of the bank. An indepth knowledge of the rules and regulations of foreign exchange business in particular and banking in general and high level of awareness of the happenings in the international economic and political arena is expected from the Executive heading the department. Since foreign exchange business requires quick decisions, the Executive is vested with enough powers to take decisions on most of the situations that would arise in the dealings of the bank. Matters involving very large amounts and those beyond the discretionary powers of the Executive are referred to the Chief Executive of the bank or its Board of Directors.

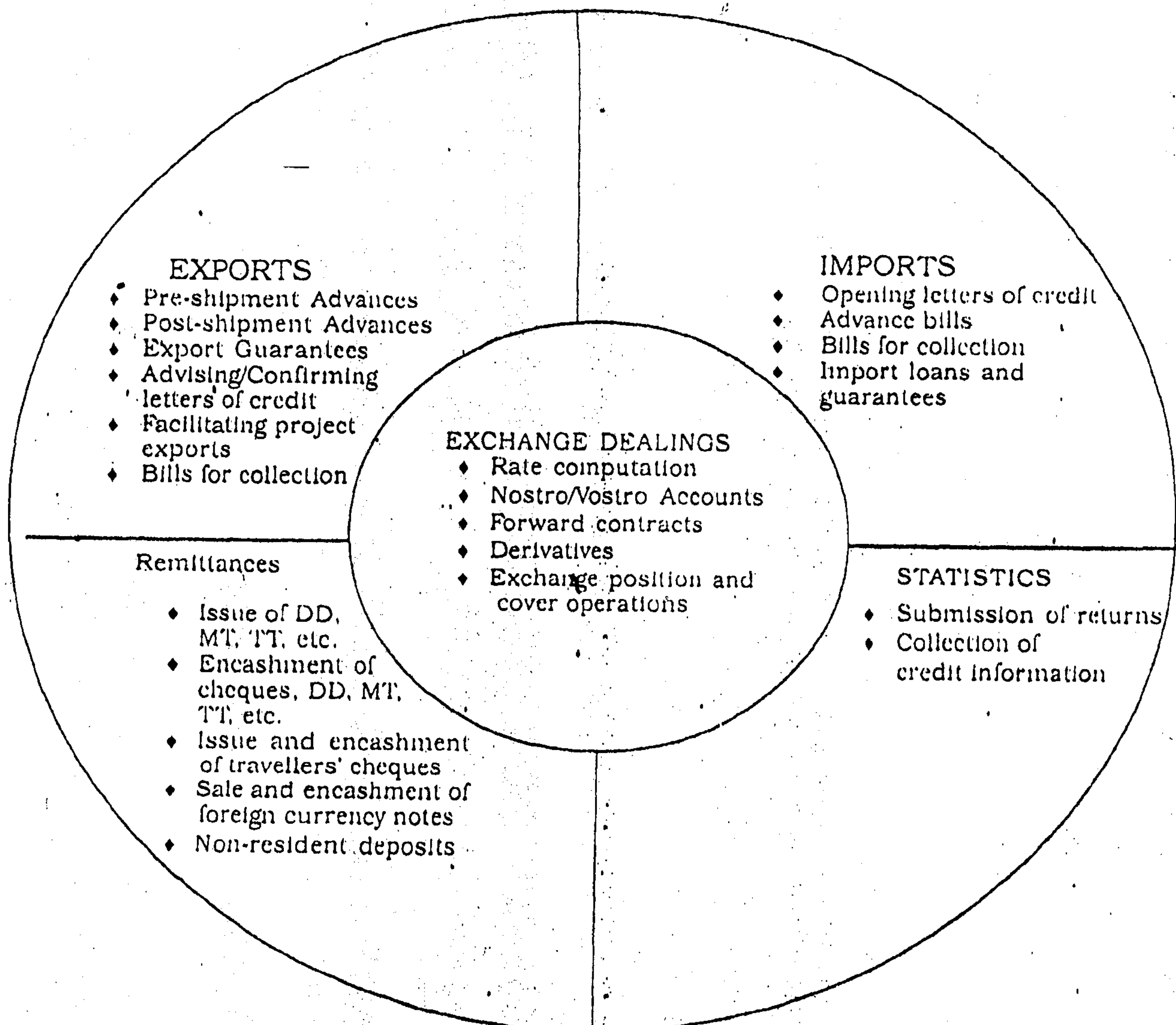

Fig. 4.2. Functions of a Foreign Exchange Department

While policy decisions are taken and foreign exchange resources are managed at the corporate level, the actual dealing with the customers takes place at select branches of the bank authorised to deal in foreign exchange. Such branches are mostly concentrated in metropolitan cities and other places where either import or export trade predominates or inflow of foreign remittances is expected to be high. These branches can, however, function only within the guidelines prescribed by the head office, from time to time.

There may also be an intermediary tier at the Zonal or Regional level. In order to decentralise decision-making and reduce the problem of communication from head office to branches spread over the length and breadth of the country, special Departments or Cells have been set up at these levels. They perform some of the functions like advising branches on the exchange rate to be quoted to customers, maintenance of foreign exchange balances abroad, etc.

Banks have also set up at select metropolitan centres special branches dealing exclusively in foreign exchange, designated as Overseas Branches. Besides dealing directly with customers engaged in foreign trade, they also take on the role of special foreign exchange cells at national Zonal levels.

The Foreign Exchange Department at the Central/Zonal office or the Overseas Branch is divided into-well-defined sections, each undertaking a specialised activity. Each section is further sub-divided into sub-sections or desks rendering specific tasks. There is no uniformity among banks either in the allocation of the tasks or in the designations of the officers manning the sections and sub-sections. Yet, an attempt is made below to delineate the important functions performed by the foreign exchange department of a bank. These functions are elaborated at appropriate chapters in this book.

❑ Correspondent Arrangement

The sphere of activities of a foreign exchange department extends over vast regions and a number of countries. It is not possible for a bank to have branches in all centres of the world. The difficulty is obviated by banks by entering into correspondent relationships. Under this arrangement one bank acts as an agent of the other in places where possible. Thus, an Indian bank may enter into correspondent relationship with an American bank, say Chasemanhattan Bank. The Indian bank will utilise the services of Chasemanrhattan Bank for its transactions in America,and also for all transactions designated in US dollars.

To facilitate the smooth functioning of the arrangement, the signatures of the authorised officials of the banks who will sign the documents and letters on behalf of the respective banks are exchanged between the banks. Besides, where the arrangement extends to drawing of TTs or exchange of information through telegram/telex, 'test code' to be used for authenticating the telecommunication message is also agreed upon.

Services under Correspondent Relationship

The following are the services generally covered by correspondent arrangement :

(a) Collection of bills, cheques, etc.
(b) Issue of demand drafts, mail transfers, telegraphic transfers and traveller cheques.
(c) Arrangement for reimbursement on letters of credit issued by the bank.
(d) Advising/Confirming and amending letters of credit.
(e) Sale and purchase of foreign currencies.
(f) Granting/Guaranteeing of loan and overdrafts.
(g) Furnishing of credit information such as report on business houses, market reports, etc.

The correspondent relationship, also known as agency arrangement, provides for other details like the schedule of charges. The arrangement is reciprocal.

Account Relationship

For facilitating the functioning of the arrangement, it is desirable that the bank establishes account relationship also. Certain services like remittance facilities require an account relationship between the banks. For other services also, it would be beneficial if the bank opens an account with the other bank.

The decision to open a bank account would depend upon the volume of transactions and the direction of its flow. Where the transactions are few, opening of a bank account may not be warranted. The maintenance of bank account abroad involves maintaining some balance in the account. If the transactions involved are few, it would be uneconomical to maintain balances in the account abroad on which no interest is earned. Further, the account would be opened with the bank in the country in whose currency most of the transactions take place. As between a bank in India and that in America, the Indian bank would open a dollar account with the latter since most of the transactions involved are designated in dollar. Most transactions between Middle East and India representing remittance of funds by Indians working in Middle East are designated in Indian rupees. Therefore, it would be preferable for the bank in Middle East to open a rupee account with the Indian bank.

Settlement of transactions between the banks is easy when there is accounting relationship. For instance, let us assume that Indian Bank maintains an account with Bank of America in New York, designated in US dollars. If Indian Bank issues a demand draft on New York, the Bank of America will debit the account of Indian Bank with it, when the demand draft is paid by it. If Bank of America issues a demand draft, which would normally be in US dollars, it would credit the account of Indian Bank with it.

Settlement of transactions becomes circuitous when there is no account relationship between the correspondent banks. For instance, Indian bank has only a correspondent relationship with Royal Bank of Canada, *i.e.*, without an account relationship. If Indian Bank issues a demand draft on Royal Bank of Canada, it may authorise the Royal Bank to claim reimbursement from Bank of America with which it has account relationship. Royal Bank of Canada, on payment of the draft, would convert the amount in Canadian dollars into US dollars at its rate of exchange and claim payment from Bank of America. If Royal Bank of Canada has an account with Chasemanhattan Bank, the Bank of America would pay the dollars claimed by the Royal Bank of Canada to the credit of that account, debiting the Indian bank's account for the value.

❑ Foreign Currency Accounts

To facilitate dealings in foreign exchange, a bank in India may maintain accounts with banks abroad. Similarly, some foreign banks may maintain accounts with banks in India. A brief description about these accounts is necessary before we attempt to understand exchange dealings.

Nostro Account

Nostro account is an account maintained by a bank in India with a bank abroad. For example, Indian Bank may maintain an account with Grindlays Bank, London. Obviously, the account would be in pound-sterling. Similarly, it may have a dollar account with Bank of America, New York. While corresponding with the foreign bank, Indian Bank would refer its account with the former as *nostro account*, meaning 'our account with you'. So, for Indian Bank nostro account means the bank account it maintains abroad in foreign currency. All foreign exchange transactions are routed through nostro accounts. For example, if the bank issues a demand draft on London

payable in pound-sterling, it would draw on Grindlays Bank, London. When the draft is presented in London, the Grindlays Bank will debit the Indian Bank's account with it. Likewise, when a bill drawn on London is given to Indian Bank for purchase or collection, it would send it for collection to Grindlays Bank. Grindlays Bank would collect and credit the account of the Indian bank with the proceeds.

Vostro Account

A foreign bank may open rupee account with an Indian bank. While corresponding with the foreign bank maintaining an account with it, the Indian bank would refer to the account as '*vostro account*' meaning 'your account with us'. For example, a bank in Middle East may open an account with an Indian bank and draw drafts on the account. On presentation of drafts, the Indian Bank would pay to the debit of the foreign bank's account with it. For exchange control purposes such accounts are known as 'non-resident bank accounts'.

It should be noted that credit to a non-resident bank account amounts to remittance of foreign currency from India to the country of the bank maintaining the vostro account. Similarly, debit to the account amounts to inflow of foreign exchange from the country concerned into India. For instance, when an import is made from Sri Lanka, the proceeds may be credited to the vostro account of the Sri Lankan bank with the Indian Bank. But for crediting the vostro account, the amount should have been remitted abroad. Besides, the balance in the account can be utilised to pay for any exports from India to that country. Thus debiting or crediting of vostro accounts is subject to the rules and regulations governing remittance of foreign exchange into and from India.

Loro Account

Peoples Bank of India is having an account with Chasemanhattan Bank, London. When the Janata Bank of India likes to refer to this account while corresponding with Chasemanhattan Bank, it would refer to it as '*loro account*' meaning 'their account with you'.

5 Foreign Exchange Markets

A foreign exchange market is a market in which currencies are bought and sold. It is to be distinguished from a financial market where currencies are borrowed and lent.

5.1. FEATURES OF EXCHANGE MARKET

❑ General Features

Location Foreign exchange market is described as an OTC (Over the counter) market as there is no physical place where the participants meet to execute the deals, as we see in the case of stock exchange. It is more an informal arrangement among the banks and brokers operating in a financial centre purchasing and selling currencies, connected to each other by tele-communications like telex, telephone and a satellite communication network, SWIFT. The term foreign exchange market is used to refer to the *wholesale segment* of the market, where the dealings take place among the banks. The *retail segment* refers to the dealings take place between banks and their customers. The retail segment is situated at a large number of places. They can be considered not as foreign exchange markets, but as the counters of such markets.

The leading foreign exchange market in India is Mumbai. Calcutta, Chennai and Delhi are other centres accounting for bulk of the exchange dealings in India. The policy of Reserve Bank has been to decentralise exchange operations and develop more broad-based exchange markets. As a result of the efforts of Reserve Bank, Cochin, Bangalore, Ahmedabad and Goa have emerged as new centres of foreign exchange market.

Size of the Market Foreign exchange market is the largest financial market with a daily turnover of over USD 2 trillion. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade. But these markets have developed on their own so much so that a turnover of about 3 days in the foreign exchange market is equivalent to the magnitude of world trade in goods and services. The largest foreign exchange market is London, followed by New York, Tokyo, Zurich and Frankfurt.

The business in foreign exchange markets in India has shown a steady increase as a consequence of increase in the volume of foreign trade of the country, improvement in the communications systems and greater access to the international exchange markets. Still the volume of transactions in these markets amounting to about USD 2 billion per day does not compare favourably with any well-developed foreign exchange market of international repute. The reasons are not far to seek. Rupee is not an internationally traded currency and is not in great demand. Much of the external trade of the country is designated in leading currencies of the world, *viz.*, US dollar, pound-sterling, Euro, Japanese yen and Swiss franc. Incidentally, these are the currencies that are traded actively in the foreign exchange market in India.

24 Hours Market The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day. However, a specific market will function only during the business hours. Some

of the banks having international network and having centralised control of funds management may keep their foreign exchange department in the key centre open throughout to keep up with developments at other centres during their normal working hours.

In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

Efficiency Developments in communication have largely contributed to the efficiency of the market. The participants keep abreast of current happenings by access to such services like Dow Jones Telerate and Reuter. Any significant development in any market is almost instantaneously received by the other market situated at a far off place and thus has global impact. This makes the foreign exchange market very efficient as if the functioning under one roof.

Currencies Traded In most markets, US dollar is the vehicle currency, viz., the currency used to denominate international transactions. This is despite the fact that with currencies like Euro and yen gaining larger share, the share of US dollar in the total turnover is shrinking.

Physical Markets In few centres like Paris and Brussels, foreign exchange business takes place at a fixed place, such as the local stock exchange buildings. At these physical markets, the banks meet and in the presence of the representative of the central bank and on the basis of bargains, fix rates for a number of major currencies. This practice is called fixing. The rates thus fixed are used to execute customer orders previously placed with the banks. An advantage claimed for this procedure is that exchange rate for commercial transactions will be market determined, not influenced by any one bank. However, it is observed that the large banks attending such meetings with large commercial orders backing up, tend to influence the rates.

❑ Participants

The participants in the foreign exchange market comprise:

(i) corporates;
(ii) commercial banks;
(iii) exchange brokers; and
(iv) central banks.

Corporates The business houses, international investors, and multinational corporations may operate in the market to meet their genuine trade or investment requirements. They may also buy or sell currencies with a view to speculate or trade in currencies to the extent permitted by the exchange control regulations. They operate by placing orders with the commercial banks. The deals between banks and their clients form the retail segment of foreign exchange market.

In India, the Foreign Exchange Management (Possession and Retention of Foreign Currency) Regulations, 2000 permits retention, by resident, of foreign currency up to USD 2,000. Foreign Currency Management (Realisation, Repatriation and Surrender of Foreign Exchange) Regulations, 2000 requires a resident in India who receives foreign exchange to surrender it to an authorised dealer:

(a) within seven days of receipt in case of receipt by way of remuneration, settlement of lawful obligations, income on assets held abroad, inheritance, settlement or gift; and
(b) within ninety days in all other cases.

Any person who acquired foreign exchange but could not use it for the purpose or for any other permitted purpose is required to surrender the unutilised foreign exchange to an authorised dealers within sixty days from the date of acquisition. In case the foreign exchange was acquired for travel abroad, the unspent foreign exchange should be surrendered within ninety days from the date of return to India

when the foreign exchange is in the form of foreign currency notes and coins and within 180 days in case of travellers cheques.

Similarly, if a resident required foreign exchange for an approved purpose, he should obtain from an authorised dealer.

Commercial Banks are the major players in the market. They buy and sell currencies for their clients. They may also operate on their own. When a bank enters a market to correct excess or sale or purchase position in a foreign currency arising from its various deals with its customers, it is said to do a cover operation. Such transactions constitute hardly 5% of the total transactions done by a large bank. A major portion of the volume is accounted by trading in currencies indulged by the bank to gain from exchange movements. For transactions involving large volumes, banks may deal directly among themselves. For smaller transactions, the intermediation of foreign exchange brokers may be sought.

Exchange brokers facilitate deal between banks. In the absence of exchange brokers, banks have to contact each other for quotes. If there are 150 banks at a centre, for obtaining the best quote for a single currency, a dealer may have to contact 149 banks. Exchange brokers ensure that the most favourable quotation is obtained and at low cost in terms of time and money. The bank may leave with the broker the limit up to which and the rate at which it wishes to buy or sell the foreign currency concerned. From the intends from other banks, the broker will be able to match the requirements of both. The names of the counterparties are revealed to the banks only when the deal is acceptable to them. Till then anonymity is maintained. Exchange brokers tend to specialise in certain exotic currencies, but they also handle all major currencies.

In India, banks may deal directly or through recognised exchange brokers. Accredited exchange brokers are permitted to contract exchange business on behalf of authorised dealers in foreign exchange only upon the understanding that they will conform to the rates, rules and conditions laid down by the FEDAI. All contracts must bear the clause "Subject to the Rules and Regulations of the Foreign Exchange Dealers' Association of India".

Central Bank may intervene in the market to influence the exchange rate and change it from that would result only from private supplies and demands. The central bank may transact in the market on its own for the above purpose. Or, it may do so on behalf of the government when it buys or sells bonds and settles other transactions which may involve foreign exchange payments and receipts.

In India, authorised dealers have recourse to Reserve Bank to sell/buy US dollars to the extent the latter is prepared to transact in the currency at the given point of time. Reserve Bank will not ordinarily buy/sell any other currency from/to authorised dealers. The contract can be entered into on any working day of the dealing room of Reserve Bank. No transaction is entered into on Saturdays. The value date for spot as well as forward delivery should be in conformity with the national and international practice in this regard.

Reserve Bank of India does not enter into the market in the ordinary course. Where the exchange rates are moving in a detrimental way due to speculative forces, the Reserve Bank may intervene in the market either directly or through the State Bank of India.

❑ Settlement of Transactions

Foreign exchange markets make extensive use of the latest developments in telecommunications for transmitting as well settling foreign exchange transactions. Banks use the exclusive network SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.

SWIFT. SWIFT is a acronym for Society for Worldwide Interbank Financial Telecommunications, a co-operative society owned by about 250 banks in Europe and North America and registered as a co-operative society in Brussels, Belgium. It is a communications network for international financial market transactions linking effectively more than 25,000 financial institutions throughout the world who have been allotted bank identifier codes. The messages are transmitted from country to country via central interconnected operating centres located in Brussels, Amsterdam and Culpeper, Virginia. The member countries are connected to the centres through regional processors in each country. The local banks, in each country, reach the regional processors through the national net works.

The SWIFT system enables the member-banks to transact among themselves quickly (i) international payments, (ii) Statements, and (iii) other messages connected with international banking. Transmission of messages takes place within seconds, and therefore, this method is economical as well as time saving. Selected banks in India have become members of SWIFT. The regional processing centre is situated at Mumbai.

The SWIFT provides following advantages for the local banking community:

1. Provides a reliable (time tested) method of sending and receiving messages from a vast number of banks in a large number of locations around the world.
2. Reliability and accuracy is further enhanced by the built-in authentication facilities, which has only to be exchanged with each counterparty before they can be activated or further communications.
3. Message relay is instantaneous enabling the counterparty to respond immediately, if not prevented by time differences.
4. Access is available to a vast number of banks globally for launching new crossborder initiatives.
5. Since communication in SWIFT is to be done using structure formats for various types of banking transactions, the matter to be conveyed will be very clear and there will not be any ambiguity of any sort for the receiver to revert for clarifications. This is mainly because the formats are used all over the world on a standardised basis for conducting all types of banking transactions. This makes the responses and execution very efficient at the receiving bank's end thereby contributing immensely to quality service being provided to the customers of both banks (sending and receiving).
6. Usage of SWIFT structure formats for message transmission to counterparties will entail the generation of local banks' internal records using at least minimum level of automation. This will accelerate the local banks' internal automation activities, since the maximum utilisation of SWIFT a significant internal automation level is required.

CHIPS CHIPS stands for Clearing House Interbank Payment System. It is an electronic payment system owned by 12 private commercial banks constituting the New York Clearing House Association. CHIPS began its operations in 1971 and has grown to be the world's largest payment system. Foreign exchange and euro-dollar transactions are settled through CHIPS. It provides the mechanism for settlement every day of payment and receipts of numerous dollar transactions among member-banks at New York, without the need for physical exchange of cheques/funds for each such transaction.

The functioning of CHIPS arrangement is explained below with an hypothetical transaction; Bank of India, maintaining a dollar account with Amex Bank, New York, sells USD 1 million to Canara Bank, maintaining dollar account with CitiBank. Fig. 5.1 explains how settlement for the transaction is done.

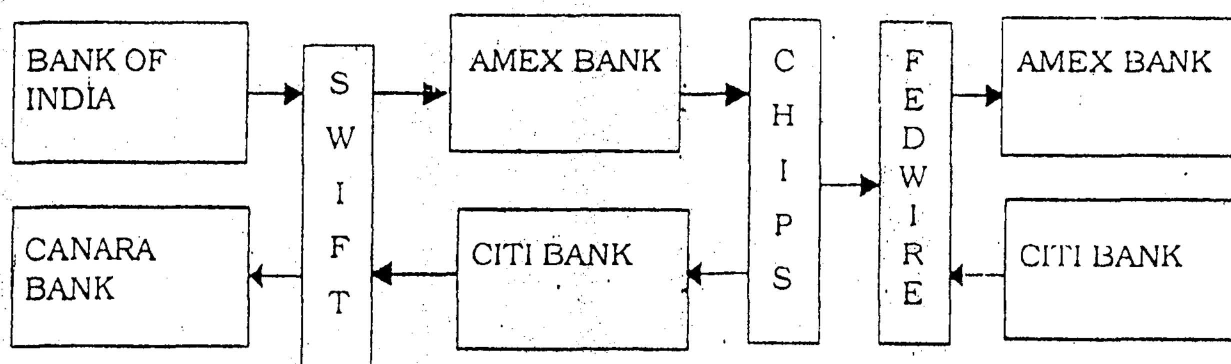

Fig. 5.1. Settlement of transaction through CHIPS

1. Bank of India intimateAmex Bank debits the account of Bank oank through SWIFT to debit its account and transfer USD 1 million to CitiBank for credit of current account of Canara Bank.
2. Amex Bank debits the account of Bank of India with USD 1 million and sends the equivalent of electronic cheque to CHIPS for crediting the account of CitiBank. The transfer is effected the same day.
3. Numerous such transactions are reported to CHIPS by member banks and transfer effected at CHIPS. By about 4.30 p.m. eastern time, the net position of each member is arrived at and funds made available at Fedwire for use by the bank concerned by 6.00 p.m. eastern time.
4. CitiBank which receives the credit intimates Canara Bank through SWIFT.

It may be noted that settlement of transactions in the New York foreign exchange market takes place in two stages. First, clearance at CHIPS and arriving at the net position for each bank. Second, transfer of Fedfunds for the net position. The real balances are held by banks only with Federal Reserve Banks (Fedfunds) and the transaction is complete only when Fedfunds are transferred. CHIPS helps in expediting the reconciliation and reducing the number of entries that pass through Fedwire.

CHAPS is an arrangement similar to CHIPS that exists in London. CHAPS stands for Clearing House Automated Payment System.

Fedwire The transactions at New York foreign exchange market ultimately get settled through Fedwire. It is a communication network that links the computers of about 7000 banks to the computers of Federal Reserve Banks. The Fedwire funds transfer system, operated by the Federal Reserve Bank, are used primarily for domestic payments, bank to bank and third party transfers such as interbank overnight funds sales and purchases and settlement transactions. Corporate to corporate payments can also be made, but they should be effected through banks. Fed guarantees settlement on all payments sent to receivers even if the sender fails.

5.2. TRANSACTIONS IN INTERBANK MARKETS

We shall now discuss how exactly transactions take place in the interbank foreign exchange market. The exchange rates quoted by banks to their customers are based on the rates prevalent in the interbank market. Quotation of rates to the customers is dealt with elaborately in the next part of the book.

The big banks in the market are known as *market makers*, as they are willing to buy or sell foreign currencies at the rates quoted by them up to any extent. Depending upon its resources, a bank may be a market maker in one or few major currencies. When a banker approaches the market maker, it would not reveal its intention to buy or sell the currency. This is done in order to get a fair price from the market maker.

❑ Two way Quotation

Typically, the quotation in the interbank market is a two-way quotation. It means, the rate quoted by the market maker will indicate two prices, one at which it is willing to buy the foreign currency, and the other at which it is willing to sell the foreign currency. For example, a Mumbai bank may quote its rate for US dollar as under:

USD 1 = Rs. 48.1525/1650

More often, the rate would be quoted as 1525/1650 since the players in the market are expected to know the 'big number' *i.e.*, Rs. 48. In the given quotation, one rate is Rs. 48.1525 per dollar and the other rate is Rs. 48.1650 per dollar.

Direct Quotation

It will be obvious that the quoting bank will be willing to buy dollars at Rs. 48.1525 and sell dollars at Rs. 48.1650. If one dollar bought and sold, the bank makes a gross profit of Rs. 0.0125. In a foreign exchange quotation, the foreign currency is the commodity that is being bought and sold. The exchange quotation which gives the *price* for the foreign currency in terms of the domestic currency is known as *direct quotation*. In a direct quotation, the quoting bank will apply the rule: "Buy low; Sell high".

Indirect Quotation

There is another way of quoting in the foreign exchange market. The Mumbai bank quote the rate for dollar as:

Rs. 100 = USD 2.0762/0767

This type of quotation which gives the *quantity* of foreign currency per unit of domestic currency is known as *indirect quotation*. In this case, the quoting bank will receive USD 2.0767 per Rs. 100 while buying dollars and give away USD 2.0762 per Rs. 100 while selling dollars. In other words, he will apply the rule : "Buy high; Sell low".

The buying rate is also known as the 'bid' rate and the selling rate as the 'offer' rate. The difference between these rates is the gross profit for the bank and is known as the 'spread'.

❑ Spot and Forward Transactions

The transactions in the interbank market may place for settlement—

(a) on the same day; or
(b) two days later; or
(c) some day late ; say after a month.

Where the agreement to buy and sell is agreed upon and executed on the same date, the transaction is known as *cash or ready transaction*. It is also known as *value today*.

The transaction where the exchange of currencies takes place two days after the date of the contact is known as the *spot transaction*. For instance, if the contract is made on Monday, the delivery should take place on Wednesday. If Wednesday is a holiday, the delivery will take place on the next day, *i.e.*, Thursday. Rupee payment is also made on the same day the foreign currency is received.

The transaction in which the exchange of currencies takes place at a specified future date, subsequent to the spot date, is known as a *forward transaction*. The forward transaction can be for delivery one month or two months or three months, etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract. A forward contract for delivery two months means the exchange of currencies will take place after two months and so on.

❑ Forward Margin/Swap Points

Forward rate may be the same as the spot rate for the currency. Then it is said to be 'at par' with the spot rate. But this rarely happens. More often the forward rate for a currency may be costlier or cheaper than its spot rate. The rate for a currency may be costlier or cheaper than its spot rate. The difference between the forward rate and the spot rate is known as the 'forward margin' or 'swap points'. The forward margin may be either at 'premium' or at 'discount'. If the forward margin is at premium, the foreign currency will be costlier under forward rate than under the spot rate. If the forward margin is at discount, the foreign currency will be cheaper for forward delivery than for spot delivery.

Under direct quotation, *premium is added* to spot rate to arrive at the forward rate. This is done for both purchase and sale transactions. *Discount is deducted* from the spot rate to arrive at the forward rate.

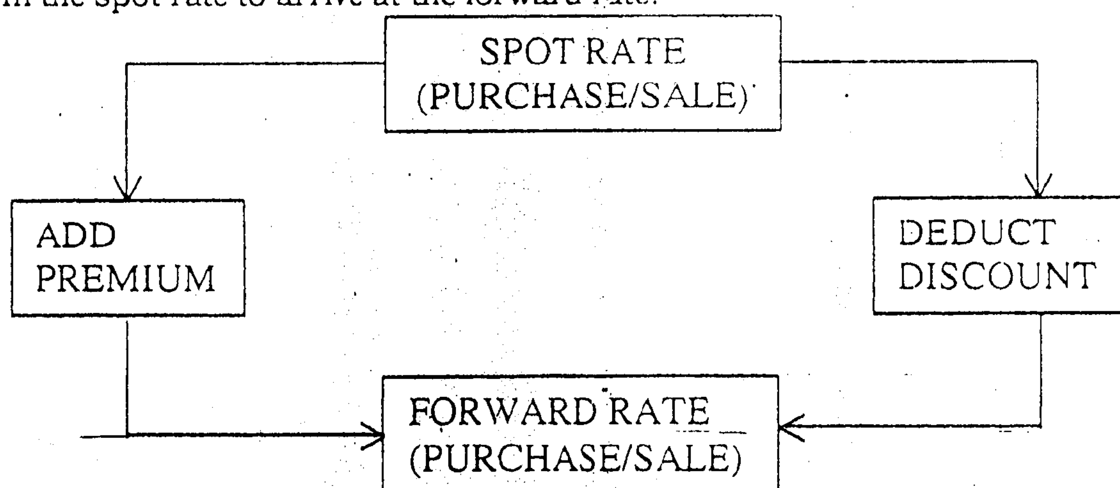

Fig. 5. 2 Calculation of Forward Rates under Direct Quotation

❑ Interpretation of Interbank Quotations

The market quotation for a currency consists of the spot rate and the forward margin. The outright forward rate has to be calculated by loading the forward margin into the spot rate. For instance, US dollar is quoted as under in the interbank market on 25th January as under:

Spot	USD 1 =	Rs. 48.4000/4200
Spot/February		2000/2100
Spot/March		3500/3600

The following points should be noted in interpreting the above quotation:

(i) The first statement is the spot rate for dollars. The quoting bank's buying rate is Rs. 48.4000 and selling rate is Rs. 48.4200.

(ii) The second and third statements are forward margins for forward delivery during the months of February and March respectively. Spot/February rate is valid for delivery end February. Spot/March rate is valid for delivery end March.

(iii) The margin is expressed in points, *i.e.*, 0.0001 of the currency. Therefore, the forward margin for February is 20 paise and 21 paise.

(iv) We have seen that under direct quotation, the first rate in the spot quotation is for buying and second for selling the foreign currency. Correspondingly, in the forward margin, the first rate relates to buying and the second to selling. Taking Spot/February as an example, the margin of 20 paise is for purchase and 21 paise is for sale of foreign currency.

(v) Where the forward margin for a month is given in ***ascending order as*** *in the quotation above, it indicates that the forward currency is at premium. The outright forward rates arrived at by adding the forward margin to the spot rates.*

The outright forward rates for dollar can be derived from the above quotation as follows:

	Buying rate		Selling rate	
	February	March	February	March
Spot rate	48.4000	48.4000	48.4200	48.4200
Add: Premium	0.2000	0.3500	0.2100	0.3600
Forward rates	48.6000	48.7500	48.6300	48.7800

From the above calculation we arrive at the following outright rates:

		Buying	Selling
Spot delivery	USD 1 = Rs.	48.4000	48.4200
Forward delivery February		48.6000	48.6300
Forward delivery March		48.7500	48.7800

If the forward currency is at discount, it would be indicated by quoting the forward margin in the descending order. Suppose that on 20th April, the quotation for pound-sterling in the interbank market is as follows:

Spot	GBP 1 = Rs.	73.4000/4300
Spot/May		3800/3600
Spot/June		5700/5400

Since the forward margin is in descending order (3800/3600), forward sterling is at discount. The outright forward rates are calculated by deducting the related discount from the spot rate. This is shown below:

	Buying rate		Selling rate	
	May	June	May	June
	Rs.	Rs.	Rs.	Rs.
Spot rate	73.4000	73.4000	73.4300	73.4300
Less: Discount	0.3800	0.5700	0.3600	0.5400
Forward rate	73.0200	72.8300	73.0700	72.8900

From the above calculations the outright rates for pound sterling can be restated as follows:

		Buying	Selling
Spot	GBP 1 = Rs.	73.4000	73.4300
Forward delivery May		73.0200	73.0700
Forward delivery June		72.8300	72.8900

Please remember:

Forward margin in ascending order = premium; add to spot rate.

Forward margin in descending order = discount; deduct from spot rate.

Alternative Method of Quotation

In the international markets, the forward margin is quoted in number of months from the date of quotation. Earlier, in India too, the same method of quotation was adopted. Under this method, the exchange rate for US dollar may be quoted on 22nd March as follows:

Spot	USD 1 = Rs.	48.4525/4750
1 month		2200/2300
2 months		4500/4600

In this case, the due date of the forward contract is calculated from the spot date. Thus 1 month forward contract will fall due on 24th April. If it is a holiday, the contract will be due on the next working day. As an exception to this rule, if the next day of such due date runs into the next month, the due date is advanced to the preceding day and not the succeeding day.

5.3. FACTORS DETERMINING FORWARD MARGIN

We have already defined forward margin as the difference between the spot rate and forward rate of a currency, making the forward currency cheaper or costlier as compared to the spot currency. The difference in the rate of interest prevailing at different financial centres is a dominant factor determining forward margin. Other factors that affect forward margin are demand and supply of currency, speculation about spot rates and exchange control regulations.

(1) ***Rate of Interest*** The difference in the rate of interest prevailing at the home centre and the concerned foreign centre determines the forward margin. If the rate of interest at the foreign centre is higher than that prevailing at the home centre, the forward margin would be at discount. Conversely, if the rate of interest at the foreign centre is lower than that at the home centre, the forward margin would be at premium. This can be explained as follows : When the bank enters into a forward sale contract with the customer, it arranges for delivery of the foreign currency on the due date by keeping the funds in deposit at the foreign centre concerned. If the interest rate is higher at the foreign centre concerned, the net gain to the bank is passed on to the customer by offering the forward rate at a discount. If the interest rate is lower at the foreign centre, the bank suffers a net loss and the loss is passed on to the customer by quoting the forward rate at a premium.

ILLUSTRATION The spot rate for US dollar is Rs. 50. The rate of interest at Mumbai is 8% p.a. and at New York it is 5% p.a. The bank has to quote 3 months selling rate to a customer. Assuming that the operation is for USD 10,000 and the entire interest loss/gain is passed on to the customer, the forward rate can be calculated as under:

To meet the needs of the customer, the bank may buy spot US dollars and deposit them in New York for 3 months so that it can deliver on due date the required dollars. The operations involved are :

Purchase dollar and invest for 3 months	USD 10,000	Borrow in Mumbai to pay for dollar at Rs. 50 Rs. 50 × 10,000	Rs. 5,00,000
Interest earned for 3 months at 5% p.a.	USD 125	Interest payable for 3 months at 8%	Rs. 10,000
Receive after 3 months	USD 10,125	Pay after 3 months	Rs. 5,10,000

The bank should be able to get Rs. 5,10,000 against USD 10,125. Therefore, the rate quoted is :

$$\frac{5,10,000}{10,125} = \text{Rs. } 50.37$$

Thus the forward premium is Re. 0.37

This can also be calculated approximately by the following formula :

$$\text{Forward Margin} = \frac{\text{Spot rate} \times \text{Forward period} \times \text{Interest differential}}{100 \times \text{Time}}$$

$$\frac{50 \times 3 \times 3}{100 \times 12} = \text{Re. } 0.37$$

If suitable conditions prevail in the market, the rate of interest would exert a greater influence than any other factor and the forward margin would tend to settle at a rate where the gain/loss in the interest rate differential is fully compensated by the forward margin. But, in practice, it is hard to find this and the forward margin at any particular time is determined by other factors listed below.

(2) ***Demand and Supply*** Forward margin is also determined by the demand for and the supply of foreign currency. If the demand for foreign currency is more than its supply, forward rate would be at premium. If the supply exceeds the demand, the forward rate would be at discount.

Some of the investors who want to gain out of the interest rate may try to borrow from low interest centre and invest in high interest centre. For example, the investor may borrow at New York (at 6%) and invest at Mumbai (at 12%). In order to secure his position, he may try to cover the transaction in the forward market. Then, he will sell spot dollar and buy forward dollar. When many investors do this, the supply of spot dollar increases pulling down the price; the demand for forward dollar increases pushing up the price. Thus the difference between spot and forward rates widens. The force of demand and supply may take the premium on forward even beyond the limit set by interest differential. Incidentally, it may also be stated that the loss on account of this premium may exceed the gain on account of interest differential on the investment. In that case, there is no point in carrying out the plan of investment.

(3) ***Speculation about Spot Rates*** Since the forward rates are based on spot rates, any speculation about the movement of spot rates would influence forward rates also. If the exchange dealers anticipate the spot rate to appreciate, the forward rate would be quoted at premium. If they expect the spot rate to depreciate, the forward rates would be quoted at a discount. These expectations about the spot rates are based on a number of factors which are outlined in the annexure to this chapter.

(4) ***Exchange Regulations*** Exchange control regulations may put some conditions on the forward dealings and may obstruct the influence of the above factors on the forward margin. Such restrictions may be with respect to keeping of balances abroad, borrowing overseas, etc. Intervention in the forward market by the central bank may also done to influence the forward margin.

Annexure 5.1 :

FACTORS DETERMINING SPOT EXCHANGE RATES

It was seen in the text of the chapter that the forward margin is primarily based on the interest differential between the financial markets in the two countries concerned. But then what determines exchange rate in the spot market? The rate of exchange in the market is the outcome of the combined effect of a multiple of factors constantly at play. Not all the factors are equal in importance. Some factors, especially the economic factors, are better guides in the long run. To understand short-term changes, some other immediate factors may have to be looked into. Besides, one factor which may exert a major influence during a given period may lose its importance after some time. An attempt is made here to delineate some of the important factors that affect exchange rates:

(1) Balance of Payments Balance of payments represents the demand for and supply of foreign exchange which ultimately determine the value of the currency. Exports, both visible and invisible, represent the supply side for foreign exchange. Imports, visible and invisible, create demand for foreign exchange. Put differently, exports from the country create demand for the currency of the country in the foreign exchange market. The exporters would offer to the market the foreign currencies they have acquired and demand in exchange the local currency. Conversely, imports into the country will increase the supply of the currency of the country in the foreign exchange market.

When the balance of payments of a country is continuously at deficit, it implies that the demand for the currency of the country is lesser than its supply. Therefore, its value in the market declines. If the balance of payments is surplus continuously, it shows that the demand for the currency in the exchange market is higher than its supply and therefore the currency gains in value.

(2) Inflation Inflation in the country would increase the domestic prices of the commodities. With increase in prices exports may dwindle because the price may not be competitive. With the decrease in exports the demand for the currency would also decline; this in turn would result in the decline of external value of the currency. It may be noted that it is the relative rate of inflation in the two countries that cause changes in exchange rates. If, for instance, both India and the USA experience 10% inflation, the exchange rate between rupee and dollar will remain the same. If inflation in India is 15% and in the USA it is 10%, the increase in prices would be higher in India than it is in the USA. Therefore, the rupee will depreciate in value relative to US dollar.

Empirical studies have shown that inflation has a definite influence on the exchange rates in the long run. The trend of exchange rates between two currencies has tended to hover around the basic rate discounted for the inflation factor. The actual rates have varied from the trend only by a small margin which is acceptable. However, this is true only where there is no drastic changes in the economy of the country. New resources found may upset the trend. Also, in the short run, the rates fluctuate widely from the trend set by the inflation rate. These fluctuations are accounted for by causes other than inflation.

(3) Interest Rates The interest rate has a great influence on the short-term movement of capital. When the interest rate at a centre rises, it attracts short-term funds from other centres. This would increase the demand for the currency at the centre and hence its value. Raising of interest rate may be adopted by a country due to tight money conditions or as a deliberate attempt to attract foreign investment. Whatever be the intention, the effect of an increase in interest rate is to strengthen the currency of the country through larger inflow of investment and reduction in the outflow of investments by the residents of the country.

Increase in interest rate will vary the exchange rate only when it is unilateral, unaccompanied by similar change in other countries. It would also be effective if the extent of increase in one country is higher than that in the other. In case the interest rates have increased by the same extent, it will have no effect on exchange rates.

(4) Money Supply An increase in money supply in the country will affect the exchange rate through causing inflation in the country. It can also affect the exchange rate directly.

An increase in money supply in the country relative to its demand will lead to large-scale spending on foreign goods and purchase of foreign investments. Thus the supply of the currency in the foreign exchange markets is increased and its value declines. The downward pressure on the external value of the currency then increases the cost of imports and so adds to inflation.

The effect of money supply on exchange rate directly is more immediate than its effect through inflation. While in the long run inflation seems to correlate exchange rate variations in a better way, in the short run exchange rates move more in sympathy with changes in money supply.

One explanation of how changes in money supply vary the exchange rate is this: the total money supply in the country represents the value of total commodities and services in the country. Based on this the outside world determines the external value of the currency. If the money supply is doubled, the currency will be valued at half the previous value so as to keep the external value of the total money stock of the country constant.

Another explanation offered is that the excess money supply flows out of the country and directly exerts a pressure on the exchange rate. The excess money

created, to the extent they are in excess of the domestic demand for money, will flow out of the country. This will increase the supply of the currency and pull down its exchange rate.

(5) National Income An increase in national income reflects increase in the income of the residents of the country. This increase in the income increases the demand for goods in the country. If there is underutilised production capacity in the country, this will lead to increase in production. There is a chance for growth in exports too. But more often it takes time for the production to adjust to the increased income. Where the production does not increase in sympathy with income rise, it leads to increased imports and increased supply of the currency of the country in the foreign exchange market. The result is similar to that of inflation, viz., decline in the value of the currency. Thus an increase in national income will lead to an increase in investment or in consumption, and accordingly, its effect on the exchange rate will change. Here again it is the relative increase in national incomes of the countries concerned that is to be considered and not the absolute increase.

(6) Resource Discoveries When the country is able to discover key resources, its currency gains in value. A good example can be the havoc played by oil in exchange rates. When the supply of oil from major suppliers, such as Middle East, became insecure, the demand for the currencies of countries self-sufficient in oil arose. Previous oil crisis favoured USA, Canada, UK and Norway and adversely affected the currencies of oil-importing countries like Japan and Germany. Similarly, discovery of oil by some countries helped their currencies to gain in value. The discovery of North Sea oil by Britain helped pound-sterling to rise to over USD 2.40 from USD 1.60 in a couple of years. Canadian dollar also benefited from discoveries of oil and gas off the Canadian East Coast and the Arctic.

(7) Capital Movements There are many factors that influence movement of capital from one country to another. Short-term movement of capital may be influenced by the offer of higher interest in a country. If interest rate in a country rises due to increase in bank rate or otherwise, there will be a flow of short-term funds into the country and the exchange rate of the currency will rise. Reverse will happen in case of fall in interest rates.

Bright investment climate and political stability may encourage portfolio investments in the country. This leads to higher demand for the currency and upward trend in its rate. Poor economic outlook may mean repatriation of the investments leading to decreased demand and lower exchange value for the currency of the country.

Movement of capital is also caused by external borrowing and assistance. Large-scale external borrowing will increase the supply of foreign exchange in the market. This will have a favourable effect on the exchange rate of the currency of the country. When repatriation of principal and interest starts the rate may be adversely affected.

(8) Political Factors Political stability induces confidence in the investors and encourages capital inflow into the country. This has the effect of strengthening the currency of the country. On the other hand, where the political situation in the country is unstable, it makes the investors withdraw their investments. The outflow of capital from the country would weaken the currency. Any news about change in the government or political leadership or about the policies of the government would also have the effect of temporarily throwing out of gear the smooth functioning of exchange rate mechanism.

The economic policies pursued by the Government have a great influence on the exchange rates. The major instruments of achieving the policies of the government are the monetary policies and fiscal policies adopted. These policies affect all the factors thus far discussed, e.g., inflation, interest, etc., and hence have an effect on the exchange rates.

The policy followed by the government depends upon the priorities it has allotted to different economic objectives. Sometimes the objectives may require contradictory policies to be followed. For instance, if a country is faced with huge balance of payments surplus and high rate of inflation in the country, an attempt to contain one may accentuate the other. Thus, if the government desires to contain inflation, it will make the goods of the country more competitive in international markets and encourage more exports. This will further accentuate the balance of payments surplus.

Another way in which the government may affect the exchange rate is through its policy of maintaining the exchange rates. It may intervene in the market if the market rate varies widely from the predetermined rate. Official intervention will have the effect of smoothening the rate in a disorderly market. But, if the authorities attempt to counter the market's anticipation and resist it by intervention, ultimately more steep and sudden exchange rate changes can occur, if the intervention is withdrawn.

The government may also enter into bilateral agreements with other countries, in which case much of the transactions are settled outside the exchange market. The other way of maintaining the rates is an agreement between the central banks of two countries to keep the exchange rates of two currencies at approximately the same level against each other.

(9) Psychological Factors and Speculation In the short run, the exchange rate is affected mostly by the views of the participants in the market about the likely changes in the exchange rates. These expectations are based on many of the factors listed above. Whenever there is a discrepancy between the previously held expectation of a given factor and actual outcome of it, exchange rates will usually be effected. For example, if the market expects the balance of payments of India to be of the order of Rs. 2.0 billion surplus, but when the actual figures are announced, it is Rs. 1.3 billion, it will immediately have an effect of depressing the price of rupee temporarily.

The behaviour of the major participant (market maker) in the market can affect the exchange rate. The influence may make the rate move differently from that determined by long-term economic forces. A large-scale buying or selling by the major participant would make others in the market to follow suit. This will have the effect of accentuating the trend.

Speculation exerts powerful influence on exchange rates, sometimes aggravating the trend set by other factors. A large-scale purchase or sale of foreign exchange by speculators with expectation of fall or rise in exchange rates further accelerates the fall or rise. The speculation may take the form of bull (purchasing heavily expecting a rise in price) or bear (selling heavily expecting a fall in price) campaigns. It may also take the form of leads and lags which means changing the time of settlement of debts with a view to getting advantage of the change in exchange rates. Arbitrage operations undertaken by the speculators to take advantage of differences in two markets also cause movements in exchange rates in both markets till a level rate is reached.

(10) Technical and Market Factors Isolated large transactions in the market may upset the market's ability to balance the supply of and demand for the currency.

The immediate effect will be wide distortion in the exchange rate. The situation will continue till the amount is fully absorbed in the market and normalcy is restored.

Similarly, some currencies are subject to regular monthly or weekly cycles due to the impact of large regular payments.

Thus, it would be seen that exchange rates are influenced by numerous factors. Some of the factors are interrelated while some are independent. Together, they decide the trend. At times, the short-term factors may take the exchange rates in opposite direction to that set by long-term factors. At other times, the short-term factors may accentuate the trend set by long-term factors. The efficiency of an operator in the foreign exchange market depends upon isolating the influence of these factors so that a correct judgment about the likely changes can be made.

6 Ready Exchange Rates

THE foreign exchange dealing of a bank with its customer is known as 'merchant business' and the exchange rate at which the transaction takes place is the 'merchant rate'. The merchant business in which the contract with the customer to buy or sell foreign exchange is agreed to and executed on the same day is known as 'ready transaction' or 'cash transaction'. As in the case of interbank transactions, a 'value next day' contract is deliverable on the next business day and a 'spot contract' is deliverable on the second succeeding business day following the date of the contract. Most of the transactions with customers are on ready basis. *In practice, the terms 'ready' and 'spot' are used synonymously to refer to transactions concluded and executed on the same day.* We shall study how ready rates for merchant business are calculated in India. At first, the concept of exchange transactions which was discussed under exchange markets is repeated here in the perspective of merchant transactions to reorient and reinforce the learning.

6.1. FOREIGN EXCHANGE TRANSACTIONS

Foreign exchange dealing is a business in which foreign currency is the commodity. It was seen earlier that foreign currency is not a legal tender. The US dollar cannot be used for settlement of debts in India; nevertheless, it has value. The value of US dollar is like the value of any other commodity. Therefore, the foreign currency can be considered as the commodity in foreign exchange dealings.

❑ Purchase and Sale Transactions

Any trading has two aspects—(*i*) purchase, and (*ii*) sale. A trader has to purchase goods from his suppliers which he sells to his customers. Likewise, the bank (which is authorised to deal in foreign exchange) purchases as well as sells its commodity—the foreign currency.

Two points need be constantly kept in mind while talking of a foreign exchange transaction :

(*i*) The transaction is always talked of from the bank's point of view; and
(*ii*) The item referred to is the foreign currency.

Therefore, when we say a purchase, we imply that

(*i*) the bank has purchased; and
(*ii*) it has purchased foreign currency

Similarly, when we say a sale, we imply that

(*i*) the bank has sold; and
(*ii*) it has sold foreign currency.

In a purchase transaction the bank acquires foreign currency and parts with home currency.

In a sale transaction the bank parts with foreign currency and acquires home currency.

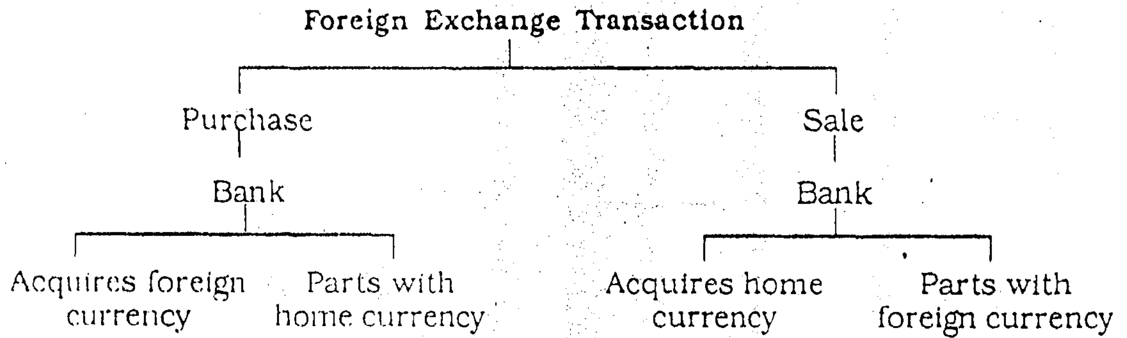

Fig. 6.1. Sale and purchase transactions

Fig. 6.1 summarises the explanation given above. This is further illustrated in Example 6.1.

EXAMPLE 6.1. Determine which of the following transactions constitute (*i*) purchase, and (*ii*) sale of foreign exchange :

(*a*) The bank issues a demand draft on London for GBP100.
(*b*) The customer of the bank purchases a telegraphic transfer on New York for GBP 500.
(*c*) A traveller encashes at the bank a traveller cheque for GBP 50.
(*d*) The bank purchases a demand draft drawn on London for GBP 500.

Answer. (*a*) and (*b*) sales: (*c*) and (*d*) purchases.

❑ Exchange Quotations

We have seen that exchange rates can be quoted in either of the two ways: (*a*) direct quotaton and (*b*) indirect quotation.

The quotation in which exchange rate is expressed as the price per unit of foreign currency in terms of the home currency is known as '*Home Currency Quotation*' or '*Direct Quotation*'. It may be noted that under direct quotation the number of units of foreign currency is kept constant and any change in the exchange rate will be made by changing the value in terms of rupees. For instance, US dollar quoted at Rs. 48 may be quoted at Rs. 46 or Rs. 49 as may be warranted.

The quotation in which the unit of home currency is kept constant and the exchange rate is expressed as so many units of foreign currency is known as '*Foreign Currency Quotation*' or '*Indirect Quotation*' or simply '*Currency Quotation*'. Under indirect quotation, any change in exchange rate will be effected by changing the number of units of foreign currency. For instance, the rate Rs. 100 = USD 2.2000 may become in due course USD 2.1545 or USD 2.2785, and so on.

The terms direct and indirect quotations are in common use and shall be used in this book.

The indirect quotation is used in London foreign exchange market. In New York and other foreign exchange markets mostly the direct method is in vogue.

In India, Direct Quotation was prevalent till 1966. After devaluation of rupee in 1966, following the practice in London exchange market, indirect quotation was adopted. Effective from 2nd August 1993, India has switched over to direct method of quotation. The change has been introduced in order to simplify and establish transparency in exchange rates in India.

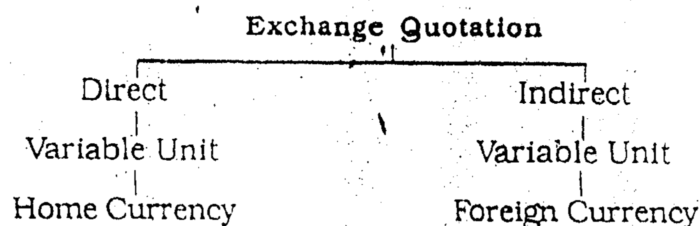

Fig. 6.2. Direct and Indirect Quotations

Direct Quotation—Buy Low; Sell High

The prime motive of any trader is to make profit. He earns profit by purchasing the commodity at a lower price and selling it at a higher price. In foreign exchange too, the banker buys the foreign currency at a lesser price and sells it at a higher price. For instance, it may buy US dollar at Rs. 48 and sell at Rs. 48.10.

Thus, in direct quotation as above, the principle adopted by the bank is to buy at a lower price and sell at a higher price. This principle is stated in the form of a maxim: *'Buy Low; Sell High'*.

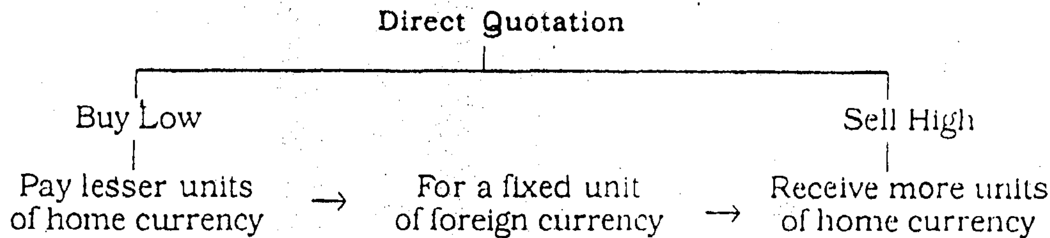

Fig. 6.3. Direct Quotation—Buy Low; Sell High.

Indirect Quotation—Buy High; Sell Low

Let us suppose the statement is to be with respect to the quantity that a trader purchases and sells instead of the variation in price. For a fixed amount of investment, he would acquire more units of the commodity when he purchases and for the same amount he would part with lesser units of the commodity when he sells. Taking the orange vendor as an example, if for Rs. 100 he gets 50 oranges from his supplier and for the same amount of Rs. 100 he sells 40 oranges, he would make profit.

The same principle can be applied to a foreign exchange quotation. In indirect quotation, it is the commodity of the trade, *viz.*, the foreign currency, which is varying in accordance with the change in exchange rates. For a fixed unit of home currency the bank would like to acquire more units of foreign currency while buying and part with lesser units of foreign currency while selling. For example, for Rs. 100, the bank may quote a selling rate of USD 2.3000 and buying rate of USD 2.3100. The difference between USD 2.3100 and USD 2.3000 is the bank's margin of profit. The position is summed up in the maxim—*Buy High; Sell Low*.

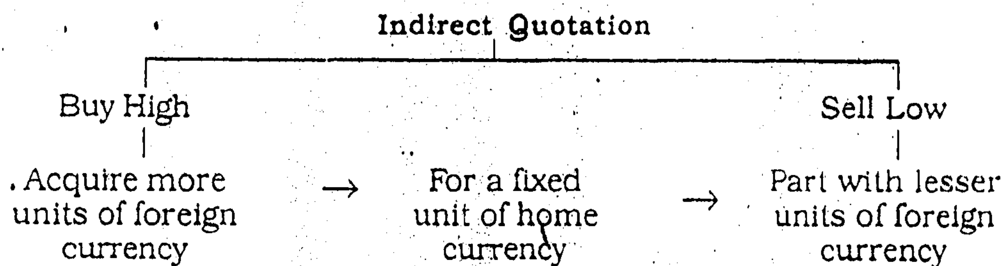

Fig. 6.4. Indirect Quotation—Buy High; Sell Low.

6.2. BASIS FOR MERCHANT RATES

When the bank buys foreign exchange from the customer, it expects to sell the same in the interbank market at a better rate and thus make a profit out of the deal. In the interbank market, the bank will accept the rate as dictated by the market. It can, therefore, sell foreign exchange in the market at the market buying rate for the currency concerned. Thus the interbank buying rate forms the basis for quotation of buying rate by the bank to its customer.

Similarly, when the bank sells foreign exchange to the customer, it meets the commitment by purchasing the required foreign exchange from the interbank market.

It can acquire foreign exchange from the market at the market selling rate. Therefore, the interbank selling rate forms the basis for quotation of selling rate to the customer by the bank.

The interbank rate on the basis of which the bank quotes its merchant rate is known as the base rate.

❑ Exchange Margin

If the bank quotes the base rate to the customer, it makes no profit. On the other hand, there are administrative costs involved. Further, the deal with the customer takes place first. Only after acquiring or selling the foreign exchange from/to the customer, the bank goes to the interbank market to sell or acquire the foreign exchange required to cover the deal with the customer. An hour or two might have lapsed by this time. The exchange rates are fluctuating constantly and by the time the deal with the market is concluded, the exchange rate might have turned adverse to the bank. Therefore, sufficient margin should be built into the rate to cover the administrative cost, cover the exchange fluctuation and provide some profit on the transaction to the bank. This is done by loading exchange margin to the base rate. The quantum of margin that is built into the rate is determined by the bank concerned, keeping with the market trend.

[Up to 1995, the exchange margin included in the merchant rates were prescribed by FEDAI. For the sake of information, the FEDAI prescribed margins are given below:

1.	TT Buying rate	0.025% to 0.080%
2.	Bills Buying rate	0.125% to 0.150%
3.	TT Selling rate	0.125% to 0.150%
4.	Bills selling rate	0.175% to 0.200% (over TT selling rate)

The exchange rates listed above are discussed in the next section.]

❑ Fineness of Quotation

The exchange rate is quoted upto 4 decimals in multiples of 0.0025. The quotation is for one unit of foreign currency except in the case of Japanese Yen, Belgian Franc, Italian Lira, Indonesian Rupiah, Kenyan Shilling, Spanish Peseta and currencies of Asian Clearing Union countries (Bangladesh Taka, Myanmar Kyat, Iranian Riyal, Pakistani Rupee and Sri Lankan Rupee) where the quotation is per 100 units of the foreign currency concerned. Examples of valid quotations are:

USD 1 = Rs. 49.2350
GBP 1 = Rs. 73.3525
EUR 1 = Rs. 48.5000
JPY 100 = Rs. 39.6075

While computing the merchant rates, the calculations can be made upto five places of decimal and finally rounded off to the nearest multiple of 0.0025. For example, if rate for US dollar works out to Rs. 49.12446 per dollar, it can be rounded off to Rs. 49.1250.

The rupee amount paid to or received from a customer on account of exchange transaction should be rounded off to the nearest rupee, *i.e.*, up to 49 paise should be ignored and 50 to 99 paise should be rounded off to higher rupee (Rule 7 of FEDAI).

6.3. PRINCIPAL TYPES OF BUYING RATES

As already noted, in a purchase transaction the bank acquires foreign exchange from the customer and pays him in Indian rupees. Some of the purchase transactions result in the bank acquiring foreign exchange immediately, while some involve delay in the acquisition of foreign exchange. For instance, if the bank pays

a demand draft drawn on it by its correspondent bank, there is no delay because the foreign correspondent bank would already have credited the nostro account of the paying bank while issuing the demand draft. On the other hand, if the bank purchases an 'On demand' bill from the customer, it has first to be sent to the drawee's place for collection. The bill will be sent to the correspondent bank for collection. The correspondent bank will present the bill to the drawee. The nostro account of the bank with its correspondent bank will be credited only when the drawee makes payment against the bill. Suppose this takes 25 days. The bank will acquire foreign exchange only after 25 days.

Depending upon the time of realisation of foreign exchange by the bank, two types of buying rates are quoted in India. They are:

(i) TT Buying Rate, and
(ii) Bill Buying Rate.

1. TT Buying Rate (TT Stands for Telegraphic Transfer)

This is the rate applied when the transaction does not involve any delay in realisation of the foreign exchange by the bank. In other words, the nostro account of the bank would already have been credited. The rate is calculated by deducting from the interbank buying rate the exchange margin as determined by the bank.

Though the name implies telegraphic transfer, it is not necessary that the proceeds of the transaction are received by telegram. Any transaction where no delay is involved in the bank acquiring the foreign exchange will be done at the TT rate.

Transactions where TT rate is applied are:

(i) Payment of demand drafts, mail transfers, telegraphic transfers, etc. drawn on the bank where bank's nostro account is already credited;
(ii) Foreign bills collected. When a foreign bill is taken for collection, the bank pays the exporter only when the importer pays for the bill and the bank's nostro account abroad is credited;
(iii) Cancellation of foreign exchange sold earlier. For instance, the purchaser of a bank draft drawn on New York may later request the bank to cancel the draft and refund the money to him. In such case, the bank will apply the TT buying rate to determine the rupee amount payable to the customer.

The method of calculating TT buying rate is sown in Format 6.1. It is assumed that the foreign exchange to be purchased is US dollars.

TT Buying Rate		
Dollar/Rupee market spot buying rate		= Rs.........
Less: Exchange margin	– Re.........	
TT Buying rate*		= Rs.........
*Rounded off to nearest multiple of 0.0025.		

Format. 6.1. Calculation of TT Buying Rate.

Note: We will use the term 'Dollar/Rupee rate' to indicate so many rupees per dollar. It is the dollar that is being sold or bought.

Example 6.2. On 15th September you receive a mail transfer from your New York correspondent for USD 5,000 payable to your customer. Your account with the correspondent bank has been credited with the amount of the mail transfer in reimbursement.

Assuming Rupee/US dollars are quoted in the local interbank market as under:

Spot	USD 1 = Rs. 49.2500/2700
Spot/October	2200/2300

Calculate the exchange rate and the Rupee amount payable to the customer bearing in mind that—

(i) You require an exchange margin of 0.080% to be loaded in the rate, and
(ii) Rupee equivalent should be nearest to the whole rupee.

Solution. The rate applicable is the TT buying rate. The rate quoted to the customer will be based on the market buying rate of Rs. 49.2500

Dollar/Rupee market spot buying rate	= Rs. 49.25000
Less: Exchange margin at 0.08% on Rs. 49.25000	– Re. 0.03940
	= Rs. 49.21060

Rounded off, the rate quoted to the customer would be Rs. 49.2100 per dollar.

Amount payable to the customer for USD 5,000 at the rate of Rs. 49.2100 per dollar is Rs. 2,46,050.

2. Bill Buying Rate

This is the rate to be applied when a foreign bill is purchased. When a bill is purchased, the rupee equivalent of the bill value is paid to the exporter immediately. However, the proceeds will be realised by the bank after the bill is presented to the drawee at the overseas centre. In the case of a usance bill, the proceeds will be realised on the due date of the bill which includes the transit period and the usance period of the bill.

If a sight bill on London is purchased, the realisation will be after a period of about 25 days (transit period). The bank would be able to dispose of the foreign exchange only after this period. Therefore, the rate quoted to the customer would be based not on the spot rate in the interbank market, but on the interbank rate for 25 days forward. Likewise, if the bill purchased is 30 days usance bill, then the bill will realise after about 55 days (25 days transit plus 30 days usance bill, period). Therefore, the bank would be able to dispose of foreign exchange only after 55 days; the rate to the customer would be based on the interbank rate for 55 days forward.

Two points need noting in loading the bills buying rate with forward margin. First, forward margin is normally available for periods of a calendar month and not for 25 days etc. Secondly, forward margin may be at a premium or discount. Premium is to be added to the spot rate and discount should be deducted from it. (See '*Forward Margin/Swap points*' in the previous chapter.) While making calculations, the bank will see that the period for which forward margin is loaded is beneficial to the bank.

Let us suppose that on 23rd January interbank quotation for US dollar was as under:

Spot	USD 1 = Rs. 49.5000/5200
Spot/January	2000/2100
/February	5000/5100
/March	7500/7600

The bank wants to calculate bill buying rate for a sight bill. The transit period is, say 25 days. The bill will fall due on 17th February. Apparently, the forward rate relevant is Spot/February rate as this is valid for the entire month of February. However, it should be noted that forward dollar is at premium. The customer will be getting more rupees per dollar under the forward rate than under the spot rate. As we have already seen, the forward premium represents the interest differential. The Spot/February forward premium includes interest differential up to the last day of February. As this benefit does not fully accrue on 17th February, when the bill is expected to mature, the bank will not concede premium up to this month. It will concede premium only up to the last completed month and base its bill buying rate for dollar on the Spot/January forward rate. [If the bank takes Spot/February forward premium, the base rate will be Rs.50.0000. By taking only Spot/January premium, the bank offers only Rs. 49.7000 per dollar, which is beneficial to the bank.] In case of a 30 days' usance bill submitted on the same date, the expected

due date (called the notional due date) is 19th March. The bank will concede premium only up to February. Thus, *where the foreign currency is at* **premium**, while calculating the bill buying rate, the bank will *round off the transit and usance periods to* **lower** month.

Let us assume that on 18th April, the dollar is at discount and the quotation in the interbank market is as under:

Spot	USD 1 = Rs. 48.7500/8000
Spot/April	1300/1200
/May	3000/2900
/June	5500/5400

The bank is required to quote a rate for purchasing a sight bill on New York. Transit period is 25 days. The bill will fall due on 13th May. Since dollar is at discount, forward dollar fetches lesser rupees than spot dollars. In other words, longer the forward period involved, the bank is able to get dollar from the customer at cheaper rate. Therefore, the bank will deduct discount up to May end while quoting for this bill. In case of a usance bill for 30 days, the due date falls on 12th June. The bank will base its rate to the customer on Spot/June forward rate. Here, the due date of the bill is rounded off to the higher month, *i.e.* end of the month in which it falls. Thus, *where the foreign currency is at* **discount**, while calculating the bill buying rate, the bank will round off the transit and usance periods to higher month.

It may be worth reciting again the rule for loading forward margin in the bill buying rate: For calculating bill buying rate, if the forward margin is at **premium** round off the transit period and usance period to **lower** month; if the forward margin is at **discount,** round off the forward margin to the **higher** month.

As noted under TT buying rate, the bank would include exchange margin in the rate quoted to the customer while quoting for purchase of bills also. The margin may be slightly higher than that for TT buying rate.

It should have been observed that there would be more than one bill rate, each for a different period of usance of the bill. The method of calculating bill buying rate is tabulated in Format 6.2, assuming US dollar to be the foreign currency.

Bill Buying Rate

Dollar/Rupee market spot buying rate	= Rs. ....
Add: Forward premium	
(For transit and usance; rounded off to lower month)	
OR	
Less: Forward discount	
(For transit and usance: rounded off to higher month)	± Rs. ....
	= Rs. ....
Less: Exchange margin	– Rs. ....
Bill buying rate*	= Rs. ....

**Rounded off to the nearest multiple of 0.0025*

Format 6.2. Calculation of Bill Buying Rate.

EXAMPLE 6.3. On 25th July, your customer has presented to you at sight documents for USD 1,00,000 under an irrevocable letter of credit. The letter of credit provides for reimbursement by the negotiating bank's own demand draft on the opening bank at New York.

Assuming Rupee/US dollars are quoted in the local interbank market as under:

Spot	USD 1 = Rs. 49.6525/6650
Spot/August	6000/5700
Spot/September	1.000/0.9700
Spot/October	1.4000/3900

Transit period for bill is 25 days. What rate will you quote to your customer provided you require an exchange margin of 0.15%?

Also calculate and show the amount in rupee payable to the customer.

Solution The bank has to quote bill buying rate. The transit period is 25 days and dollar is at discount. Therefore, the transit period will be rounded off to one month and the rate quoted will be based on one month forward buying rate (*i.e.*, Spot/August) for dollar in the interbank market.

Dollar/Rupee market spot buying rate	=	Rs. 49.65250
Less: Discount for one month	–	Re. 0.60000
Dollar/Rupee one month forward buying rate	–	Rs. 49.05250
Less: Exchange margin at 0.15% on Rs. 49.0525	–	Re. 0.07358
Bill Buying rate= Rs. 48.97892		

The rate quoted to the customer would be **Rs. 48.9800** per dollar, rounding off to nearest multiple of 0.0025.

The rupee amount payable to the customer on purchase of the bill for USD 1,00,000 at Rs. 48.9800 per dollar is **Rs. 48,98,000.**

Recovery of Interest on Bills Purchased When the bank buys a bill from the customer, it immediately pays him in Indian rupees. The bank is entitled to claim interest from the customer from the date of purchase of the bill till the bill is realised and credited to the nostro account of the bank with correspondent bank abroad.

On the rupee value of the bill purchased, on the date of purchase itself, the bank should collect separately, by debit to customer's account, the interest on the bill up to its anticipated due date (called the 'notional due date') comprising:

(*i*) the normal transit period; and

(*ii*) the usance of the bill.

Normal transit period is the average period normally involved from the date of negotiation/purchase of the bill till the receipt of bill proceeds in the nostro account of the bank. FEDAI prescribes a uniform period of 25 days as normal transit period for all foreign currency bills, irrespective of the destination. (Earlier different normal transit periods were prescribed for countries in different continents.) As an exception to the general rule, for bills drawn under letters of credit providing for reimbursement claim by telecommunication, the normal transit period is 5 days.

In case of export usance bills where the due dates are calculated from the date of shipment or date of bill of exchange etc., no normal transit period is applicable since the actual due date is known.

The rate of interest to be collected will be determined by the bank concerned subject to the directives of Reserve Bank in this regard. In the examination, interest shall be calculated at the rate given in the problem. *Interest shall also be rounded off to the nearest rupee.*

Interest is calculated by the formula:

$$\frac{\text{Rupee value of bill} \times \text{Rate of Interest} \times \text{Number of days}}{100 \times 365}$$

For the bill in Example 6.3, assuming an interest rate of 10% p.a., the interest recovered on purchase of the bill would be as follows:

$$\frac{48{,}98{,}000 \times 10 \times 25}{100 \times 365} = \text{Rs. } 33{,}548$$

Exchange Earner's Foreign Currency Account (EEFC) The exporter/beneficiary of a foreign exchange remittance has the choice that he may retain upto 50% of the value of the bill/remittance in foreign currency itself (upto 100 for

[1] Status holder exporters are those recognised as export houses, trading houses, etc. as per the Exim Policy.

professionals, export oriented units, and status holder exporters[1]) to be used by him for making payment in foreign exchange for any approved purposes. The amount so retained shall be credited to the Exchange Earner's Foreign Currency (EEFC) account of the exporter with the bank. Where a part of the bill value/remittance is retained in foreign exchange, the exchange rate will be applied and the value converted into rupees only for the balance amount. The EEFC account will be credited with the amount retained only on realisation of the bill.

Example 6.4. On 8th September, an exporter tenders a demand bill for USD 1,00,000 drawn on New York. The ruling rates for US dollars in the interbank market are as under:

Spot	USD 1 = Rs. 49.3000/3500
Spot /September	6000/7000
October	8000/9000
November	1.0000/1000

Transit period is 25 days. You require an exchange margin of 0.10%. Interest on export finance is 10% p.a. The customer opts to retain 15% of the proceeds in US dollars.

You are required to compute:

(a) The rate at which the bill will be purchased by the bank;
(b) The rupee amount payable to the customer ; and
(c) Interest to be recovered from him.

Solution. Since the currency is at premium, the transit period will be rounded off to lower month (*i.e.*, nil) and the rate to the customer will be based on spot rates.

Dollar/Rupee market spot buying rate	= Rs. 49.30000
Less: Exchange margin at 0.10% on Rs. 49.30000	– Re. 0.04930
	= Rs. 49.25070

Rounded off to the nearest multiple of 0.0025, the rate quoted to the customer would be **Rs. 49.2500** per dollar.

The customer's account will be credited with the rupee equivalent of USD 85,000 being 85% of the value of the bill. At the rate of Rs. 49.2500 per dollar, the rupee amount credited will be **Rs.41,86,250.**

Interest charged on Rs. 41,86,250 at 10% for 25 days: **Rs. 28,673.**

Example 6.5. On 26th August, an exporter tenders for purchase a bill payable 60 days from sight and drawn on New York for USD 25,650. The Dollar/Rupee rates in the interbank exchange market were as under:

Spot	USD 1 = Rs. 48.6525/6850
Spot/September	1500/1400
Spot/October	2800/2700
Spot/November	4200/4100
Spot/December	5600/5500

(i) Exchange margin of 0.10% is to be loaded.
(ii) Rate of interest is 10% p.a.
(iii) Fineness as per FEDAI Rules.
(iv) Out-of-pocket expenses Rs. 500 to be recovered.

What will be the exchange rate to be quoted to the customer and the rupee amount payable to him?

Solution. The notional due date is (60+25) 85 days from 26th August, *i.e.*, 19th November (Note that transit period of 25 days is to be taken even if the question is silent.). Since the dollar is at discount (forward margin in descending order), this period will be rounded off to higher month, *i.e.*, end November, and the rate quoted will be based on Spot/November rate for US dollar in the interbank market.

Dollar/Rupee market spot buying rate		= Rs. 48.65250
Less: Discount for Spot/November		– Re. 0.42000
		= Rs. 48.23250
Less: Exchange margin at 0.10% on Rs. 48.2325		– Re. 0.04823
		= Rs. 48.18427

Rounded off to the nearest multiple of 0.0025, the rate quoted would be **Rs. 48.1850** per dollar.

Rupee amount payable on the bill for USD 25,650 at Rs. 48.1850 per dollar		= Rs. 12,35,945
Less : Interest for 85 days at 10% on Rs. 12,35,945	28,782	
Out of pocket expenses	500	29282
Net amount credited		12,06,663

6.4. PRINCIPAL TYPES OF SELLING RATES

When a bank sells foreign exchange it receives Indian rupees from the customer and parts with foreign currency. The sale is effected by issuing a payment instrument on the correspondent bank with which it maintains the nostro account. Immediately on sale, the bank buys the requisite foreign exchange from the market and gets its nostro account credited with the amount so that when the payment instrument issued by it is presented to the correspondent bank it can be honoured by debit to the nostro account. Therefore, for all sales on ready/spot basis to the customer, the bank resorts to the interbank market immediately and the base rate is the interbank spot selling rate. However, depending upon the work involved, *viz.*, whether the sale involves handling of documents by the bank or not, two types of selling rates are quoted in India. They are:

(*i*) TT selling rate ; and

(*ii*) Bills selling rate.

1. TT Selling Rate

This is the rate to be used for all transactions that do not involve handling of documents by the bank.

Transactions for which this rate is quoted are:

(*i*) Issue of demand drafts, mail transfers, telegraphic transfers, etc., other than for retirement of an import bill; and

(*ii*) Cancellation of foreign exchange purchased earlier. For instance, when an export bill purchased earlier is returned unpaid on its due date, the bank will apply the TT selling rate for the transaction.

The TT selling rate is calculated on the basis of interbank selling rate. The rate to the customer is calculated by adding exchange margin to the interbank rate.

2. Bills Selling Rate

This rate is to be used for all transactions which involve handling of documents by the bank: for example, payment against import bills.

The bills selling rate is calculated by adding exchange margin to the TT selling rate. That means the exchange margin enters into the bills selling rate twice, once on the interbank rate and again on the TT selling rate.

The method of calculating selling rate is tabulated in Format 6.3. with US dollar representing the foreign currency.

Selling Rates *(TT and Bills Selling)*		
Dollar/Rupee market spot selling rate	=	Rs. .....
Add: Exchange margin for TT selling rate	+	Rs. .....
TT Selling Rate*	=	Rs. .....
Add: Exchange margin for Bills selling rate	+	Rs. .....
Bills Selling Rate*	=	Rs. .....
**Rounded off to nearest multiple of 0.0025 and quoted to customer.*		

Format 6.3. Calculation of TT and Bills Selling Rates.

Example 6.6. Your customer requested you to issue a demand draft on New York for USD 25,000.

Assuming the ongoing spot rates in the local market for US dollar are as under:

Spot	USD 1 = Rs. 49.3575/3825
1 month forward	Rs. 49.7825/8250

You require an exchange margin of 0.15%.

What rate will you quote to your customer and what is the rupee amount payable by the customer?

Solution The bank has to quote its TT selling rate based on the market selling rate.

Dollar/Rupee market spot selling rate	= Rs. 49.38250
Add: Exchange margin at 0.15% on Rs. 49.3825	+ Re. 0.07407
	= Rs. 49.45657

Rounding off to the nearest multiple of 0.0025, the rate quoted to the customer would be **Rs. 49.4575** per dollar.

The amount payable by the customer for USD 25,000 at Rs. 49.4575 per dollar is **Rs. 12,36,438.**

Example 6.7. On 12th February your customer has received an import bill for USD 10,000. He asks you to retire the bill to the debit of his account. Interbank rate for dollar is:

Spot	USD 1 = Rs. 48.7050/7200
Spot/March	5000/4500

You require an exchange margin of 0.15% for TT Sales and 0.20% for bills selling rate. With what amount will you debit his account?

Solution The bank is to quote bills selling rate to the customer based on market selling rate.

Dollar/Rupee market spot selling rate	= Rs. 48.72000
Add: Exchange margin at 0.15% on Rs. 48.7200 for TT selling	+ Re. 0.07308
TT selling rate	= Rs. 48.79308
Add: Exchange margin at 0.20% on Rs. 48.79308 for Bills selling	+ Re. 0.09759
Bills selling rate	= Rs. 48.89067

Rounded off to the nearest multiple of 0.0025, the rate quoted would be **Rs. 48.8900** per dollar.

Customer's account would be debited for USD 10,000 at Rs. 48.8900 a dollar with **Rs. 4,88,900.**

Example 6.8. You had purchased an export bill for USD 1,00,000 at Rs 49.1600. The bill was unpaid on presentation and your customer authorised you to debit the bill amount to his account.

Assuming the US dollar was quoted in the interbank market as under:

Spot USD 1 = Rs. 48.9500/9700 and you require an exchange margin of 0.15% to be loaded on the exchange rate, what rate will you quote to your customer to recover your advance against the bill? What will be the profit or loss to the exporter on this transaction?

Solution The customer's account will be debited at the TT selling rate.

Dollar/Rupee interbank selling rate	= Rs. 48.9700
Add: Exchange margin at 0.15% on Rs. 48.9700	+ Re. 0.0735
	= Rs. 49.0435

Rounded off, the TT selling rate is Rs. 49.0425

Amount paid to the customer on purchase of the bill for USD 1,00,000 at Rs. 49.1600	Rs. 49,16,000
Amount debited to his account on return of bill at Rs. 49.0425	Rs. 49,04,250
Profit to the customer	Rs. 11,750

Example 6.9. You had negotiated 'at sight' bill under an irrevocable letter of credit for USD 1,00,000 at Rs. 49.5200 and covered yourself by sale in the market for one month forward delivery at Rs. 49.5400. However, it was found later that terms of L/C had not been complied with and that you had to recover your advance from your customer and cover your sale in the interbank market at Rs. 49.6000.

The interbank rates for dollar were as under:

Spot	USD 1 = Rs. 49.5225/5275
One month	Rs. 49.5800/5875

The merchant rates for dollar were as follows:

TT	USD 1 = Rs. 49.4800	49.5600
One month	Rs. 49.5200	49.6200

(*a*) At what rate will you cancel your purchase contract from the customer?
(*b*) What will be the rupee equivalent you will recover from the customer?
(*c*) What will be the profit/loss to the customer on the transaction?

Solution. The purchase contract will be cancelled at one month forward TT selling rate prevailing on the date of cancellation, *viz.*, Rs. 49.6200 (It may be noted that the bank covers the cancellation by buying one month forward in the market.)

Amount paid to customer on purchase of bill for USD 1,00,000 at Rs. 49.5200	Rs. 49,52,000
Amount recovered from customer on cancellation of contract at Rs. 49.6200	Rs. 49,62,000
Loss to the customer on cancellation	Rs. 10,000

6.5. SOME ASPECTS OF EXCHANGE QUOTATION

❑ Exchange rates for non-trade transactions

The method of calculation of exchange rates described in this chapter relates to trade related transactions. Separate rates are quoted by banks for the following transactions:

(*a*) issue and encashment of foreign travellers cheques;
(*b*) purchase of personal cheques;
(*c*) purchase of foreign currency notes and coins.

The methods of calculating these rates are not discussed in this book.

❑ Quoting Better/Best Rate

In the case of valued customers having large foreign exchange dealings with the bank or of importance to the bank otherwise, the bank may endeavour to quote a better rate than is normally quoted to the customers. Any one or a combination of the following methods may be adopted to quote a better rate:

(*i*) Rounding off the rate to the advantage of the customer instead of to the banker or to the nearest multiple of 0.0025. That is, the rate may be rounded off to higher multiple for buying and lower multiple for selling.
(*ii*) The exchange margin may be reduced to the minimum.

(iii) The rate may be based on the cheapest market rate. Moreover, the current prevailing market rates may be verified to see if any favourable shift is there and the rate may be based on on-going market rates.

(iv) Instead of rounding off the premium/discount to the whole month, proportionate forward margin up to the exact due date of the bill may be conceded in favour of the customer.

❑ Rounding off for Card Rates

For transactions of smaller value, say less than the equivalent of USD 1,000, banks do not calculate the rates for each transaction separately. The rates calculated at the beginning of the day are applied to all transactions taking place during the day, unless the movement in the exchange rates in the market warrant otherwise. These rates are known as "Card Rates". The card rates are quoted to the nearest paise.

6.6. PROBLEMS FOR PRACTICE

Problem 6.1 You receive an advice from your correspondent bank at New York to whom you had sent an export bill for USD 40,000 for collection that the bill has been realised on 14th August and your nostro account with them has been credited with USD 39,950 after deducing their charges.

On 14th August, US dollar was quoted in the interbank market as under:

Spot	USD 1 = Rs. 48.7500/7650
Spot/September	6000/6500

On 18 August, when the realisation advice from the correspondent bank was received by you, the rates for US dollar were as follows in the interbank market:

Spot	USD 1 = Rs. 48.6850/7000
Spot/September	5500/6000

The transit period is 25 days. Interest on post-shipment finance is 10%. Exchange Margin 0.08% on TT buying and 0.10% on Bills buying.

Please calculate the rate at which and the amount with which the account of the export customer would be credited towards the export bill.

[*Ans. Rs. 48.6450; Rs. 19,43,368*]

Problem 6.2 M/s ABC Exporters have presented to you documents for USD 48,573.56 under an irrevocable letter of credit which provides for TT reimbursement of drawings thereunder. Assuming USD/INR is being quoted in the local inter-bank as 49.4300/4500 and one month forward is at par, what will be the exchange rate to be quoted to the customer and the rupee amount payable to him bearing in mind the following:

(i) Exchange margin of 0.10% is to be loaded;
(ii) Rate of interest : 10% p.a.;
(iii) Transit period : 5 days;
(iv) Out-of-pocket expenses of Rs. 400 to be recovered?

[*Ans. Rs. 49.3800; Net amount credited Rs. 23,94,876*]

Problem 6.3 On 17th June, your customer tenders an export bill for USD 50,000 payable at sight and drawn on New York for purchase. Assuming US dollar is quoted in the interbank market as:

Spot	USD 1 = Rs. 48.7825/8000
Spot /July	4000/3700
August	6500/6200
September	9000/8700

What rate you will quote to the customer for the transaction provided you require an exchange margin of 0.10%?

Also calculate the rupee amount that would be credited to the account of the exporter and the interest to be recovered from him at 10%. p.a.

[*Ans. Rs. 48.7350; Rs. 24,36,750; Rs. 16,690*]

PROBLEM 6.4. Your customer has presented to you documents for USD 1,48,000 under an irrevocable letter of credit which provides for TT reimbursement for drawings thereunder. Assuming USD/Re. is being quoted in the local interbank as 49.3675/3750 and one month forward is at par, what will be the exchange rate to be quoted to the customer and the rupee amount payable to him bearing in mind the following:

(*i*) Exchange margin of 0.08%,
(*ii*) Transit period 5 days,
(*iii*) Rate of interest 10% p.a.,
(*iv*) Telex charges Rs. 300 to be recovered, and
(*v*) Ignore out-of-pocket expenses

[*Ans. Rs. 49.3275; Net amount credited Rs. 72,90,169*]

PROBLEM 6.5. On 20th April, your customer presents to you 60 days sight documents for USD 2,50,000. You have been requested to purchase the bill.

Assuming US dollars are quoted in the local interbank market as:

Spot	USD 1 = Rs. 49.3525/3675
Spot/May	49.6525/6675
June	50.9525/9675
July	51.2525/2675
August	51.5525/5675

What rate will you quote to your customer provided you require an exchange margin of 0.10% bearing in mind the following:—

(*a*) Transit period for bill is 25 days;
(*b*) Transit period and usance period interest at 10% p.a.; and
(*c*) Interest on export finance to be calculated separately and recovered from the customer?

Also calculate and show the amount in rupees payable to the customer and interest payable by him separately.

The customer desires to retain 25% in his EEFC account.

[*Ans. Rs. 50.9025; Rs.95,44,219; Rs. 2,22,263*]

PROBLEM 6.6. Your customer requested you to issue a demand draft on Colombo for USD 10,000.

Assuming the ongoing spot rates in the local market for dollar are as under:
USD 1 = Rs. 49.2000/2125

Reserve Bank of India selling and buying rates for US dollar are as follows:
USD 1 = Rs. 49.2050/2100

You require an exchange margin of 0.15%.

What rate will you quote to your customer?

Also calculate the rupee amount payable by the customer.

[*Ans. Rs. 49.2875; Rs. 4,92,875*]

PROBLEM 6.7. Your import customer has requested you to retire a bill drawn on him for USD 50,000 received for collection.

Assuming the ongoing interbank rates for dollar are:

Spot	USD 1 = Rs. 49.6725/6850
One month forward	Rs. 49.3725/3900

Your correspondent charges USD 100. You require an exchange margin of 0.15% on TT selling and 0.2% on bill selling.

Calculate the exchange rate and the rupee amount payable by your customer.

[*Ans. Rs. 49.8600; Rs. 24,97,986*]

7 Ready Rates Based on Cross Rates

It would have been observed that in the previous chapter although the principles of calculation of exchange rates were discussed in general, the illustrations were confined to US dollar. That was so because the calculation of exchange rates for foreign currencies other than US dollar ('other currencies' in brief) involves all the steps explained previously and something more. The exchange rates for other currencies are quoted to customers based on the rates for the currency concerned prevailing in international foreign exchange markets like London, Singapore and Hongkong. These rates are available in terms of US dollar. They have to be converted into rupee terms before quoting to the customers. We shall first examine how exchange rates are quoted in international markets and then we shall see how these rates are used for quoting rates for currencies other than US dollar in India.

7.1. EXCHANGE QUOTATIONS IN INTERNATIONAL MARKETS

In international markets, barring few exceptions, all rates are quoted in terms of US dollar. For instance, at Singapore Swiss franc may be quoted at 1.5425/5440 and Japanese Yen at 104.67/70. This should be understood as:

USD 1 = CHF 1.5425 – 1.5440
USD 1 = JPY 104.67 – 104.70

In interpreting an international market quotation, we may approach from either the variable currency or the base currency, *viz.*, the dollar. For instance, we may take a transaction in which Swiss francs are received in exchange for dollars as: (*a*) purchase of Swiss francs against Dollar or (*b*) sale of Dollar against Swiss francs. For the sake of uniformity we will assume the base currency as the currency being bought or sold.

The quotation for Swiss franc is CHF 1.5425 and CHF 1.5440 per Dollar. While buying dollar the quoting bank would part with fewer francs per dollar and while selling dollars would require as many francs as possible. Thus, CHF1.5425 is the dollar buying rate and DEM 1.5440 is the dollar selling rate. It may be observed that when viewed from dollar, the exchange quotation partakes the character of a direct quotation and the maxim 'Buy low; Sell high' is applicable. We will denote such rates as 'Dollar/Foreign Currency Rates', implying that dollar is being bought or sold against foreign currency.

Few currencies such as pound-sterling and Euro are quoted in variable units of US dollar. They are quoted as so many US dollars per unit of foreign currency concerned. Examples are:

GBP 1 = USD 1.4326/4348
EUR 1 = USD 0.9525/9548

The base currency here is the foreign currency. Taking Euro as example, the quoting bank will buy that currency at USD 0.9525 and sell at USD 0.9548. We will indicate such quotation as 'Foreign Currency/Dollar Rate', the quotation being for purchase or sale of foreign currency against dollars.

❑ Forward Margin/Swap Points

Dollar/Foreign Currency Quotation

At Singapore market dollar may be quoted against Deutsche mark and French franc as follows :

	Swiss Franc	*Japanese Yen*
Spot	1.5425/40	104.67/70
1 month forward	50/60	17/16
2 months forward	70/80	30/29

The forward margin (also called swap margin or swap points) is quoted in terms of points. A point is the last decimal place in the exchange quotation. Thus, in a four digit quotation, a point is 0.0001. In a two decimal quotation, it is 0.01.

As against Swiss franc, the forward margin for dollar is CHF 0.0050/0.0060. Since the order in which the forward margin is ascending, forward dollar is at premium. *Premium is added to the spot rate to arrive at the forward rates*, both in respect of purchase and sale transactions.

Based on the data given above, the forward rates for dollar against Swiss francs are arrived at as follows :

	Dollar Buying	*Dollar Selling*
1 month forward	CHF 1.5475	1.5500
2 months forward	CHF 1.5495	1.5520

As against Japanese Yen, the forward dollar is at a discount. (Note that the forward margin is in descending order.) *Discount is deducted from the spot rate to arrive at the forward rate*, both for buying and selling.

The forward rates for dollar against Japanese yen, based on the data already given are as follows :

	Dollar Buying	*Dollar Selling*
1 month forward	JPY 104.50	104.54
2 months forward	JPY 104.37	104.41

Foreign Currency/Dollar Quotation

Let us assume the following exchange rates are prevailing:

	Pound Sterling	*Euro*
Spot	1.4326/48	0.9525/35
1 month forward	50/53	65/62
2 months forward	90/93	84/82

Against dollar, the forward pound-sterling is at premium. Premium should be added to the spot rate to arrive at the forward rate.

Thus the forward rates for pound-sterling are as follows:

	Pound Sterling Buying	*Pound Sterling Selling*
1 month forward	USD 1.4376	1.4401
2 months forward	USD 1.4416	1.4441

Forward Euro is at discount, since the forward margin is quoted in the descending order. Discount should be deducted from the spot rate to arrive at the forward rate.

Based on the data given, forward rates for Euro can be arrived at as follows:

	Euro Buying	*Euro Selling*
1 month forward	USD 0.9460	0.9473
2 months forward	USD 0.9441	0.9453

7.2. CROSS RATES AND CHAIN RULE

Let us now see how exchange rates are calculated in India based on quotations in international markets.

In India, buying rates are calculated on the assumption that the foreign exchange acquired is disposed of abroad in the international market and the proceeds realised in US dollars. The US dollars thus acquired would be sold in the local interbank

market to realise the rupee. For example, if the bank purchased a CHF 10,000 bill it is assumed that it will sell the Swiss francs at the Singapore market and acquire US dollars there. The US dollars are then sold in the interbank market against Indian rupee.

The bank would get the rate for US dollars in terms of Indian rupees in India. This would be the interbank rate for US dollars. It would also get the rate for US dollars in terms of Swiss franc at the Singapore market. The bank has to quote the rate to the customer for Swiss franc in terms of Indian rupees.

The fixing of rate of exchange between the foreign currency and Indian rupee through the medium of some other currency is done by a method known as 'Chain Rule'. The rate thus obtained is the 'cross rate' between these currencies. For example, let us assume that in the interbank market dollar is quoted at Rs. 49.50 and at Singapore market the dollar is quoted at CHF 1.8000. With this information, the rate of exchange of Swiss franc in terms of rupees may be calculated as follows:

? Rs. = CHF 1 ... (1)
if CHF 1.8000 = USD 1 ... (2)
and USD 1 = Rs. 49.50 ... (3)

It should be noted that the currency which appears as the second item (right-hand side) in the first equation appears as first item (left-hand side) in the next equation. Thus franc appears on the right-hand side in the first equation and left-hand side in the second equation. US dollar which appears on the right-hand side in the second equation appears on the left-hand side in the third equation.

The rate of exchange between Indian rupee and Swiss franc can be calculated by dividing the product of the right-hand side by the product of the left-hand side.

$$\frac{49.50 \times 1 \times 1}{1.8000} = \text{Rs. } 27.50$$

It would be immediately seen that the above calculation involves simply dividing the rupee-dollar rate by the dollar-mark rate.

In respect of currencies quoted indirectly against US dollar, *e.g.*, Euro and Sterling, the foreign currency/rupee rate is calculated by multiplying the dollar/rupee rate and foreign currency/dollar rate. This is illustrated numerically below.

Rupee/dollar is 49.50 and Euro/dollar is 0.9568. Rupee/Euro rate can be calculated thus:

? Rs. = Eur 1
Eur 1 = USD 0.9568
USD 1 = Rs.49.50

$$\frac{1 \times 0.9568 \times 49.50}{1 \times 1} = \text{Rs. } 47.3616$$

7.3. CALCULATION OF READY RATES

Calculation of ready rates for Euro and Pound-sterling is studied in the next section. Here we discuss calculation of ready rates for other currencies.

❑ Buying Rates

Let us call the currency (other than US dollar) for which the exchange rate is to be calculated as the 'foreign currency'. Suppose a customer tenders a foreign currency bill for purchase by the bank. We have seen in the last chapter that when the customer tenders a dollar bill, the bank disposes of the dollar acquired from the customer in the interbank market at the market buying rate and therefore the interbank buying rate for dollar forms the basis for quoting dollar buying rate to the customer. In the case of a foreign currency being tendered by the customer, the bank should first get foreign currency converted to US dollar in the international market. In other words, it has to buy dollars in the international market against

foreign currency. The bank can do so at the market selling rate for dollar. Therefore, the merchant rate for the foreign currency would be calculated by crossing the dollar selling rate against the foreign currency in the international market and dollar buying rate against rupee in the interbank market. The method of calculating ready rates thus is tabulated below.

TT Buying Rate			
Dollar/Rupee market spot buying rate	=	Rs.	
Less: Exchange Margin	−	Rs.	
TT buying rate for dollar	=	Rs.	...(1)
Dollar/Foreign Currency market spot selling rate	=	FC	...(2)
TT buying rate for Foreign Currency = (1) divided by (2)	=	Rs. ....*	
* *Rounded off to nearest multiple of 0.0025*			

Format 7.1 (*a*). Calculation of TT buying rates based on cross rates.

Bill Buying Rate			
Dollar/Rupee market spot buying rate		Rs.	
Add: Forward premium (for transit and usance periods; rounded off to lower month)			
OR			
Less: Forward discount (for transit and usance periods; rounded off to higher month)	±	Rs.	
	=	Rs.	
Less: Exchange margin	−	Rs.	
Bill buying rate for dollar	=	Rs.	...(1)
Foreign currency/Dollar market spot selling rate	=	FC.	
Add: Forward premium (for transit and usance periods : rounded off to higher month)			
OR			
Less: Forward discount (for transit and usance periods; rounded off to lower month)	±	FC.	
	=	FC.	...(2)
Bill buying rate for foreign currency = (1) Divided by (2)	=	Rs. .....*	
**Rounded off to nearest multiple of 0.0025.*			

Format 7.1 (*b*). Calculation of bill buying rates based on cross rates.

Example 7.1. You issued a demand draft on Montreal for Canadian dollar 50,000 at CAD 1 = Rs. 34.4850. However, after a few days the purchaser of the draft requested you to cancel it and repay the rupee equivalent to him.

Assuming the Canadian dollars were quoted in the Singapore Foreign Exchange market as under:

USD 1 = CAD 1.4541/4561

and in the interbank market USD 1 = Rs. 49.5275/5350, how much the customer will gain or lose on cancellation of the draft? Exchange margin on TT buying is 0.08%.

Solution. The bank cancels the demand draft at TT buying rate.

US Dollar/Rupee market buying rate	=	Rs.	49.5275
Less: Exchange margin at 0.08% on Rs. 49.5275	−	Re.	0.0396
	=	Rs.	49.4879
US dollar/Canadian dollar market selling rate	=	CAD	1.4561
Canadian dollar TT buying rate (49.4879 ÷ 1.4561)	=	Rs.	33.9866
Rounded off, the rate applicable is Rs. 33.9875			
Amount paid by the customer on purchase of DD for CAD 50,000 at Rs. 34.4850	=	Rs.	17,24,250

Amount received by the customer on cancellation of DD	for	CAD 50,000
at Rs. 33.9875	Rs.	16,99,375
Loss to the customer	Rs.	24,875

EXAMPLE 7.2. An exporter received an advance remittance of Danish Kroner 1,00,000 by way of Telegraphic Transfer. He likes to retain 15% of the remittance in foreign currency.

In the interbank market dollar was quoted at:

Spot	USD 1 =	Rs. 42.3500/3600
1 month forward		1100/1200

At Singapore market, Danish Kroner was quoted as under:

Spot	USD 1 =	DKR 7.9220/9280
1 month forward		40/45

The bank requires an exchange margin of 0.08%. What rate will be quoted to the customer? What is the rupee amount payable to him?

SOLUTION. The bank has to quote TT buying rate to the customer.

Dollar/Rupee spot buying rate	=	Rs.	49.35000
Less : Exchange margin at 0.08% on Rs. 42.35000	–	Re.	0.03948
TT buying rate for dollar	=	Rs.	49.31052
Dollar/Kroner spot selling rate	=	DKR	7.92800
TT buying rate for Kroner = (49.31052 ÷ 7.92800)	=	Rs.	6.2198

Rounded off to the nearest multiple of 0.0025, the rate quoted to the customer would be **Rs. 6.2200** per kroner.

Amount paid to customer for DKR 85,000 at Rs. 6.2200 is **Rs. 5,28,700.**

EXAMPLE 7.3. Your export customer requests you to quote him a rate for purchase of a Singapore Dollars 1,00,000.

Assuming US dollar quoted in the interbank market as under:

Spot	USD 1 = Rs. 49.5500/5600
1 month forward	49.3500/3600
2 months forward	49.0500/0600
3 months forward	48.7600/7700

and Singapore dollars are quoted in Singapore market as under:

Spot	USD 1 = SGD 1.8220/8340
1 month forward	0.0040/0.0045
2 months forward	0.0060/0.0065
3 months forward	0.0080/0.0085

What will be the rate quoted to the customer? Also calculate the rupee amount payable to him and the interest to be recovered.

Notes :

(1) Transit period is 25 days.
(2) Exchange margin to be included in the rate is 0.10%.
(3) Interest to be recovered at 10%.

SOLUTION. The bank has to quote bill buying rate to the customer.

Dollar is at discount against rupee. Since this is a buying rate, the transit period will be rounded off to the higher month and one month forward dollar/rupee buying rate will be taken.

Dollar/Rupee one month forward buying rate	=	Rs.	49.35000
Less: Exchange margin at 0.10% **on Rs. 49.3500**	=	Re.	0.04935
Bill buying rate for dollar	=	Rs.	49.30065

US dollar is at premium against Singapore dollar. Since this is a selling rate, the transit period will be rounded off to the higher month and one month forward US dollar/Singapore dollar selling rate will be taken.

US dollar/Singapore dollar spot selling rate	=	SGD	1.8340
Add: Premium for one month	+	SGD	0.0045
	=	SGD	1.8385

Bill buying rate for Singapore dollar (49.30065 ÷ 1.8385) = Rs. 26.8157

Rounded off to the nearest multiple of 0.0025, the rate quoted to the customer would be **Rs. 26.8150** per Singapore dollar.

Amount payable to customer on purchase of bill for SGD1,00,000 at Rs. 26.8150 a dollar is **Rs. 26,81,500.**

Interest to be recovered at 10% for 25 days on Rs. 26,81,500 is **Rs. 18,366.**

EXAMPLE 7.4. Your customer has requested you to purchase a 30 days sight bill for Swiss Francs 5,00,000.

Assuming Rupee/US dollars are quoted in the local interbank market as under:

Spot	USD 1 = Rs. 49.2800/2875
One month forward	1700/1750
Two months forward	3500/3550
Three months forward	5500/5550

and Swiss Francs are quoted in Singapore market as under:

Spot	USD 1 = CHF 1.4250/4375
One month forward	50/55
Two months forward	105/110
Three months forward	155/160

What rate will you quote to your customer provided you require an exchange margin of 0.10% bearing in mind the following:

(*i*) Transit period for bills = 25 days,
(*ii*) Rate of interest = 10% p.a., and
(*iii*) Commission on export bill is Rs. 500?

Also show the net amount payable to the customer. Rupee amount to be quoted nearest to the whole rupee.

SOLUTION. The usance of the bill and transit period come to 55 days. In the Dollar/Rupee leg, forward dollar is at premium. In this case, since dollar buying rate is reckoned, 55 days will be rounded off to lower period, *viz.*, one month.

Dollar/rupee market spot buying rate	=	Rs.	49.28000
Add: Premium for one month	+	Re.	0.17000
	=	Rs.	49.45000
Less: Exchange margin at 0.10% on Rs. 49.4500	–	Re.	0.04945
Bill buying rate for dollar	=	Rs.	49.40055

In the Dollar/Swiss francs quote dollar is at premium in this case since dollar selling rate is taken 55 days will be rounded off to higher period, *i.e.*, 2 months.

Dollar/franc (market) spot selling rate	=	CHF	1.4375
Add: Premium for two months	+	CHF	0.0110
	=	CHF	1.4485

Bill buying rate for Swiss Franc (49.40055 ÷ 1.4485) = Rs. 34.1046

Rounded off to the nearest multiple of 0.0025, the rate quoted to the customer would be **Rs. 34.1050** per Swiss franc.

Amount payable to customer for CHF 5,00,000 at Rs. 34.1050 per franc is **Rs. 1,70,52,500.**

Interest recoverable at 10% for 55 days on Rs. 1,70,52,500 is Rs. 2,56,955.

Net amount credited to customer's account:

Value of bill		Rs.	1,70,52,500
Less: Interest	Rs. 2,56,955		
Commission	Rs. 500	Rs.	2,57,459
Net amount credited		Rs.	1,67,95,045

❑ Selling Rates

When the bank sells foreign exchange (other than dollar) to the customer, it has to acquire the required foreign currency in the international market by selling the equivalent US dollars. The bank can sell US dollars in the international market at the market buying rate for US dollars against the foreign currency concerned. US dollars required to effect this sale have to be acquired in the interbank market at the market selling rate. Therefore, in calculating the merchant selling rate for foreign currency, the relevant rates are dollar buying rate against the foreign currency concerned in the international market and dollar selling rate against rupee in the interbank market.

Selling Rates		
Dollar/Rupee market spot selling rate	= Rs.	
Add: Exchange margin for TT selling	+ Rs.	
TT Selling rate for dollar	= Rs.	...(1)
Add: Exchange margin for bill selling	+ Rs.	
Bills selling rate for dollar	= Rs.	...(2)
Dollar/Foreign Currency market buying rate	= FC	...(3)
TT selling rate for foreign currency = (1) divided by (3)	= Rs. .....*	
Bills selling rate for foreign currency = (2) divided by (3)	= Rs. .....*	
**Rounded off to nearest multiple of 0.0025 and quoted to the customer.*		

Format 7.1 (c). Calculation of selling rates based on cross rates.

Example 7.5. On 17th July US Dollar is quoted in the interbank market as follows:

Spot	USD 1	= Rs. 48.6025/6100
Spot/July		500/600
/August		1500/1600

At Singapore, Malaysian Ringits are quoted as follows:

Spot	USD 1	= MYR 3.8012/59
1 month		24/26
2 months		48/50

The bank requires exchange margin of 0.10% on TT selling and 0.15% on bills selling.

(*i*) Mr. Y.K. Kapoor requests for a bank draft for MYR.5,000.

(*ii*) M/s Hightech Ltd. desire to retire an import bill for MYR 15,000.

Calculate the exchange rate to be quoted by the bank in each of the above cases.

Solution. First we calculate the selling rate for US dollar.

Dollar/Rupee market spot selling rate	=	Rs.	48.6100
Add: Exchange margin at 0.10% on Rs.48.6100	+	Rs.	0.0486
TT Selling Rate for Dollar	=	Rs.	48.6586
Add: Exchange margin at 0.15% on Rs.48.6586	+	Rs.	0 0730
Bill Selling Rate for Dollar	=	Rs.	48.7316

(*i*) *TT Selling Rate for Malaysian Ringit*

Dollar/Rupee TT Selling rate		Rs.	48.6586
Dollar/Ringit Spot buying rate		MYR	3.8012
Ringit/Rupee TT selling rate (48.6586 ÷ 3.8012)	=	Rs.	12.8009

Rounding off to the nearest multiple of 0.0025, the bank will quote a rate of Rs. 12.8000 for issue of demand draft.

(*ii*) *Bill Selling Rate for Malaysian Ringit*

Dollar/Rupee Bill Selling rate		Rs.	48.7316
Dollar/Ringit Spot buying rate		MYR	3.8012
Ringit/Rupee Bill selling rate (48.7316 ÷ 3.8012)	=	Rs.	12.8201

Rounding off to the nearest multiple of 0.0025, the bank will quote a rate of Rs. 12.8200 for retiring the import bill.

7.4. CALCULATION OF READY RATES FOR EURO AND STERLING

It has been noted earlier that in respect of Euro and Sterling, the exchange rate is quoted in terms of US dollars per unit of the currency concerned. Thus it is a Foreign currency/Dollar rate. We also interpreted the rates from the standpoint of buying or selling Euro. Thus when a bank buys Euro from its customer, it would sell the Euro in the international market at the market buying rate. The USD obtained from the deal is sold in the interbank market at the market buying rate for dollar to obtain rupees. Thus the relevant rates to be crossed for quoting to the customer are buying rate for Euro in the international market and buying rate for dollar in the interbank market.

Similarly, for quoting selling rate to the customer, the bank crosses the Euro selling rate in the international market and dollar selling rate in the interbank market.

Formats 7.1 (*a*) to (*c*) given earlier for calculation of ready rates based on cross rates have to be modified for calculating ready rates for Euro and sterling. The modified tables are given as Formats 7.2 (*a*) to (*c*). Please note carefully the changes with respect to the rounding off of forward margin in respect of bill buying rates.

TT Buying Rate		
Dollar/Rupee market spot buying rate	= Rs.	
Less: Exchange Margin	− Rs.	
TT buying rate for dollar	= Rs.	...(1)
Foreign Currency/Dollar market spot buying rate	= USD	...(2)
TT buying rate for Foreign Currency = (1) multiplied by (2)	= Rs. .....*	
*Rounded off to nearest multiple of 0.0025		

Format 7.2 (*a*). Calculation of TT buying rates for Euro/Pound Sterling.

Bill Buying Rate		
Dollar/Rupee market spot buying rate	Rs.	
Add: Forward premium (for transit and usance periods: rounded off to lower month)		
OR		
Less: Forward discount (for transit and usance periods: rounded off to higher month)	± Rs.	
	= Rs.	
Less: Exchange margin	− Rs.	
Bill buying rate for dollar	= Rs.	...(1)
Foreign currency/Dollar market spot buying rate	= USD	
Add: Forward premium (for transit and usance periods ; rounded off to lower month)		
OR		
Less: Forward discount (for transit and usance periods: rounded off to higher month)	± USD.....	
	= USD.....	...(2)
Bill buying rate for foreign currency = (1) multiplied by (2)	= Rs. .....*	
*Rounded off to nearest multiple of 0.0025.		

Format 7.2 (*b*). Calculation of bill buying rates for Euro/Pound Sterling.

Selling Rates		
Dollar/Rupee market spot selling rate	= Rs.	
Add: Exchange margin for TT selling	+ Rs.	
TT Selling rate for dollar	= Rs.	...(1)
Add: Exchange margin for bill selling	+ Rs.	

Bills selling rate for dollar	=	Rs.	...(2)
Foreign Currency/Dollar market selling rate	=	USD	...(3)
TT selling rate for foreign currency = (1) multiplied by (3)	=	Rs. ......*	
Bills selling rate for foreign currency = (2) multiplied by (3)	=	Rs. ......*	

*Rounded off to nearest multiple of 0.0025 and quoted to the customer.

Format 7.2 (c). Calculation of selling rates for Euro/Pound Sterling.

Example 7.6. An exporter in Export Processing Zone tenders for negotiation a 30 days' bill for Euro 25,000 drawn under a letter of credit. 50% of the value of the bill is required to be retained in foreign exchange.

Assuming:

(*a*) In the interbank market the rates for US dollar were as follows:

Spot	USD 1 = Rs. 49.3225/3750
1 month forward	5000/5500
2 months forward	8500/9000
3 months forward	11000/11500

(*b*) Euro was quoted in Singapore as follows:

Spot	USD 1 = EUR 0.9665/683
1 month forward	60/50
2 months forward	90/80
3 months forward	140/130

Required computing:

(*a*) The exchange rate quoted to the customer for the above transaction;
(*b*) The rupee amount payable to him; and
(*c*) Interest to be recovered on the transaction.

Notes :

(*i*) Transit period 25 days.
(*ii*) Interest for post-shipment credit is 10%.
(*iii*) Exchange margin required is 0.1%.
(*iv*) Exchange rate to be quoted nearest to the decimal as per FEDAI Rules.

Solution. The bank has to quote 30 days' bill buying rate for Euro. The transit and usance involve 55 days.

In the dollar/rupee quote, dollar is at premium (forward margin in ascending order). The transit and usance period will be rounded off to the lower month and one month forward buying rate for dollar will be taken.

Dollar/rupee market spot buying rate	=	Rs.	49.32250
Add: Premium for one month	+	Re.	0.50000
	=	Rs.	49.82250
Less: Exchange margin at 0.10% on Rs. 49.8225	−	Re.	0.04982
Bill buying rate for dollar	=	Rs.	49.77268

In the Euro/Dollar quote, Euro is at discount (forward margin in descending order). The transit and usance period will be rounded off to the higher month.

Euro/dollar market spot buying rate	=	USD	0.9665
Less: Discount for two months	−	USD	0.0090
	=	USD	0.9575
Bill buying rate for Euro (49.77268 × 0.9575)	=	Rs.	47.6573

Rounded off to the nearest multiple of 0.0025, the rate quoted to the customer would be **Rs. 47.6575** per Euro.

Amount paid to customer for Euro 12,500 at Rs. 47.6575 an Euro is **Rs. 5,95,719.**

Interest recovered on Rs. 5,95,719 at 10% for 55 days is **Rs. 8,977.**

Example 7.7. Euro is quoted in Singapore as under:

Spot	EUR 1 = USD 0.9725/850
1 month forward	0.0050/0.0075

In the interbank market, US dollar is quoted as under:

Spot	USD 1 =	Rs. 49.1250/1375
1 month forward		6000/6100

You are required to load an exchange margin of 0.15% in the exchange rate for TT selling and 0.20% for bill selling.

(*a*) A Shipping Company has asked you to quote your spot TT selling rate for a freight remittance of EUR 1,50,000 to Frankfurt.

(*b*) Another customer requires you to retire an import bill drawn on him for Euro 12,000.

What rate(s) will you quote to your customers?

N.B.: Exchange rate(s) inclusive of exchange margin should be quoted as per FEDAI Rules.

Solution.

Dollar/rupee market spot selling rate	= Rs.	49.13750
Add: Exchange margin at 0.15% on Rs. 49.13750	+ Re.	0.07371
TT selling rate for dollar	= Rs.	49.21121
Add: Exchange margin at 0.20% on Rs. 49.21121	= Re.	0.09842
Bill selling rate for dollar	= Rs.	49.30963
Euro/Dollar market spot selling rate	= USD	0.9850
(*a*) TT selling rate for Euro (49.21121 × 0.9850)	= Rs.	48.4730

Rounded off to the nearest multiple of 0.0025, the rate quoted to the shipping company for issue of DD is **Rs. 49.4725** an Euro.

(*b*) Bills selling rate for Euro (49.30963 × 0.9850) = Rs. 48.5670

Rounded off to the nearest multiple of 0.0025, the rate quoted to the import customer is **Rs. 48.5675.**

7.5. PROBLEMS FOR PRACTICE

Problem 7.1 Your export customer has requested you to purchase an export bill for Swiss francs 200,000 drawn at sight.

Assuming Swiss franc is quoted at Singapore market as under:

Spot	USD 1 =	CHF 1.4900/4960
One month forward		30/25
Two months forward		60/55

US dollar is quoted in the interbank market at:

Spot	USD 1 =	Rs. 49.2050/2150
One month forward		2500/2650
Two months forward		4500/4700

You are required to quote to the customer the exchange rate for the transaction.

Notes:

(*i*) You are required to load an exchange margin of 0.10% in the rate.

(*ii*) Interest at 10% per annum for normal transit period of 25 days to be recovered from the customer separately. Indicate the interest amount due from the customer. *[Ans. Rs. 32.8575; Rs. 65,71,500; Rs. 45,010]*

Problem 7.2 On 20th May, your customer tenders a 30 days sight bill drawn under a letter of credit in his favour opened by your Singapore branch. The bill is for Singapore Dollars 1,00,000 drawn on Hongkong. The customer desires to retain 25% of the proceeds of the bill in foreign exchange.

Assuming Singapore dollars are quoted in Singapore market as under:

Spot	USD 1 =	SGD 1.6210/6240
1 month forward		42/40
2 months forward		63/60
3 months forward		84/80

US dollars are quoted in interbank market as under:

Spot	USD 1 =	Rs. 49.4525/4600
Spot/June		1100/1000
Spot/July		2200/2100
Spot/August		3300/3200

What rate will you quote to your customer ?
You require an exchange margin of 0.10%.
Transit period is 25 days.
Interest on post-shipment finance is 10%.
Also calculate the rupee amount payable to the customer and interest to be recovered from him. *[Ans. Rs. 30.3600; Rs. 22,77,000; Rs. 34,311]*

Problem 7.3. On 27th June, you are requested by your export customer to negotiate a 60 days' DA bill on Frankfurt for Euro 1,00,000.

At Singapore exchange market, Euro is quoted as follows:

Spot	EUR 1 =	USD 0.9727/9759
1 month forward		40/45
2 months forward		80/90
3 months forward		120/135
4 months forward		160/180

At the interbank market US dollar is quoted as follows:

Spot	USD 1 =	INR 49.2725/2850
Spot/July		1550/1500
Spot/August		2600/2500
Spot/September		4100/4000
Spot/October		6200/6000

Interest period is 25 days.
Interest on export bills is 10% per annum.
Exchange margin required is 0.10%.
Required to calculate :
(*a*) The rate of exchange quoted to the customer for the transaction;
(*b*) The rupee amount payable to the customer; and
(*c*) Interest to be recovered from him.
[Ans. Rs. 47.8725; Rs. 47,87,250; Rs. 1,11,484]

Problem 7.4 A valued constituent of your bank wants to remit CHF2,00,000. The spot interbank levels are:
USD/INR 49.3550/3650 and USD/CHF1.5028/48.
Calculate the rupee amount to be recovered from the customer taking into account:
(*i*) Exchange margin of 0.10%.
(*ii*) Out-of-pocket expenses of Rs. 200. *[Ans. Rs. 32.8150; Rs. 65,63,200]*

Problem 7.5 You are required to issue a draft for Swiss francs 50,000 towards freight remittance.

Assuming Swiss francs are quoted in Singapore market as under:

Spot	USD 1 =	CHF 1.4685/4720
1 month forward		50/60
2 months forward		90/100
3 months forward		130/140

and that US dollars are quoted in the interbank market as under:

Spot	USD 1 =	Rs. 49.2575/2650
1 month forward		1200/1300
2 months forward		2400/2600
3 months forward		3600/3900

and that you require an exchange margin of 0.10%, calculate the rupee amount payable by the customer for the draft. *[Ans. Rs. 33.5825; Rs. 16,79,125]*

PROBLEM 7.6 You receive a bill for collection drawn on your customer for Swiss francs 1,00,000. You are required by the drawee to make remittance against the bill by debit to his account with you.

Assuming the exchange rates are as given in Problem 7.5 and you require an exchange margin of 0.15%, calculate the amount by which the customer's account will be debited. *[Ans. Rs. 33.6325; Rs. 33,63,250]*

8 Forward Exchange Contracts

An exporter in India contracts to sell to a firm in London machinery at a price of GBP 10,000. Before agreeing to this price, the exporter calculates his cost of production, adds a reasonable margin for profit and satisfies that the proceeds of GBP 10,000 would cover this amount. He bases his calculations on the exchange rate prevailing as on the date of his quotation. For example, if the exchange rate on the date is Rs. 70 per sterling pound, he expects to receive Rs. 7,00,000 on execution of the contract.

The exchange rate is not stable: it is changing every day. By the time the exporter executes his contract and his bill is realised, which may be after a lapse of 3 months or six months, the rate of exchange might have turned adverse for him. For example, if the rate prevailing on the date the bill is realised or purchased by his banker is Rs. 65, he would receive only Rs. 6,50,000 as against his estimate of Rs. 7,00,000. Thus he may have to bear a shortfall of Rs. 50,000. True, the rate may turn favourable to him and bring him unexpected profits. But the fact remains that the amount that he would receive on execution of the contract remains uncertain.

This uncertainty about the rate that would prevail on a future date is known as the 'exchange risk'. For the exporter, the exchange risk is that the foreign currency in which the transaction is designated may depreciate in future and may bring less than the expected realisation in local currency terms.

The importer too faces exchange risk when the transaction is designated in a foreign currency. The risk is that the foreign currency may appreciate in value and he may be compelled to pay in local currency an amount higher than that was originally contemplated. Importers generally make arrangements for loans for payment for the imports. If the foreign currency appreciates subsequent to the arrangement of the loan, the importer may find that the resources are not sufficient to meet the importer bill putting him in a difficult situation.

8.1. FEATURES OF A FORWARD EXCHANGE CONTRACT

Forward exchange contract is a device which can afford adequate protection to an importer or an exporter against exchange risk. Under a forward exchange contract a banker and a customer or another banker enter into a contract to buy or sell a fixed amount of foreign currency on a specified future date at a predetermined rate of exchange. Our exporter, for instance, instead of groping in the dark or making a wild guess about what the future rate would be, enters into a contract with his banker immediately. He agrees to sell foreign exchange of specified amount and currency at a specified future date. The banker on his part agrees to buy this at a specified rate of exchange. The exporter is thus assured of his price in the local currency. In our example, the exporter may enter into a forward contract with the bank for 3 months delivery at Rs. 49.50. This rate, as on the date of contract, is known as 3 months forward rate. When the exporter submits his bill under the contract, the banker would purchase it at the rate of Rs. 49.50 irrespective of the spot rate then prevailing.

When rupee was devaluated by about 18% in July 1991, many importers found that their liabilities had increased overnight. The devaluation of the rupee had the effect of appreciation of foreign currency in terms of rupees. The importers who had booked forward contracts to cover their imports were a happy lot.

❑ Date of Delivery

According to Rule 7 of FEDAI, a 'forward contract' is deliverable at a future date, duration of the contract being computed from the spot value date of the transaction.

Thus, if a 3 months forward contract is booked on 12th February, the period of two months should commence from 14th February and the forward contract will fall due on 14th April.

Date of delivery under forward contracts will be:

(i) In case of bills/documents negotiated, purchased or discounted: date of negotiation/purchase/discount and payment of rupees to customer.

(ii) In case of bills/documents sent for collection: date of payment of rupees to the customer on realisation.

(iii) In case of retirement/crystallisation* of import bills/documents: the date of retirement or crystallisation of liability, whichever is earlier.

❑ Fixed and Option Forward Contracts

The forward contract under which the delivery of foreign exchange should take place on a specified future date is known as 'fixed forward contract'. For instance, if on 5th March a customer enters into a three months forward contract with his bank to sell GBP 10,000, it means the customer would be presenting a bill or any other instrument on 7th June to the bank for GBP 10,000. He cannot deliver foreign exchange prior to or later than the determined date.

We saw that forward exchange is a device by which the customer tries to cover the exchange risk. The purpose will be defeated if he is unable to deliver foreign exchange exactly on the due date. In real situations, it is not possible for any exporter to determine in advance the precise date on which he will be tendering export documents. Besides internal factors relating to production, many other external factors also decide the date on which he is able to complete shipment and present documents to the bank. At the most, the exporter can only estimate the probable date around which he would be able to complete his commitment.

With a view to eliminating the difficulty in fixing the exact date for delivery of foreign exchange, the customer may be given a choice of delivering the foreign exchange during a given period of days. *An arrangement whereby the customer can sell or buy from the bank foreign exchange on any day during a given period of time at a predetermined rate of exchange is known as 'Option Forward Contract'.* The rate at which the deal takes place is the option forward rate. For example, on 15th September a customer enters into two months forward sale contract with the bank with option over November. It means the customer can sell foreign exchange to the bank on any day between 1st November and 30th November. The period from 1st to 30th November is known as the 'Option Period'.

Rules Regarding Option Forward Contracts (Rule 7 of FEDAI)

1. The option period of delivery should not exceed one month. Examples of valid option periods are 3rd January to 10th January; 18th January to 17th February; 1st April to 30th April.
2. As between a bank and a customer the option is that of the customer. So the bank cannot force the customer to deliver foreign exchange on any specific date. It is up to the customer to choose any date within the option period.

8.2. EXCHANGE CONTROL REGULATIONS

While booking forward contracts for customers, banks are required to observe that the exchange control regulations are complied with. Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 govern

* In case of an import bill received under a letter of credit, if the customer does not pay within ten days, his liability will be crystallised, *i.e.*, converted into Indian rupees, on the tenth day of receipt of documents by the bank.

forward exchange contracts in India. Schedule 1 to the Regulations provides that a person resident with an authorised dealer in India to hedge an exposure to exchange risk in respect of a transaction for which sale and/or purchase of foreign exchange is permitted under Foreign Exchange Management Act subject to certain terms and conditions. The terms and conditions relate to booking, cancellation, rebooking etc. of forward exchange contracts. Those relating to booking of forward contracts are given below:

(*a*) The authorised dealer, through verification of documentary evidence, should be satisfied about the genuineness of the underlying exposure.

(*b*) The maturity of the hedge should not exceed the maturity of the underlying transaction.

(*c*) The currency of hedge and tenor are left to the choice of the customer.

(*d*) Where the exact amount of the underlying transaction is not ascertainable, the contract can be booked on the basis of a reasonable estimate.

(*e*) Foreign currency loans/bonds will be eligible for hedge only after final approval is accorded by the Reserve Bank, where such approval is necessary.

(*f*) In case of Global Depository Receipts (GDRs)*, the issue price should have been finalised.

(*g*) Substitution of contracts for hedging trade transactions may be permitted by an authorised dealer on being satisfied with the circumstances under which such substitution has become necessary.

The operational aspects of the above conditions are discussed below:

1. Forward contracts can be booked for resident customers who are exposed to exchange risk in respect of genuine transactions permitted under current regulations.

2. Before entering into a forward contract, it should be ensured that the customer is, in fact, exposed to exchange risk in a permitted currency in the underlying transaction. The choice of the currency in which the forward contract is entered into is left to the customer. The implication of this provision is that the forward contract need not be booked in the same currency as that of the underlying transaction. Thus a customer who has an export order for Japanese Yen 1 million may book any of the following forward contracts:

   (*a*) Forward purchase (by the bank) of Yen against Indian rupees.

   (*b*) Forward purchase (by the bank) of US dollar against Indian rupees.

   (*c*) Forward purchase (by the bank) of Yen against US dollar.

   (*d*) Forward purchase (by the bank) of Mark against US dollar.

   Any contract other than Yen against Indian rupee will keep the customer open on the other leg of the transaction, which will be done at the spot rate. For example, under (*b*) when the bill is tendered, it will be converted into US dollar at the forward rate and the equivalent US dollar will be converted into Indian rupees at the spot rate.

3. While booking forward contracts, irrespective of the underlying transaction being a current account transaction or a capital account transaction, the bank should verify suitable documents to ensure the authenticity and the amount of the permitted currency of the underlying transaction. The amount, date and number of the forward contract should be marked on such documents under the stamp and signature of the bank in order to ensure that more than one forward contract is not booked in respect of the same

* For details of GDRs, please refer to Chapter 31.

underlying transaction. Copies of the documents so marked should be retained by the bank for its record.

4. Forward contracts may be booked for exporters/importers, without production of documents, up to the average of past three years export/import turnover. However, at any point of time, the outstanding contracts shall not exceed 25% of eligible limit, subject to a cap of USD 100 million.
5. Forward contract may be booked for the whole or part amount of the underlying transaction. Ordinarily the maturity of the forward contract should match that of the underlying transaction. Thus in case of exports, the maturity of the forward contract should match with the due date of the bill expected to be drawn under the relevant export order. Contracts may, however, be booked for shorter maturities with a view to reducing costs to the customer.
6. The bank may permit the customer to substitute an import/export order under a forward contract provided it is satisfied after verifying the documentary evidence that a genuine exposure to the extent of the amount of the original forward contract subsists under the substituted order.

8.3. BOOKING OF FORWARD CONTRACTS

The stages involved in booking and utilisation of a forward contract may be summarised as under:

1. The transaction of booking of forward contract is initiated with the customer enquiring of his bank the rate at which the required forward currency is available. Before quoting a rate the bank should get details about (*i*) the currency, (*ii*) the period of forward cover, including the particulars of option, and (*iii*) the nature and tenor of the instrument. For instance, when the customer says simply 'dollar', the bank should ascertain whether it is US dollar or Canadian dollar or Australian dollar. Similarly, if it is a bill transaction, it should be ascertained whether it is sight bill or 30 days bill, etc. In the case of usance bills, whether the due date is calculated from sight or from the date of bill of lading. Differences on these counts would vary the rate applicable.
2. The branch may not be fed with forward rates of all currencies by the Dealing Room. Even for major currencies forward rates for standard delivery periods may only be available at the branch. If the rate for the currency and/or delivery period is not available, the branch should contact the Dealing Room over phone or telex and obtain the rate.
3. If the rate quoted by the bank is acceptable to the customer, he is required to submit an application to the bank along with documentary evidence to support the application, such as the sale contract.
4. After verification of the application and the documentary evidence submitted, the bank prepares a 'Forward Exchange Contract'.
5. While preparing the contract, the following points are to be noted:

FORWARD EXCHANGE CONTRACT

N. FC/KRT/6/20xy Date 7-2-20xy

From To

Forex Bank Ltd.
Bangalore Main Branch

Exim India Ltd.
9, Sankey Road,
Bangalore-1

We confirm having bought from you foreign exchange as under:

Tenor	*Delivery Period*	*Currency Value*	*Rate*	*Rupee Equivalent*
		US $	US $	Rs.
Sight Bill	8-3-2000 to 7-4-2000	1,00,000	49.50	49,50,000

(Subject to rules and regulations of the Foreign Exchange Dealers' Association of India.) Please sign and return to us the enclosed confirmation.

For Forex Bank Ltd.,
M.A. Nager
Manager

Record of Delivery

Date of Delivery	*Currency Amount*	*Rupee Equivalent*	*Currency Balance*	*Rupee Balance*
	US $	Rs.	US $	Rs.
23-3-20xy	60,000	29,70,000	40,000	19,80,000
28-3-20xy	40,000	19,80,000	Nil	Nil

Fig. 8.1. Specimen of a Forward Exchange Contract.

(*a*) The branch may give a serial number to the contract, so that further reference to it becomes easy.

(*b*) Contracts must state the first and last dates of delivery. It is not permissible to state in contracts 'delivery one week' or 'delivery one month' or 'delivery three months forward', etc.

(*c*) When more than one rate for bills with different deliveries are mentioned, the contract must state the amount and delivery against each rate.

(*d*) No usance option may be stated in any contract for the purchase of bills. That is, the contract should not give option to the customer to tender sight bill or in the alternative 30 days' bill, etc. It can be either sight bill or a usance bill of a specified usance as mentioned in the contract.

(*e*) The first portion of the contract is relevant for booking of the contract. The second portion is used for recording deliveries under the contract.

(*f*) The contract should be complete in all respects.

6. The number of copies of the contract prepared will depend upon the requirements of the bank. The original of the contract duly signed by the bank, along with the duplicate, is sent to the customer. The duplicate signed by the customer is returned to the bank for its records.
7. The details of the contract are entered in a Forward Contract Register. The register also provides for recording of details of documentary evidence verified.
8. The documents are verified and marked with the bank stamp and signature of the bank official, after entering the particulars of the forward contract booked. It is returned to the customer.
9. The due date of the contract should be diarised in a register and followed up on the due date.
10. Charges for booking the forward contract as prescribed by the bank concerned is recovered from the customer.
11. When the customer delivers foreign exchange on the due date, the transaction is done at the rate agreed.

8.4. CALCULATION OF FIXED FORWARD RATES

The method of calculation of forward rates is similar to that for ready rates. The only difference is that in the case of forward rates, the forward margin that is included in the rate will be for forward period as well. That is, the forward discount or the forward premium included in the buying rate will be not only for the transit period and usance, but also for the forward period. For instance, if the bank buys a 30 days' sight bill for 2 months forward, the total forward discount will be for (30 days usance + 25 days transit + 2 months forward, rounded off to higher month) 4 months.

For selling rates, forward margin is not considered while calculating ready rates. In the case of forward rates, the forward margin for the forward period will be included. In other respects, the calculation is same as that of ready rates.

The method of calculation of forward rates is shown below. It may be seen that the formats are extensions of Formats 6.1 to 6.3 in Chapter 6. Separate format for TT buying is not given since the method is same as that for bill buying rate. For TT buying rate, forward margin will be included only for forward period.

Forward Buying Rate for Dollar		
Dollar/Rupee market spot buying rate	= Rs.	
Add : Forward premium (for forward period, transit period and usance period: rounded off to lower month)		
OR		
Less : Forward discount (for forward period, transit period and usance period: rounded off to higher month)	± Rs.	
	= Rs.	
Less : Exchange Margin	− Rs.	
Forward buying rate for dollar	= Rs. .....*	...(1)
**Rounded off to nearest multiple of 0.0025.*		

Format 8.1. Calculation of Forward Buying Rate for Dollar.

Forward Selling Rate		
Dollar/Rupee market spot selling rate	= Rs.	
Add : Forward premium (for forward period)		
OR		
Less : Forward discount (for forward period)	± Rs.	
	= Rs.	
Add : Exchange Margin to TT selling rate	+ Rs.	
Forward TT selling rate for dollar	= Rs. .....*	...(1)
Add : Exchange Margin for selling rate	+ Rs.	
Forward bills selling rate for dollar	= Rs. ....*	...(2)
**Rounded off to nearest multiple of 0.0025 when quoted to customer.*		

Format 8.2. Calculation of Forward Selling Rate for Dollar.

Example 8.1. From the following information you are required to calculate (*a*) ready bill buying rate, (*b*) 2 months forward buying rate for demand bill, (*c*) ready rate for 60 days usance bill, and (*d*) 2 months forward buying rate for 60 days usance bill.

Interbank rate US dollar	
Spot	USD 1 = Rs. 48.6000/6075
1month	3500/3600
2 months	5500/5600
3 months	8500/8600
4 months	1.1500/1.1600

5 months	1.3500/1.3600
6 months	1.5500/1.6600

Transit period is 25 days. All forward rates are for fixed delivery. Exchange margin is 0.10%

SOLUTION.

(*a*) **Ready buying rate**

Dollar/Rupee market spot buying rate	=	Rs.	48.60000
Less : Exchange margin at 0.10% on Rs. 48.6000	–	Re.	0.04860
	=	Rs.	48.55140

Rounded off to nearest multiple of 0.0025, the rate quoted for ready bill buying is **Rs. 48.5525.**

(*b*) **2 months forward buying rate**

Dollar/Rupee (market) spot buying rate	=	Rs.	48.60000
Add: Forward premium for 2 months (Transit period 25 days and forward period 2 months, rounded off to lower month)	+	Re.	0.55000
	=	Rs.	49.15000
Less :Exchange margin at 0.10% on Rs. 49.1500	–	Re.	0.04915
	=	Rs.	49.10085

Rounded off, the rate quoted for 2 months forward purchase of dollar bill is **Rs. 49.1000.**

(*c*) **Ready rate for 60 days usance bill**

Dollar/Rupee (market) spot buying rate	=	Rs.	48.60000
Add: Forward premium for 2 months (Transit period 25 days and forward period 2 months, rounded off to lower month)	+	Re.	0.55000
	=	Rs.	49.15000
Less : Exchange margin at 0.10% on Rs. 49.1500	–	Re.	0.04915
	=	Rs.	49.10085

Rounded off, the rate quoted for ready purchase of 60 days usance dollar bill is **Rs. 40.1000.**

(*d*) **2 months forward rate for 60 days bill**

Dollar/Rupee (market) spot buying rate	=	Rs.	48.60000
Add: Forward premium for 4 months (Transit period 25 days and forward period 2 months, rounded off to lower month)	+	Re.	1.15000
	=	Rs.	49.75000
Less :Exchange margin at 0.10% on Rs. 49.7500	–	Re.	0.04975
	=	Rs.	49.70025

Rounded off, the rate quoted for 2 months forward purchase of 60 days usance dollar bill is **Rs. 49.7000.**

Note: Compare (*b*), (*c*) and (*d*) to understand clearly the difference between ready and forward rates.

EXAMPLE 8.2. Assuming the data in Example 8.1, calculate (*a*) 1 month forward TT selling rate, and (*b*) 3 months forward bill selling rate. Exchange margin required is 0.15% for TT selling and 0.20% for bill selling.

SOLUTION.

(*a*) **1 month forward TT selling rate**

Dollar/Rupee (market) spot selling rate	=	Rs.	48.60750
Add: 1 month forward premium	+	Re.	0.36000
	=	Rs.	48.96750
Add: Exchange margin at 0.15% on Rs. 48.9675	+	Re.	0.07345
	=	Rs.	49.04095

Rounded off to nearest multiple of 0.0025, the one month forward TT selling rate for dollar is **Rs. 49.0400.**

(*b*) **3 months forward bill selling rate**

Dollar/Rupee (market) spot selling rate	=	Rs.	48.60750
Add: Forward premium for 3 months	+	Re.	0.86000
	=	Rs.	49.46750
Add: Exchange margin for TT selling at 0.15% on Rs. 49.4675	+	Re.	0.07420
	=	Rs.	49.54170
Add: Exchange margin for bills selling at 0.20% on Rs. 49.5417	+	Re.	0.09908
	=	Rs.	49.64078

Rounded off, 3 months forward bill selling rate for dollar is Rs. **49.6400.**

8.5. CALCULATION OPTION FORWARD RATES

Under an option forward contract the customer has the freedom to deliver the foreign exchange on any day during the option period. The bank should quote a single exchange rate valid for the entire option period.

Suppose that the following rates prevail for US dollar on 17th February:

	Buying Rs.	*Selling* Rs.
Spot	49.45	49.50
Spot/March	0.05	0.06 pm
Spot/April	0.08	0.09 pm
Spot/May	0.11	0.12 pm

(*a*) In respect of purchase transaction, the forward premium for delivery March is 5 paise and for delivery April is 8 paise. We have already seen that normally forward margin is to compensate the interest differential. The additional premium of 3 paise for April over that for March represents the interest differential for one month. If a customer requires forward purchase rate for fixed delivery 30th April, the bank would concede him the premium up to April end, and quote him the rate of Rs. 49.53 per dollar. On the other hand, if the customer wants to deliver foreign exchange on 1st April, he is not entitled to the premium for April. The forward premium for April beginning would be the same as that for March end. The bank will therefore quote him a rate of Rs. 49.50, inclusive of premium up to March. Suppose the customer requires the bank to book a forward purchase contract delivery April. It means, the customer can deliver foreign exchange on any day during April, *i.e.*, 1st April to 30th April, but the bank should quote a single rate which would be applicable to any of these days. The bank would play safe and quote the rate of Rs. 49.50 (*i.e.*, the rate for March) for an option forward contract with option to the customer over the entire April.

It may be argued on behalf of the customer that the option forward rate quoted to him is based on the interbank option forward rate. The bank would cover itself by entering into a forward sale with the market with option of delivery 1st to 30th April, in which case the premium of 8 paise is available to it.

It may be noted that as between two banks, the option of delivery under a forward contract rests with the buying bank. If the customer delivers foreign exchange on 1st April, the bank has to pay rupees to the customer immediately. In case the counterparty (buyer) in the cover deal chooses to require delivery on 30th April, the bank has to either keep the dollars received form the customer with itself or invest it for one month. Dollar is at premium because the cost of dollar funds is lower than that of rupee funds. For one month, even if the dollar is invested, the bank would be

losing on the interest differential which has to be compensated by offering lower premium to the customer.

From the above discussion, we may deduce the following rule: *For purchase transactions quote premium for the earliest delivery.*

(*b*) In a sale transaction with delivery entire April, the earliest date is 1st April, and latest date is 30th April. In case of fixed forward contracts, the selling rate applicable would be Rs. 49.56 on 1st April and Rs. 49.59 on 30th April. While quoting a rate for option forward contract, the bank would like to assume the worse situation of the customer requiring delivery on 30th April and quote the rate of Rs. 49.59. It is too obvious to mention that if the bank quotes Rs. 49.56 and the customer chooses delivery on 30th April the bank would be put to loss.

Therefore, *for sale transactions quote premium for latest delivery.*

Let us take the case of a currency at discount. Assume that Euro is quoted on 17th February as under:

	Buying Rs.	*Selling* Rs.
Spot	46.25	46.30
Spot/March	0.11	0.09 dis.
Spot/April	0.20	0.18 dis
Spot/May	0.29	0.27 dis

(*c*) For a fixed forward contract with delivery on 1st April the rates quoted would be Rs. 46.14 (Rs. 46.25–Re. 0.11). For a contract due on 30th April, the rate quoted would be Rs. 46.05 (Rs. 46.25–Re. 0.20). When required to quote for a forward contract with option over entire April, the bank would quote a rate of Rs. 46.05. The assumption is that the customer may not deliver till that date.

Hence, *for purchase transactions quote discount for latest delivery.*

(*d*) In case the bank is selling, again it has to choose between the rates for two dates—earliest, corresponding to April first or March end (Rs. 46.21) or latest, terminating with April end (Rs. 46.12). With the option lying with the customer, the bank would choose the safer course of quoting March end rate, *i.e.*, Rs. 46.21.

Thus *for sale transactions quote discount for earliest delivery.*

The above rule can be represented in a tabular form as under:

Transaction	Forward margin	
	Premium	Discount
Purchase	Earliest delivery	Latest Delivery
Sale	Latest delivery	Earliest Delivery

Fig. 8.1. Rule for application for forward margin.

Example 8.3. Your export-customer requests you on 15th July to book a foreign exchange contract delivery September covering 30 days sight bill on New York under an irrevocable letter of credit for USD 65,000.

Assuming US dollars are quoted in the local interbank market as under:

Spot	USD 1 = Rs. 49.5675/5750
Spot/July	800/900
Spot/August	1700/1800
Spot/September	2250/2325
Spot/October	3200/3300
Spot/November	4100/4200
Spot/December	5150/5250

What rate will you quote to your customer bearing in mind the following factors: Exchange margin 0.10%; Transit period 25 days?

SOLUTION. Dollar is at premium. The rule is to take the earliest delivery. The option to the customer is over September. Taking earliest delivery, the date of delivery will be taken as 1st September. The usance of the bill 30 days and transit period of 25 days will work out to 24th October as the probable date of the bank acquiring foreign exchange. This will be rounded off to the lower month, and the rate to the customer will be based on Spot/September buying rate in the interbank market.

Dollar/Rupee spot interbank buying rate	=	Rs. 49.56750
Add: Premium for September	+	Re. 0.22500
	=	Rs. 49.79250
Less: Exchange margin at 0.10% on Rs. 49.7925	–	Re. 0.04979
	=	Rs. 49.74271

Rounded off, the rate quoted to the customer would be **Rs. 49.7425.**

EXAMPLE 8.4. An import-customer of your bank wishes to book a forward contract with you on 2nd August, 1999 for sale to him of USD 1,50,000 delivery full November 1999.

The spot rates on 2nd August, 1999 are USD/Rs. 49.3700/3800 and the swap points are:

	USD/Re.
Spot/August	0300/0400
Spot/September	1100/1300
Spot/October	1900/2200
Spot/November	2700/3100
Spot/December	3500/4000

Calculate the rates to be quoted to the customer keeping an exchange margin of 5 paise. Fineness of quotations as per FEDAI Rules.

SOLUTION. The rate to the customer will be based on Spot/November rate in the market.

Dollar/Rupee spot selling rate	=	Rs. 49.3800
Add: Premium for Spot/November	+	Re. 0.3100
	=	Rs. 49.6900
Add: Exchange margin	+	Re. 0.0500
	=	Rs. 49.7400

The selling rate of US dollar delivery full November is **Rs. 49.7400** per dollar.

8.6. PROBLEMS FOR PRACTICE

PROBLEM 8.1. On 30th April, your customer requests you to book a forward contract for fixed delivery two months for USD 50,000 towards an export bill payable at sight and to be drawn on New York.

Assuming US dollar is quoted in the interbank market at:

Spot	USD 1 = Rs. 49.4325/4375
Spot/May	2000/2100
Spot/June	3000/3100
Spot/July	4000/4100

What rate will you quote to the customer for the transaction provided the transit period is 25 days and you require an exchange margin of 0.10%?

Also calculate the rupee amount that would be credited to the account of the exporter on tender of the bill. *[Ans. Rs 49.6825; Rs. 24,84,125]*

PROBLEM 8.2. On 15 May, your customer requests you to book a forward purchase contract for USD 2,50,000 with option to the customer over July towards advance remittance expected by him.

Assuming Rupee/US dollars quoted in the local interbank market as:

Spot	USD 1 = Rs. 49.3525/3600
Spot/June	1800/1900
Spot/July	2800/2900
Spot/August	3800/3900
Spot/September	4800/4900

What rate will you quote to your customer provided you require an exchange margin of 0.08% on TT buying and 0.10% on bill buying? *[Ans. Rs. 49.4925]*

Problem 8.3. Your import-customer has requested you on 15th October to book a forward contract for one month with option to the customer over November to retire USD bill for 50,000 expected by him.

Assuming the on-going interbank rates for Dollar are:

Spot	USD 1 = Rs. 49.5675/5725
Spot/October	1800/1900
Spot/November	2000/2100

You require an exchange of 0.10% on TT selling and 0.15% on bill selling.

Calculate the exchange rate quoted to the customer and the rupee amount payable by him on the contract. *[Ans. Rs. 49.9075; Rs. 24,96,375]*

9 Forward Exchange Rates Based on Cross Rates

In Chapter 7 we saw that calculation of spot rates for currencies other than US dollar is based on the principle of crossing the dollar/rupee rate with relevant foreign currency/dollar rate. The same principle is applied for calculation of forward rates also for other currencies. At first, we illustrate the method of calculating rates for currencies expressed in dollar/foreign currency terms in the international markets. Thereafter, the method of calculating rates for Euro and Pound sterling, which are expressed in dollars terms in the international market is explained.

9.1. CALCULATION OF FORWARD RATES FOR OTHER CURRENCIES

The method of calculating forward rates for currencies expressed in Dollar/Foreign currency terms is tabulated below:

Forward Buying Rate for Other Currencies		
Dollar/Rupee market spot buying rate	= Rs.	
Add : Forward premium (for forward period, transit period and usance period : rounded off to lower month)		
OR		
Less : Forward discount (for forward period, transit period and usance period: rounded off to higher month)	± Rs.	
	= Rs.	
Less : Exchange Margin	− Rs.	
Forward buying rate for dollar	= Rs. .....*	...(1)
Dollar/Foreign currency market spot selling rate	= FC. ...	
Add : Forward premium (for forward period, transit period and usance period : rounded off to higher month)		
OR		
Less : Forward discount (for forward period, transit period and usance period: rounded off to lower month)	± Fc.	
	= Fc .....*	...(2)
Forward buying rate for foreign currency = (1) divided by	= Rs.	...(2)
**Rounded off to nearest multiple of 0.0025 when quoted to customer.*		

Format 9.1. Calculation of Forward Buying Rate for other currencies.

Forward Selling Rate for Other Currencies		
Dollar/Rupee market spot selling rate	= Rs.	
Add : Forward premium (for forward period)		
OR		
Less : Forward discount (for forward period)	± Rs.	
	= Rs.	
Add : Exchange Margin to TT selling rate	+ Rs.	
Forward TT selling rate for dollar	= Rs. .....*	...(1)
Add : Exchange Margin for selling rate	+ Rs.	

Forward bills selling rate for dollar	= Rs. .....*	...(2)
Dollar/foreign currency spot buying rate	= FC	
Add : Forward premium (for forward period) OR *Less :* Forward discount (for forward period)	± FC	
	= FC	...(3)
Forward TT selling rate for foreign currency = (1) divided by	= Rs. .....*	...(3)
Forward bill selling rate for foreign currency = (2) divided by	= Rs. .....*	...(3)

**Rounded off to nearest multiple of 0.0025 when quoted to customer.*

Format 9.2. Calculation of Forward Selling Rate.

Example 9.1. Your exporter-customer has requested you to book a fixed date TT forward contract for Swiss Francs 5,00,000 in respect of an export bill due for payment 180 days from the date of the contract. Assuming you cover yourself by sale of Swiss Francs in London market for the corresponding delivery date when the exchange rates for Swiss Francs were as under:

Spot	USD 1 = CHF1.6120/6165
One month	60/58
Three months	165/160
Six months	330/320

and US dollars are quoted in the local interbank market as under:

Spot	USD 1 = Rs. 48.4025/4175
One month forward	48.6550/6725
Three months forward	48.8550/8750.
Six months forward	49.2550/2800

Calculate the exchange rate and the rupee amount payable to the customer bearing in mind the following:

(*i*) An exchange margin of 0.08% is required.
(*ii*) Rupee equivalent to be nearest to the whole rupee.

Solution. The bank has to quote forward TT buying rate for Franc with fixed delivery 180 days from the date of contract.

Dollar/Rupee six months forward buying rate	=	Rs.	49.2550
Less: Exchange margin at 0.08% on Rs. 49.2550	–	Re.	0.0394
Forward buying rate for dollar	=	Rs.	49.2156
Dollar/Franc spot selling rate	=	CHF	1.6165
Less: Discount for 6 months	–	CHF	0.0320
	=	CHF	1.5845
Forward TT buying rate for Franc (49.2156 ÷ 1.5845)	=	Rs.	31.0607

Rounded off the rate quoted would be Rs. 31.0600 per Swiss Franc.

Amount payable on realisation of the bill for CHF 5,00,000 at Rs. 31.0600 is Rs. 1,55,30,000.

Example 9.2. On 16th July, your export-customer requests you to book a forward contract for fixed delivery 2 months in respect of a 30 days bill for Australian Dollar 40,000.

US dollars were quoted in the interbank market as under:

Spot	USD 1 = 48.6850/7275
Spot/August	4000/4200
Spot/September	7500/7700
Spot/October	1.0500/1.0700
Spot/November	1.4000/1.4200

At Singapore market, Australian Dollars were quoted as follows:

Spot	USD 1 = AUD 1.9130/9140
One month	112/102
Two months	202/192
Three months	300/295
Four months	385/378

Transit period is 25 days. Exchange margin is 0.10%. Calculate the rate to be quoted to the customer.

Solution. Considering the forward period of 2 months, usance 30 days and transit period of 25 days, the bill is expected to realise on 12th November. US dollar is at premium against Indian rupee. Therefore, the period will be rounded off to end October.

Dollar/Rupee spot buying rate	=	Rs. 48.68500
Add: Premium for October	+	Rs. 1.05000
	=	Rs. 49.73500
Less: Exchange margin at 0.10% on Rs. 49.7350	−	Re. 0.04974
	=	Rs. 49.68526

Against Australian dollar, the US dollar is at discount. Since the selling rate is being considered, the forward margin will be taken for three months rounding off the forward period of 2 months, usance 30 days and transit period 25 days to the lower month.

US Dollar/Australian Dollar spot selling rate	=	AUD 1.9140
Less: Discount for 3 months	−	AUD 0.0295
	=	AUD 1.8845
Forward buying rate for Australian dollar	=	Rs. 26.3652
		(49.68526 ÷ 1.8845)

Rounded off, the rate quoted would be **Rs. 26.3650.**

Example 9.3. Your importer-customer has requested you to book a forward exchange contract for Swedish Kroner 35,000 for fixed delivery 6th Month.

Assuming Swedish Kroners are quoted in Singapore foreign exchange market against US dollars as under:

Spot	USD 1 = SEK 6.0700/0750
3 months forward	950/1050
6 months forward	2300/2500

and the US dollars are quoted in the local interbank exchange market as under:

Spot	USD 1 = Rs. 48.7000/8500
3 months forward	1.8000/1.6000
6 months forward	3.7000/3.5000

What rate will you quote to your customer bearing in mind that your exchange margin is 0.15% for TT selling and 0.2% for bills selling?

Solution.

Dollar/Rupee spot selling rate	=	Rs. 48.8500
Less: Discount for 6 months	−	Rs. 3.5000
	=	Rs. 45.3500
Add: Exchange margin at 0.15% for TT selling on Rs. 45.3500	+	Re. 0.0680
	=	Rs. 45.4180
Add: Exchange margin at 0.20% for Bill selling on Rs.45.4180	+	Re. 0.0908
Forward bill selling rate for dollar	=	Rs. 45.5088
Dollar/Kroner spot buying rate	=	SEK 6.0700
Add: Premium for six months	+	SEK 0.2300
	=	SEK 6.3000
Forward bills selling rate for Kroner (45.5008 ÷ 6.3000)	=	Rs. 7.2236

Rounded off, the rate quoted is **Rs. 7.2225** per Kroner.

Example 9.4. An importer-customer of your bank wishes to book a forward contract with you on 2nd August for sale to him of SGD 5,00,000 delivery on 30th September.

The spot rates on 2nd August are USD/Rs. 49.3700/3800 and USD/SGD 1.7058/68 and the swap points are:

USD/Rs.		USD/SGD	
Spot/August	0300/0400	1st month forward	48/49
Spot/September	1100/1300	2nd month forward	96/97
Spot/October	1900/2200	3rd month forward	138/140
Spot/November	2700/3100		
Spot/December	3500/4000		

Calculate the rates to be quoted to the customer keeping an exchange margin of 5 paise. Fineness of quotations as per FEDAI Rules.

Solution. The customer requires the rate for fixed date delivery on 30th September. The rate quoted to him will be based on Spot/September rate of US dollar/Rupee and second month forward rate for US dollar/Singapore dollar.

US Dollar/Rupee spot selling rate	=	Rs.	49.3800
Add: Forward premium for delivery September	+	Re.	0.1300
	=	Rs.	49.5100
Add: Exchange margin	+	Re.	0.0500
Forward selling rate for US dollar	=	Rs.	49.5600
US Dollar/Singapore Dollar spot buying rate	=	SGD	1.7058
Add: Forward premium for 2nd month	+	SGD	0.0096
	=	SGD	1.7154
Forward selling rate for Mark (49.5600 ÷ 1.7154)	=	Rs.	28.8912

Rounded off, the rate quoted is **Rs. 28.8900.**

Example 9.5. Your export-customer requests you on 4th April to book a forward contract of CAD 85,000 for delivery customer's option June.

Assuming you cover your purchase of Canadian dollars in Singapore market and the USD-CAD are quoted as under:

Spot	USD 1 = CAD 1.5625/5635
1 month	30/25
2 months	60/55
3 months	80/75

and the Rupee-US dollar are quoted in the interbank market as under:

Spot	USD 1 = Rs. 49.4875/4975
Spot/May	1100/1200
June	2200/2300
July	3300/3400

What rate will you quote to your customer bearing in mind that an exchange margin of 0.10% has to be loaded in the exchange rate? What will be the rupee amount payable to the customer?

Solution. US Dollar is at premium against rupee. So earliest delivery will be taken (1st June) and the customer will be quoted on the basis of Spot/May buying rate for dollar in the interbank market.

US Dollar/Rupee spot buying rate	=	Rs.	49.4875
Add: Premium for May	+	Re.	0.1100
	=	Rs.	49.5975
Less: Exchange margin at 0.10% on Rs. 49.5975	–	Re.	0.0496
Forward buying rate for US dollar	=	*Rs.*	*49.5479*

US dollar is at discount against Canadian dollar. Since selling rate is reckoned earliest delivery date will be considered, which is 1st June and falls between first and second month. Rounding off to the earlier month, the customer rate will be based on one month US dollar/Canadian dollar rate at Singapore market.

US dollar/Canadian dollar spot selling rate	= CAD	1.5635
Less: Discount for one month	– CAD	0.0025
	= CAD	1.5610
Forward buying rate for Canadian dollar (49.5479 ÷ 1.5610)	= Rs.	31.7411.

Rounded off, the rate quoted is **Rs. 31.7400** per Canadian dollar.

Rupee amount payable to the customer for CAD 85,000 is **Rs. 26,97,900.**

Example 9.6. Your customer requests on 8th May to book a forward contract to cover an export bill for Singapore Dollars 1,00,000 drawn on Singapore and payable 30 days after sight, with option to him over the month of July.

The following rates prevail in the interbank market for US dollars:

Spot	USD 1 = Rs. 49.4875/4925
Spot/May	1600/1700
June	3100/3200
July	4600/4700
August	6100/6200
September	7600/7700
October	9100/9200

At Singapore market, Singapore Dollar is quoted at:

Spot	USD 1 = SGD 1.4004/4078
1 month forward	70/75
2 months forward	110/115
3 months forward	150/155
4 months forward	190/195
5 months forward	230/235
6 months forward	270/275

Transit period is 25 days. Exchange margin required is 0.10%.

What rate will you quote to your customer?

Solution. US Dollar is at premium against rupee. Earliest delivery under the forward contract is on 1st July. Usance period of 30 days and transit period of 25 days, add up to 55 days making 25th August the due date of the bill. This will be rounded off to the lower month and the exchange rate to the customer will be based on Spot/July rate for US dollar in the interbank market.

US Dollar/Rupee spot buying rate	= Rs.	49.4875
Add: Premium for July	+ Re.	0.4600
	= Rs.	49.9475
Less: Exchange margin at 0.10% on Rs. 49.9475	– Re.	0.0499
Forward buying rate for US dollar	= Rs.	49.8976

US dollar is at premium against Singapore dollar. Since selling rate is to be considered, taking latest delivery of 31st July, the bill is expected to realise on 20th September, which falls in the fifth month from 5th May. The forward rate to the customer will be calculated based on 5 months forward US dollar/Singapore dollar rate.

US dollar/Singapore dollar spot selling rate	= SGD	1.4078
Add : Premium for 5 months	+ SGD	0.0235
	= SGD	1.4313
Forward buying rate for Sing. dollar (49.8976 ÷ 1.4313)	= Rs.	34.8617

The rate quoted to the customer is **Rs. 34.8625** per Singapore dollar.

Example 9.7. Your import-customer requests you on 20th February to book a forward exchange contract for Japanese Yen 2 million delivery April.

Assuming US dollars are quoted in Singapore market against Japanese yen as under:

Spot	USD 1 = JPY 117.5840/5950
1 month forward	100/95
2 months forward	200/195
3 months forward	300/295
4 months forward	400/395
5 months forward	500/495
6 months forward	600/595

and US dollar in the local interbank market as:

Spot	USD 1 = Rs. 49.2575/2625
Spot/March	875/900
April	1200/1300
May	1900/2000
June	2500/2600
July	3200/3125
August	3725/3800

What rate will you quote to your customer bearing in mind that you are required to keep an exchange margin of 0.15% on TT selling and 0.20% on bills selling?

Solution. Against rupee dollar is quoted at premium. Since this is a sale transaction, late delivery will be taken. The forward rate to the customer will be based on Spot/April selling rate in the interbank market.

Dollar/Rupee spot selling rate	=	Rs.	49.2625
Add: Premium for April	+	Re.	0.1300
	=	Rs.	49.3925
Add: Exchange margin for TT selling at 0.15% on Rs. 49.3925	+	Re.	0.0741
Forward TT selling rate for dollar	=	Rs.	49.4666
Add: Exchange margin for bills selling at 0.20% on Rs. 49.4668	+	Re.	0.0989
Forward bills selling rate for dollar	=	Rs.	49.5655

Against Yen, Dollar is quoted at discount. Since the buying rate is reckoned for this leg of the transaction, the latest delivery date of 31st April will be taken. This falls under third month from 20th February.

Dollar/Yen spot buying rate	= JPY 117.5840
Less: Discount for 3 months	− JPY 0.0300
	= JPY 117.5540

Forward bills selling rate for Yen

$$\left[\frac{49.5655}{117.5540} \times 100\right] = \text{Rs. } 41.1640$$

Rounded off, the rate quoted would be **Rs. 41.1650** per 100 yen.

9.2. CALCULATION OF FORWARD RATES FOR EURO AND STERLING

The steps involved in the calculation of forward rates for currencies expressed in terms of so many units of US dollar are tabulated below.

Forward Buying Rate for Euro/Sterling

Dollar/Rupee market spot buying rate	= *Rs.* ....
Add: Forward premium (for forward period, transit period and usance period: rounded off to lower month)	
OR	
Less: Forward discount (for forward period, transit period and usance period: rounded off to higher month)	± Rs. ....
	= Rs. ....

Less : Exchange Margin − Rs. ....

Forward buying rate for dollar = Rs. .....* ...(1)

Foreign currency/Dollar market spot buying rate = USD. ...

Add : Forward premium (for forward period, transit period and usance period: rounded off to lower month)

OR

Less : Forward discount (for forward period, transit period and usance period: rounded off to higher month) ± USD. ...

= USD ....(2)

Forward buying rate for foreign currency

= (1) multiplied by (2) = Rs. ....*

**Rounded off to nearest multiple of 0.0025 when quoted to customer.*

Format 9.3. Calculation of Forward Buying Rate for Euro/Sterling.

Forward Selling Rate for Euro/Sterling

Dollar/Rupee market spot selling rate = Rs. ....

Add : Forward premium (for forward period)

OR

Less : Forward discount (for forward period) ± Rs. ......

= Rs. ....

Add : Exchange Margin to TT selling rate + Rs. .....

Forward TT selling rate for dollar = Rs. .....* ...(1)

Add : Exchange Margin for selling rate + Rs. .....

Forward bills selling rate for dollar = Rs. ....* ...(2)

Foreign currency/Dollar spot selling rate = USD .....

Add : Forward premium (for forward period)

OR

Less : Forward discount (for forward period) ± USD .....

= USD ....(3)

Forward TT selling rate for foreign currency

= (1) multiplied by (3) = Rs. .....*

Forward bill selling rate for foreign currency

= (2) multiplied by (3) = Rs. ....*

**Rounded off to nearest multiple of 0.0025 when quoted to customer.*

Format 9.4. Calculation of Forward Selling Rate.

EXAMPLE 9.8. On 18th July, an export-customer seeks forward cover for Euro 100,000, with option to him over the month of September, covering an export bill on Frankfurt with 30 days usance.

The interbank rates for US dollar were as follows:

Spot	USD 1 = Rs.48.6325/6400
Spot /July	500/600
/August	1500/1600
/September	2800/2900
/October	4200/4300
/November	6300/6400
/December	8500/8600

Euro is quoted in the Singapore Market as under:

Spot	Euro 1 = USD 0.9815/865
1 month	20/21
2 months	40/41
3 months	60/61
4 months	80/81

5 months	100/101
6 months	120/121

Transit period is 25 days. The bank requires an exchange margin of 0.10%. Calculate the rate to be quoted to the customer.

Solution. Dollar is at premium against rupee. Hence the earliest date of option will be taken. The notional due date falls on 25th October. Premium up to September will be conceded.

Dollar/rupee market spot buying rate	=	Rs.	48.6325
Add: Premium for September	+	Re.	0.2800
	=	Rs.	48.9125
Less: Exchange margin at 0.10% on Rs.48.9125	–	Re.	10.0489
Forward bill buying rate for dollar	=	Rs.	48.8636

Euro is also at premium at Singapore market. Taking the earliest date of option, the notional due date is 25th October. This date falls between third and fourth months from the date of the contract. Rounded off to earlier month, premium for 3 months will be taken.

Euro/dollar market spot buying rate	=	USD	0.9815
Add: 3 months premium	+	USD	0.0060
Euro/dollar 3 months forward buying rate	=	USD	0.9875
Euro/rupee forward bill buying rate (Rs.48.8636×0.9875)	=	Rs.	48.2528

Rounding off to the nearest multiple of 0.0025, the rate quoted would be Rs.48.2525 per Euro.

Example 9.9. Assuming the exchange rates given in Example 9.8, calculate the forward TT selling rate for Euro with option to the customer over the month of October. The bank requires an exchange margin of 0.15%.

Solution. The dollar is at premium against rupee. Since this is a sale transaction, latest date of delivery will be taken and premium up to October included in the rate to the customer.

Dollar/rupee market spot selling rate	=	Rs.	48.6400
Add: Premium for October	+	Re.	0.4300
	=	Rs.	49.0700
Add: Exchange margin at 0.15% on Rs.49.0700	–	Re.	0.0736
Forward bill selling rate for dollar	=	Rs.	49.1436

Euro is also at premium. Last date of delivery is October 31st, which falls under the fourth month from date of contract.

Euro/dollar market spot selling rate	=	USD	0.9865
Add: 4 months premium	+	USD	0.0081
Euro/dollar 4 months forward selling rate	=	USD	0.9946
Euro/rupee forward bill selling rate (Rs.49.1436×0.9946)	=	Rs.	48.8782

Rounding off to the nearest multiple of 0.0025, the rate quoted would be Rs.48.8775 per Euro.

9.3. PROBLEMS FOR PRACTICE

Problem 9.1. On 23rd September, your export-customer has requested you to book a forward purchase contract for Swiss Franc 2,00,000 with option to the customer over November.

Assuming Swiss Francs is quoted at Singapore market as under:

Spot	USD 1 = CHF 1.4900–1.4910
One month forward	0.0030–0.0025
Two months forward	0.0060–0.0055
Three months forward	0.0090–0.0085
Four months forward	0.0120–0.0115

US dollar is quoted in the interbank market as under:

Spot	USD 1 = Rs. 49.6025/6100
Spot/October	2000/2100
Spot/November	4000/4100
Spot/December	6000/6100
Spot/January	8000/8100

You are required to quote to the customer the exchange rate for the transaction.

Notes:

(*i*) you are required to load an exchange margin of 0.10% in the rate.
(*ii*) Transit period is 25 days. [*Ans. Rs. 33.4925*]

Problem 9.2. On 15th May, your customer approaches you with a request to book a forward contract for Singapore Dollars 1,00,000 in respect of a 30 days sight bill which he expects to draw under a letter of credit in his favour opened by your Singapore branch during the third week of July.

Assuming Singapore dollars are quoted in Singapore market as under:

Spot	SGD 1 = SGD 1.6210/6222
1 month forward	42/40
2 months forward	63/60
3 months forward	84/80
4 months forward	105/100
5 months forward	126/120

US dollars are quoted in interbank market as under:

Spot	USD 1 = Rs. 49.4500/4575
Delivery July	49.2500/2575
Delivery August	49.0500/0575
Delivery September	48.8500/8575
Delivery October	48.6500/6575
Delivery November	48.4500/4575

You are required to quote the rate to the customer for a suitable forward period.
You require an exchange margin of 0.10%.
Transit period is 25 days.
Also calculate the rupee amount payable to the customer.

[*Ans. Rs. 30.3000; Rs. 30,30,000*]

Problem 9.3. On 7th January, you are requested by your import-customer to book a forward contract for Singapore dollar 1,00,000 with option to him over March.

At Singapore exchange market, Singapore dollar is quoted as follows:

Spot	USD 1= SGD 1.6300/6350
1 month forward	40/45
2 months forward	80/90
3 months forward	120/135
4 months forward	160/180

At the interbank market, US dollars is quoted as follows:

Spot	USD = 1 Rs. 49.4825/4875
Spot/January	1550/1600
Spot/February	2550/2600
Spot/March	3550/3600
Spot/April	4550/4600

Transit period is 25 days.

Exchange margin required is 0.08% on TT buying, 0.10% on bill buying, 0.10% on TT selling and 0.15% on bill selling.

Required to calculate:

(*a*) The rate of exchange quoted to the customer for the transactions; and
(*b*) The rupee amount payable by the customer.

[*Ans. Rs. 30.5825; Rs. 30,58,250*]

PROBLEM 9.4. On 2nd August, your import-customer approached you for booking a forward contract for sterling pounds 50,000. Delivery will be taken by him on 3rd October.

On 2nd August, market is as under:

	1 USD = Rs. 49.3625/775	1 Stg. Pound = USD 1.5138/48
1st month	1025/1350	37/33
2nd month	2000/2725	63/59
3rd month	3225/4050	90/83

Calculate the rupee amount payable by the customer on due date taking into consideration:

(*i*) The direct quotation system.

(*ii*) An exchange margin of 0.15% is required by you and exchange rates to be quoted nearest to two decimals in multiples of 1 paisa.

(*iii*) Ignore out-of-pocket expenses. [*Ans. Rs. 75.0300; Rs. 37,51,500*]

10 Interbank Deals

INTERBANK deals refer to purchase and sale of foreign exchange between the banks. In other words, it refers to the foreign exchange dealings of a bank in the interbank market.

10.1. COVER DEALS

Purchase and sale of foreign currency in the market undertaken to acquire or dispose of foreign exchange required or acquired as a consequence of its dealings with its customers is known as the 'cover deal'. The purpose of cover deal is to insure the bank against any fluctuation in the exchange rates.

We have seen that in quoting a rate to the customer the bank, is guided by the interbank rate to which it adds or deducts its margin, and arrives at the rate it quotes to the customer. For example, if it is buying dollar from the customer spot, it takes interbank buying rate, deducts its exchange margin and quotes the rate. This exercise is done on the assumption that immediately on purchase from the customer the bank would sell the foreign exchange to interbank market at market buying rate.

Since the foreign currency is a peculiar commodity with wide fluctuations in price, the bank would like to sell immediately whatever it purchases and whenever it sells it goes to the market and makes an immediate purchase to meet its commitment. In other words, the bank would like to keep its stock of foreign exchange near zero. The main reason for this is that the bank wants to reduce the exchange risk it faces to the minimum. Otherwise, any adverse change in the rates would affect its profits.

It the case of spot deals the transaction is quite simple. If the bank has purchased USD 10,000, it would endeavour to find another customer to whom it can sell this. If it succeeds, the profit would be the maximum because both buying and selling rates are determined by the bank and the margin between the rates is the maximum. If it, cannot find another customer, it sells in the interbank market where the rate is determined by the market conditions. The margin is narrower here.

EXAMPLE 10.1. Your dealer in the 'Dealing Room' sells through an exchange broker in the local market USD 5,00,000 delivery spot in cover of a telegraphic transfer from abroad.

Calculate the rupee amount receivable from this sale assuming that Rupee/US dollar rates are quoted in the local market as under:

Spot	USD 1 = Rs. 48.8000/8500
Brokerage 0.01%	

SOLUTION. The bank sells at the market buying rate of Rs. 48.8000.

Rupee amount received on sale of USD 5,00,0000 at Rs. 48.8000	=	Rs.	2,44,00,000
Brokerage payable at 0.01%	–	Rs.	2,440
Net amount receivable on the deal	=	Rs.	2,43,97,560

EXAMPLE 10.2. You sold Euro 10,00,000 value spot to your customer at Rs. 48.3300 and covered yourself in London market on the same day when the exchange rates were as under:

Spot EUR 1 = USD 0.9875/890

Local interbank market rates for US dollars were:

Spot USD 1 = Rs. 48.7000/8500

Calculate the cover rate and ascertain the profit or loss in the transaction. Ignore brokerage on the interbank transaction.

Solution. The bank covers itself by buying Euro (or selling dollars) from the London market at market buying rates for dollar. The requisite dollar is acquired in the local interbank market at the market selling rate for dollar against rupee.

Dollar/Rupee selling rate	=	Rs.	48.8500
Euro/Dollar selling rate	=	USD	0.9890
Euro/Rupee cross rate (48.8500 × 0.9890)	=	Rs.	48.31265*
Euro is sold to customer at		Rs.	48.33000
The sale is covered at		Rs.	48.31265
Profit per Euro sold	=	Re.	0.01735

Profit on Eur 10,00,000 at Re. 0.01735 per Euro = **Rs. 17,350.**

***Note:** This rate has not been rounded off because no transaction is done at this rate but is calculated only to arrive at the profit.

10.2. TRADING

Trading refers to purchase and sale of foreign exchange in the market other than to cover bank's transactions with the customers. The purpose may be to gain on the expected changes in exchange rates.

Example 10.3. Your forex dealer had entered into a cross currency deal and had sold USD 5,00,000 against Swiss Francs at USD 1 = CHF 1.4400 for spot delivery. However, later during the day, the market became volatile and the dealer in compliance with his top management's guidelines had to square up the position by purchasing USD 5,00,000 against CHF at the on-going rate. Assuming the spot rates are as under:

USD 1 = INR 49.4300/4500

and USD 1 = CHF1.4440/4450

What will be the gain or loss in the transaction? Your answer should be in rupees. Ignore brokerage. *(IIB Nov. 1995; Adapted)*

Solution. To square its position the bank can purchase US dollars against Swiss francs at the market selling rate of CHF1.4450 per dollar.

CHF acquired on sale of USD 5,00,000 at CHF1.4400	=	CHF	7,20,000
CHF paid on purchase of USD 5,00,000 at CHF 1.4450	=	CHF	7,22,500
Loss on combined deal in Marks	=	CHF	2,500

In terms of rupees the loss would be the rupee outlay required to acquire CHF 2,500 from the market. The bank can sell USD and acquire CHF at the market USD buying rate of CHF 1.4440. The requisite USD it can acquire in the market at the market selling rate of Rs. 49.4500. The Franc/Rupee cross rate is (49.4500 ÷ 1.4440) Rs. 34.2452.

Loss on the transaction in rupees = Rs. 34.2452 × 2,500 = **Rs. 85,613.**

10.3. FUNDING OF NOSTRO ACCOUNT

Funding of *nostro* account of the bank is done by realisation of foreign exchange in the relevant currency purchased by the bank. If sales exceed purchases to avoid overdraft in the nostro account, the bank would purchase the requisite foreign exchange in the interbank market and arrange for its credit to the nostro account.

Some of the foreign banks who maintain *nostro* accounts with the bank may fund the account by arranging remittance through some other bank. Or the foreign bank concerned may request the Indian bank to credit its rupee account and in compensation credit the account of the Indian bank with it. When required to quote a rate for this transaction, the bank in India would quote the rate at which it could dispose of the foreign exchange in India, *viz.*, the market buying rate. Exchange margin may not be taken for such transactions.

Example 10.4. Your foreign correspondent wants to purchase 20 million rupees against USD for funding their account with you. Assuming that the interbank rates are 49.4250/4350, what would be the rate you would quote to them? Ignore

exchange margin, brokerage, etc. If the deal is struck, what would be the amount of US dollars that would be credited to your account? (*IIB Nov. 1995; Adapted*)

Solution. The bank will buy US dollars from the foreign correspondent at the dollar buying rate of Rs. 49.4250. Its nostro account would be credited with:

$$\text{USD}\frac{2,00,00,000}{49.4250} = \text{USD } 404,653.52.$$

10.4. SWAP DEALS

A 'swap deal' is a transaction in which the bank buys and sells the specified foreign currency simultaneously for different maturities. Thus a swap deal may involve:

(*i*) simultaneous purchase of spot and sale of forward or *vice versa*; or

(*ii*) simultaneous purchase and sale, both forward but for different maturities. For instance, the bank may buy one month forward and sell two months forward. Such a deal is known as 'forward to forward swap'.

The term swap will be used rather loosely in the chapters on Cancellation and Extension of Forward Contracts. To be precise, a deal should fulfil the following conditions to be called a swap deal:

(*i*) There should be simultaneous buying and selling of the same foreign currency of same value for different maturities; and

(*ii*) The deal should have been concluded with the distinct understanding between the banks that it is a swap deal.

A swap deal is done in the market at a difference from the ordinary deals. In the ordinary deals, the following factors enter into the rates:

(*i*) The difference between the buying and selling rates; and

(*ii*) The forward margin, *i.e.*, the premium or discount.

In a swap deal, the first factor is ignored and both buying and selling are done at the same rate. Only the forward margin enters into the deal as the swap difference. The nature of a swap deal is explained below with an example.

Illustration. Following rates are ruling in the market for US dollars:

Spot	Rs. 42.2800/3000
3 months forward	7000/7200

PN Bank sells to UCO Bank USD 2 million delivery 3 months. This is an outright forward sale deal for the PN Bank. UCO Bank may accept the deal at Rs. 49.9800 being its three months forward buying rate. PN Bank also buys spot USD 2 million from Dena Bank. It is a spot purchase deal for PN Bank. Dena Bank may accept the deal at its spot selling rate of Rs. 49.3000. In the above case, the purchase and sale are with different banks and there are two separate contracts.

In a swap deal, both purchase and sale are done with the same bank and they constitute two legs of the same contract. In the above case, if PN Bank decides to do both buying and selling from and to UCO Bank and the latter agrees, it results in swap deals for both banks. PN Bank buys spot and sells forward and UCO Bank sells and buys forward.

If PN Bank approaches UCO Bank to quote its swap rate for spot to 3 months, UCO Bank may quote the rate as 7000/7200. This means the forward rate in the swap deal is at a premium over the spot rate at 70 paise for purchase and 72 paise for sale. If the swap is for the UCO Bank (quoting bank) to buy spot and sell forward, the swap difference is premium of 72 paise. If the swap is for the quoting bank to sell spot and buy forward, the swap difference is premium of 70 paise. In our case, if UCO Bank is required to buy forward against spot sale, premium of 70 paise is applicable.

In a swap deal, it does not really matter as to what is spot rate. What is important is the swap difference which determines the quantum of net receipt of payment for the bank as a result of the combined deal. But the spot rate decides

the total value in rupees that either of the banks has to deploy till receipt of forward proceeds on the due date. Therefore, it is expected that the spot rate is the spot rate ruling in the market. Normally, the buying or selling rate is taken depending upon whether the spot side is respectively a sale or purchase to the market-maker. The practice is also to take the average of the buying and selling rates. However, it is of little consequence whether the purchase or selling or middle rate is taken as the spot rate. In our case either Rs. 49.2800 or Rs. 49.3000 can be the spot rate. Whatever be the spot rate taken, the forward rate will be quoted by adding the agreed premium. If UCO Bank takes Rs. 49.2800 as the spot rate, then the forward rate will be Rs. 49.9800.

❑ Need for Swap Deals

Some of the cases where swap deal may become necessary are described below:

(1) When the bank enters into a forward deal for a large amount with the customer and cannot find a suitable forward cover deal in the market, recourse to swap deal may become necessary. For example, the bank has bought two months forward from a customer Hongkong dollars 1.5 million. If the bank is unable to find a buyer in the market for two months forward for the currency, it cannot wait till it finds one because the rate may change adversely. To cover the exchange risk, it will sell spot in the market. Let us say that the market rate is Rs. 6.82-6.86 spot and 2 months forward discount is 3 APIs. The bank would have quoted a rate something less than Rs. 6.79, say Rs. 6.78. The bank sells spot to the market at the market buying rate of Rs. 6.82.

The position of the bank is:

(i) Spot sale HKD 1.5 million at Rs. 6.82; and
(ii) Forward purchase HKD1.5 million at Rs. 6.78.

The above deals cover the exchange risk for the bank. But the spot sale would result in an overdraft in the bank's account maintained abroad. Therefore, the bank has to make spot purchase to fund the account. The next day, the bank carries out a swap buying spot and selling forward. If in the meanwhile, the rate has moved to Rs. 6.80-6.84 and the forward margin is 3 paise discount, the bank would be able to buy spot at Rs. 6.80 and sell forward at Rs. 6.77.

It may be noted that under the swap deal the movement of the spot rate does not affect the bank. If the bank could have found cover in the market for forward on the date of purchase from the customer, it could have sold two months forward to the market at the market buying rate of Rs. 6.79. Having purchased from the customer at Rs. 6.78, the profit to the bank would have been 1 paisa per dollar. Under the swap deal too, the combined effect of all the four transactions results in a profit of 1 paisa per dollar to the bank as under:

	Purchases Rs.		*Sales* Rs.
Forward	6.78	Spot	6.82
Spot	6.80	Forward	6.77
	13.58		13.59

The net difference is 1 paisa in favour of the bank.

Had the bank waited for the next day, it could have sold forward at the market buying rate of Rs. 6.77. The net result would be a loss of 1 paisa per dollar to the bank.

(2) Swap may be needed when early delivery or extension of forward contracts is effected at the request of the customers. Please see chapters on Execution of Forward Contracts and Extension of Forward Contracts.

(3) Swap may be carried out to adjust cash position in a currency. This is explained later in the chapter on Exchange Dealings.

(4) Swap may also be carried out when the bank is overbought for certain maturities and oversold for certain other maturities in a currency.

❑ Swap and Deposit/Investment

Let us suppose that the bank sells USD 10,000 three months forward. Instead of covering its position by a forward purchase, the bank may buy from the market spot dollar and keep the amount in deposit with a bank in New York. The deposit will be for a period of three months. On maturity, the deposit will be utilised to meet its forward sale commitment. Such a transaction is known as 'swap and deposit'. The bank may resort to this method if the interest rate at New York is sufficiently higher than that prevailing in the local market.

If instead of keeping the amount in deposit with a New York bank, in the above case, the spot dollar purchased is invested in some other securities, the transaction is known as 'swap and investment'.

EXAMPLE 10.5. A bank does a swap of USD 1,00,000 selling spot and buying two months forward. US dollar is quoted locally at Rs. 49.1900/2200. Two months forward is quoted at 30 p. above spot rate. Interest in Bombay is 12% p.a. Interest in New York is 6% p.a. Brokerage on swap deal is 1.5 paise per Rs. 100. Indicate the gain/loss made by the bank on the swap.

SOLUTION. The bank sells spot to the market at the market buying rate of Rs. 49.1900. Since it is a swap deal, it can buy forward at 30 paise above Rs. 49.1900, i.e., Rs. 49.4900. The brokerage is payable at 0.75 paise per Rs. 100 for each leg of the deal.

(*a*) Amount obtained on sale of USD 1,00,000 at Rs. 49.1900	=	Rs. 49,19,000
Less: Brokerage at 0.75 paise per Rs. 100	–	Rs. 369
	=	Rs. 49,18,631
Interest earned on Rs. 49,18,631 at 12% for 2 months	+	Rs. 98,373
Total amount receivable	=	Rs. 50,17,004
(*b*) On spot sale, the bank's account will be overdrawn at New York to the extent of USD 1,00,000 on which it has to pay interest at the rate of 6%.		
Interest on USD 1,00,000 at 6% for 2 months	=	USD 1,000
Therefore, the total amount it has to buy to adjust the overdraft	=	USD 1,01,000
Amount the bank has to pay on purchase of USD 1,01,000 at Rs. 49.4900	=	Rs. 49,98,490
Add: Brokerage at 0.75 paise per Rs. 100	+	Rs. 375
Total amount payable	=	Rs. 49,98,865
(*c*) Amount receivable on sale	=	Rs. 50,17,004
Amount payable on purchase	=	Rs. 49,98,865
Profit to the bank	=	Rs. 18,139

In practice, forward purchase could be for USD 1,00,000. Interest of USD 1,000 has to be purchased spot on maturity.

10.5. ARBITRAGE OPERATIONS

If perfect conditions prevail in the market, the exchange rate for a currency should be the same in all centres. For example, if US dollar is quoted at Rs. 49.4000 in Mumbai, it should be quoted at the same rate of Rs. 49.4000 at New York. But under imperfect conditions prevailing, the rates in different centres may be different. Thus at New York Indian rupees may be quoted at Rs. 49.4800 per dollar. In such a case, it would be advantageous for a bank in Mumbai to buy US dollars locally

and arrange to sell them at New York. Assuming the operation to involve Rs. 10 lakhs, the profit made by the bank would be:

At Mumbai US dollars purchased for Rs. 10,00,000 at Rs. 49.4000 would be (10,00,000 ÷ 49.4000) USD 20,242.91.

Amount in rupees realised on selling USD 20,242.91at New York at Rs. 49.4800 would be Rs. 10,01,619.

Therefore, the gross profit made by the bank on the transaction is Rs. 1,619. The net profit would be after deducting cable charges, etc., incurred for the transaction.

The purchase and sale of a foreign currency in different centres to take advantage of the rate differential is known as 'arbitrage operations'.

When the arbitrage operation involves only two currencies, as in our illustration, it is known as 'simple' or 'direct' arbitrage.

Sometimes the rate differential may involve more than two currencies. For example, let us say that these rates are prevailing:

Mumbai on New York	Rs. 49.4000
New York on London	USD 1.5100
Mumbai on London	Rs. 74.6150

Based on quotation for dollar in Mumbai and for sterling in New York, the sterling rate in Mumbai should be Rs. 74.5956 while the prevailing rate is Rs. 74.6150. The bank can buy dollar locally and utilise it in New York to acquire sterling there. The sterling thus purchased may be disposed of locally. Let us say the transaction is undertaken for Rs. 10,00,000.

1. The bank buys dollars for Rs. 10,00,000 at Mumbai. Amount realised in dollars is (10,00,000 ÷ 49.4000) USD 20,242.91.
2. The bank sells USD 20,241.91at New York and acquires pound sterling. Amount realised in pound sterling at USD 1.5100 per pound is (20,241.91÷ 1.5100) GBP 13,405.90.
3. The bank sells GBP 13,405.90 at Bombay at Rs. 74.6150 and realises Rs. 10,00,281.

Therefore, the gross profit on the combined transaction is Rs. 281.

Such an arbitrage operation which involves more than two currencies is known as 'compound' or 'indirect' arbitrage.

Example 10.6. You, as a foreign exchange dealer of your bank, are informed that your bank has sold a T.T. on Copenhagen for Danish Kroner 1,000,000 at the rate of Danish Kroner 1 = Rs. 6.5150. You are required to cover the transaction through London or New York whichever course offers you a more profitable rate. The rates on that date are as under:

Mumbai — London	Rs. 74.3000	74.3200
Mumbai — New York	Rs. 49.2500	49.2625
London — Copenhagen	DKK 11.4200	11.4350
New York — Copenhagen	DKK 7.5670	7.5840

Will you cover the transaction through London or New York and what will be the exchange profit on the transaction? Ignore brokerage at all centres.

Solution. Amount realised on selling Danish Kroner 10,00,000 at Rs. 6.5150 per Kroner = Rs. 65,15,000.

Cover at London

Bank buys Danish Kroner at London at the market selling rate. Pound sterling required for the purchase (10,00,000 ÷ 11.42000) = GBP 87,565.67.

Bank buys locally GBP 87,565.67 for the above purchase at the market selling rate of Rs. 74.3200. The rupee cost = Rs. 65,07,881.

Profit (Rs. 65,15,000 – Rs. 65,07,881) = Rs. 7,119.

Cover at New York

Bank buys Kroners at New York at the market selling rate. Dollars required for the purchase (10,00,000 ÷ 7.5670) = USD 1,32,152.77

Bank buys locally USD 1,32,152.77 for the above purchase at the market selling rate of Rs. 49.2625. The rupee cost = Rs. 65,10,176. Profit (Rs. 65,15,000 – Rs. 65,10,176) = Rs. 4,824.

The transaction would be covered through London which gets the maximum profit of **Rs. 7,119.**

Example 10.7. Your bank's London office has surplus funds to the extent of USD 5,00,000 for a period of 3 months. The cost of the funds to the bank is 4% p.a. It proposes to invest these funds in London, New York or Frankfurt and obtain the best yield, without any exchange risk to the bank. The following rates of interest are available at the three centres for investment of domestic funds thereat for a period of 3 months:

London 5% p.a.
New York 8% p.a.
Frankfurt 3% p.a.

The market rates in London for US dollars and Euro are as under:

London on New York	
Spot	1.5350/90
1 month	15/18
2 months	30/35
3 months	80/85
London on Frankfurt	
Spot	1.8260/90
1 month	60/55
2 months	95/90
3 months	145/140

At which centre will the investment be made and what will be the net gain (to the nearest pound) to the bank on the funds?

Solution.

Cost of funds at 4% p.a. for 3 months (on GBP 5,00,000)	=	GBP	5,000
Amount invested	=	GBP	5,00,000
	=	GBP	5,05,000

(a) *Investment in London*

Interest earned on GBP 5,00,000 at 5% p.a. for 3 months	=	GBP	6,250
Less: Cost of funds	–	GBP	5,000
Net Yield on investment	=	GBP	1,250

(b) *Investment in New York*

The bank buys US dollars at the spot rate and invests the funds in New York. It also enters into a three months forward contract selling this amount together with interest thereon.

The bank buys US dollars for GBP 5,00,000 at the market selling rate of USD 1.5350.

Amount realised in US dollars	=	USD	7,67,500
Interest earned on USD 7,67,500 at 8% for 3 months	+	USD	15,350
Total amount available at the end of three months	=	USD	7,82,850

This amount the bank sells to the market at the market three months forward buying rate of USD 1.5475 (USD 1.5390 + 0.0085).

Amount realised in pound sterling (7,82,850 ÷ 1.5475)	=	GBP	5,05,880
Less: Amount to be repaid	=	GBP	5,05,000
Net Yield	=	GBP	880

(c) *Investment in Frankfurt*

The bank buys Euro for GBP 5,00,000 at the market spot selling rate of EUR 1.8260.

Amount realised in Euro	=	EUR	9,13,000
Interest at 3% p.a. for 3 months on EUR 9,13,000	=	EUR	6,847
Total amount available at the end of 3 months	=	EUR	9,19,847

This amount the bank sells to the market at the market 3 months forward buying rate of EUR 1.8150 (1.8290 – 0.0140).

Amount realised in pound sterling (9,19,847 ÷ 1.8150)	=	GBP	5,06,803
Amount to be repaid	=	GBP	5,05,000
Net yield	=	GBP	1,803

Investment will be made in Frankfurt where highest net yield of **GBP 1,803** is obtained.

10.6. PROBLEMS FOR PRACTICE

Problem 10.1. Your forex dealer had entered into a cross-currency deal in the interbank market and bought CHF 5,00,000 against USD at USD 1 = CHF 1.5150 for spot delivery. However, the market turned volatile and therefore he squared up his position by disposing of Swiss Francs against US dollars at the on-going market rates.

Assuming S. Francs were quoted in the market as under:

Spot	USD 1 = CHF1.5250/5300
One month forward	1.5200/5250

and if spot USD 1 = Rs. 49.6300/6450 in the local interbank market, what will be the gain or loss in the transaction?

Your answer should be to the nearest rupee. (*Ans. Loss Rs. 1,60,632*)

Problem 10.2. US dollars are quoted in Mumbai at Rs. 49.6850/6925 and Re. 0.4000 premium on 3 months forward. A banker swaps USD 1,00,000 selling spot and buying forward. Interest in Mumbai is 12% and in New York 8% p.a. The brokerage is Rs. 2,000 per USD 1 million. What is the profit or loss made by the bank on the transaction? (*Ans. Profit Rs.4,825*)

Problem 10.3. You had sold USD 1,00,000 in the interbank market at Rs. 49.5025 in cover of an inward TT reported by your branch in India. However, it was detected that the transaction was erroneously reported twice and you are, therefore, required to cancel your sale.

Assuming that dollar was quoted in the local interbank market as under:

Spot	USD 1 = 49.6500/6575
One month forward	1200/1500

What will be the loss or gain to the Bank bearing in mind you are required to pay brokerage of one paisa per Rs. 100 and telex charge of Rs. 300?

(*Ans. Loss Rs. 17,092*)

Problem 10.4. ABN-Amro Bank, Amsterdam, wants to purchase 15 million rupees against US dollars for funding their Nostro account. Assuming the interbank rates are 49.3625/3700, what would be the rate you would quote to the foreign bank? Ignore exchange margin, brokerage etc. If the deal is struck, what would be the US dollar amount that would be credited to your Nostro account?

(*IIB, May 1995; Rates updated*)
(*Ans. USD 3,03,874.40*)

Problem 10.5. On 6th August, a bank from Frankfurt maintaining a Nostro Account with you contracted you on telex for funding their account with Rs. 15 million for value spot, i.e., 8th August, against US dollars. Assuming the on-going interbank market on 6th August to be 49.3675/3750 per US dollar, what rate would you quote to your correspondent bank?

What would be the US Dollar amount that would be credited to your Nostro Account if the deal is concluded at the said rate?

No exchange margin is to be loaded.

Ignore telex charges. *(IIB, Nov. 1993; Adapted)*

(USD 3,03,843.62)

Problem 10.6. Your exchange dealer has an overnight oversold position in US dollars 3 million at Rs. 49.6400. The following deals were done by him on the next day:

Purchase	*Rate* Rs.
USD 10,00,000	@ 49.6450
USD 15,00,000	@ 49.65
USD 5,00,000	@ 49.6375

Find out his position in Dollars after these deals and his profit or loss. Ignore brokerage and telex charges. *(IIB Sept. 1994; Rates updated)*

(Ans. Loss Rs. 18,750)

Problem 10.7. You sold Japanese Yen 5,00,00,000 value spot to your customer at JPY 100 = INR 41.9000. You then covered yourself by buying Japanese Yen 5,00,00,000 against US dollars in Singapore on the same day for value spot when the exchange rates were as under:

Spot USD 1 = JPY 117.92/97

Local interbank USD 1 = INR 49.3675/3725

Calculate the profit or loss in the transaction in rupees.

(IIB, May 1995; Rates updated)

(Ans. Profit Rs.15,257)

Problem 10.8. You sold Japanese Yen 6,00,00,000 (Sixty million) to your import customer at JPY 100 = Rs. 41.3000 You had bought JPY 10 million at Rs. 41.0500 and balance against USD when rates were USD 1 = 117.61/111.68 JPY and local interbank market USD 1 = INR 48.6100/6175.

Calculate the profit or loss in rupees. *(IIB, June 1996; Rates updated)*

(Ans. Profit Rs. 6,052)

Problem 10.9. You sold at 10 A.M., USD 10,00,000 against CHF at USD 1 = CHF 1.4500. Later at 3 P.M., you reversed the transaction against CHF at on-going rate:

USD 1 = Rs. 49.4200/4400

USD 1 = CHF1.45/4510

How much would be gain/loss in rupees? *(IIB, June 1996; rates updated)*

(Ans. Loss Rs. 34,097)

11 Execution of Forward Contract

By definition, the time and amount of foreign exchange to be delivered are predetermined under a forward contract and the customer is bound by this agreement. So, theoretically, there should not be any variation and on the due date of the forward contract the customer will either deliver or take delivery of the fixed sum of foreign exchange agreed upon. But, in practice, quite often the delivery under a forward contact may take place before or after the due date, or delivery of foreign exchange may not take place at all. The bank generally agrees to these variations provided the customer agrees to bear the loss, if any, that the bank may have to sustain on account of the variation.

Let us now analyse the possibilities of the fate of a forward contract. The foreign exchange may be delivered on the due date as per the forward contract. Or, the delivery may take place earlier or later than the due date. Alternatively, the customer may request cancellation of the contract. This request for cancellation may be made on the due date, before the due date or later than the due date. Yet another alternative is that the customer may request postponement of the date of delivery under the forward contract. This request for postponement may be made on the due date, earlier than the due date or after the due date.

The various possibilities are summarised in the form of a chart below:

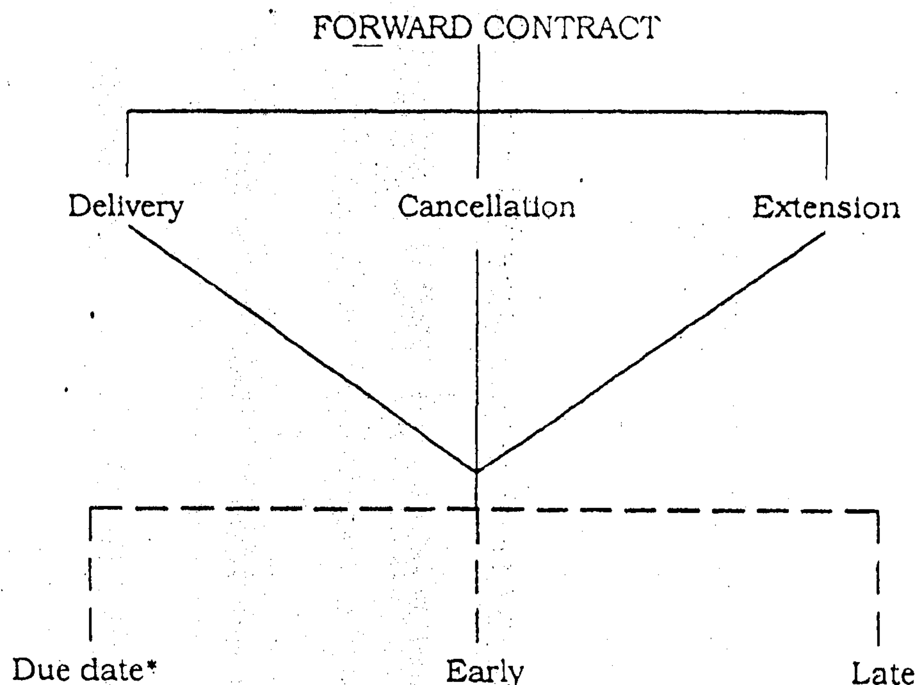

Fig. 11.1. Execution of Forward Contract

From Fig. 11.1 it is clear that a forward contract may end up in any of the following ways:

1. Delivery on the due date.
2. Early delivery.
3. Late delivery.
4. Cancellation on the due date.

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*In case of option contracts, due date refers to any date during the option period.

5. Early cancellation.
6. Late cancellation.
7. Extension on the due date.
8. Early extension.
9. Late extension.

Rule 8 of FEDAI governing this subject stipulates that the request for delivery, cancellation or extension of the forward contract should be made by the customer on or before its maturity date. A forward contract which remains unutilised after the due date becomes an overdue contract. This chapter deals with delivery on or before the due date. Other variations are discussed in the next chapter.

11.1. DELIVERY ON DUE DATE

This is the situation envisaged when the forward contract was entered into. When the foreign exchange is delivered on the due date, the rate applied for the transaction would be the rate originally agreed, irrespective of the spot rate prevailing.

Example 11.1. The bank had entered into a contract of forward purchase of Swiss Francs 10,000 with a customer at the rate of Rs. 32.5000. On the due date, the spot rate is Rs. 32.7600/8200. State the amount that will be credited to the account of the customer on purchase of the bill.

Solution. The bank would apply the rate of Rs. 32.5000 as originally agreed for purchase of the bill. The amount credited to the account would be **Rs. 3,25,000.**

Example 11.2. On 1st March, the bank enters into a forward contract for 2 months for selling USD at Rs. 48.6600. On 1st May, the contract is put through in retirement of a bill for USD 1,000 drawn on the customer. On this date, the spot rates are Rs. 49.3100/5600. Calculate the amount that would be debited to the account of the customer.

Solution. The bank would apply the rate originally agreed upon, i.e., Rs. 48.6600 and debit the account of the customer with **Rs. 48,660.**

11.2. EARLY DELIVERY

When a customer requests early delivery of a forward contract, *i.e.*, delivery before its due date, the bank may accede to the request provided the customer agrees to bear the loss, if any, that may accrue to the bank.

When the bank entered into a forward sale contract with a customer, it would have covered its position by entering into a forward purchase contract with the market for the same amount and for a matching period. For example, suppose the bank has agreed on 1st April to sell USD 10,000 to the customer delivery June at the rate of Rs. 49.1400. Theoretically, on the same day, i.e., on 1st April, a forward purchase would be made by the bank with the market for USD 10,000 due June. The idea is that during June when the contract matures, the bank can realise the purchase contract and sell it to the customer. Suppose further that the customer requests that the contract be executed on 1st May itself. The bank would execute the contract at the original rate agreed upon, viz., Rs. 49.1400 and recover separately any loss that it may suffer. Let us study how the loss is computed.

On 1st May the bank can sell US dollars to the customer by buying it from the market at the spot rate prevailing. But the bank has already entered into a forward purchase contract with the market due June and it has to meet its commitment. Therefore, on 1st May, the bank would enter into another forward sale contract with the market due June and thus be able to dispose of the US dollars when received under the forward purchase contract.

The various operations involved may be summarised thus:

	With Customer	With Market
1st April	(*a*) Sell forward due June.	(*b*) Buy forward due June.
1st May	(*c*) Sell in execution of (*a*)	(*d*) Buy spot to accomplish (*c*) (*e*) Sell forward due June, to dispose of the proceeds of (b)
1st June		(*f*) Receive delivery under (*b*) (*g*) Deliver proceeds of (*f*) in execution of (*e*)

On 1st May, the bank makes a spot purchase and forward sale of the same urrency for the same value. The difference between the rate at which the currency s purchased and sold in a swap deal is the swap difference.

The swap difference may be a 'swap loss' or 'swap gain' depending upon the rates revailing in the market. If the bank buys high and sells low, the difference is swap oss recoverable from the customer. If the bank buys low and sells high, the ifference is the swap gain payable to the customer.

On 1st May, the bank receives rupees from the customer on sale of foreign xchange to him. It pays rupees to the market for the spot purchase made. If the mount paid exceeds the amount received, the difference represents outlay of funds. nterest on outlay of funds is recoverable from the customer from the date of early elivery to the original due date at a rate not lower than the prime lending rate of ne bank concerned.

If the amount received exceeds the amount paid, the difference represents inflow f funds. At its discretion, the bank may pay interest to the customer on inflow of ınds at the appropriate rate applicable for term deposits for the period for which ne funds remained with it.

Charges for early delivery will comprise of:

(*a*) Swap difference;

(*b*) Interest on outlay of funds; and

In addition, at its discretion, the bank may levy some processing charges.

Important Note In the deal with its customer the bank is the 'market maker' nd the transaction is talked of as 'purchase' or 'sale' from the bank's point of iew. When the bank deals with the market, it is assumed that the market is the narket maker'. Therefore, the market rates are interpreted with the market 'buying' r 'selling' the foreign exchange. The bank can buy at the market selling rate and ell at the market buying rate.

Example 11.3. The bank entered into an agreement with its customer on 15th March, for a forward purchase contract for SGD 4,000 delivery 1st July, at the ate of Rs. 28.1400 per dollar covering itself by a forward sale at Rs. 28.1600. On 15th April, the customer requests the bank to purchase a bill for SGD 4,000 under his contract. Calculate the amount that would be paid to the customer assuming he following rates in the interbank market on 15th April :

Spot	SGD 1 = Rs. 28.1025/1075
Delivery July	28.6475/6550

Interest on outlay of funds at 12% and inflow of funds at 7%.

Solution. On 15th April the bank would purchase form the customer SGD 4,000 at the rate agreed upon, *viz.*, Rs. 28.1400. Charges for early delivery will be debited o the account of the customer.

The bank sells to the market SGD 4,000 received from the customer at the market buying rate of Rs. 28.1025. It buys from the market delivery July at the market selling rate of Rs. 28.6550 to meet its commitment.

(a) *Swap difference* :

Bank sells at	+	Rs.	28.1025
It buys at	−	Rs.	28.6550
Swap loss per mark is	−	Re.	0.5525

Swap loss for SGD 4,000 is Rs. 2,210.

(b) *Interest on outlay of funds* :

On 15th April, the bank sells to market at	+	Rs.	28.1025
It buys from customer at	−	Rs.	28.1400
Outlay of funds per mark	=	Re.	0.0375

Outlay of funds for SGD 4,000 is Rs. 150.

Interest on outlay of funds on Rs. 150 for 77 days (15th April to 1st July) at 12% p.a. is Rs. 4.

(c) *Charges for early delivery* :

Swap loss	Rs.	2,210
Interest on outlay of funds	Rs.	4
	Rs.	2,214

The customer's account will be credited towards proceeds of the bill for SGD 4,000 at Rs. 28.1400 per dollar, with Rs. 1,12,560.

His account will be debited with early delivery charges of **Rs. 2,214**.

Example 11.4. The bank had agreed on 20th February that it will sell on 20th April to the customer USD 10,000 at Rs. 49.5700. On the same day, the bank covered its position by buying forward from the market due 20th April at the rate of Rs. 49.5550. On 20th March, the customer approaches the bank to sell USD 10,000 under the forward contract earlier entered into. The rates prevailing in the interbank market on this date are :

Spot	Rs. 49.4725/4800
April	Rs. 49.2550/2625

Interest on outlay of funds at 12% and on inflow of funds at 7%.

What is the amount that would be recovered from the customer on the transaction?

Solution. The bank would sell Dollars to the customer at the rate agreed under the forward contract. In addition, the loss to the bank on early delivery would be received from him.

On 20th March, the bank buys from the market USD 10,000 at the market selling rate of Rs. 49.4800 to enable it to sell this amount to the customer. The bank sells one month forward to dispose of the receipt under the original forward contract. This it does at the market buying rate of Rs. 49.2550.

(a) *Swap difference* :

Bank sells at	+	Rs.	49.2550
It buys at	−	Rs.	49.4800
Swap loss per dollar is	−	Re.	0.2250

Swap loss for USD 10,000 is Rs. 2,250.

(b) *Interest on outlay of funds* :

On 20th March, the bank sells to customer at	+	Rs.	49.5700
It buys spot from market at	−	Rs.	49.4800
Inflow of funds per dollar	+	Re.	0.0900

Inflow of funds for USD 9,000 is Rs. 810.

Interest on Rs. 810 at 7% p.a. for one month is Rs. 5.

(c) *Charges for early delivery* :

Swap loss	Rs.	2,250
Less: Interest on inflow of funds	Rs.	5
Net charge for early delivery	Rs.	2,245

The account of the customer would be debited with Rs. 4,95,700 for the forward contract value and with Rs. 2,245 towards early delivery charges.

12 Cancellation/Extension of Forward Contract

THE customer may approach the bank for cancellation when the underlying transaction becomes infructrious, or for any other reason he wishes not to execute the forward contract. If the underlying transaction is likely to take place on a day subsequent to the maturity of the forward contract already booked, he may seek extension in the due date of the contract. Such requests for cancellation or extension can be made by the customer on or before the maturity of the forward contract.

12.1. CANCELLATION ON DUE DATE

When a *forward purchase* contract is cancelled on the due date, it is taken that the bank purchases at the rate originally agreed and sells the same back to the customer at the ready TT rate. The difference between these two rates is recovered from/paid to the customer. If the purchase rate under the original forward contract is higher than the ready TT selling rate, the difference is payable to the customer. If it is lower, the difference is recoverable from the customer. The amounts involved in purchase and sale of foreign currency are not passed through the customer's account. Only the difference is recovered/paid by way of debit/credit to the customer's account.

In the same way, when a *forward sale* contract is cancelled it is treated as if the bank sells at the rate originally agreed and buys back at the ready T.T. buying rate. The difference between these two rates is recovered from/paid to the customer.

EXAMPLE 12.1. On 15th January, you booked a forward sale contract for USD 2,50,000 for your import customer delivery 15th February at Rs. 49.3450. On the due date, the customer requests cancellation of the contract.

Assuming US dollars were quoted in the local interbank exchange market as under on the date of cancellation:

Spot	USD 1 = Rs. 49.2900/2975
Spot/March	3000/3100
Spot/April	6000/6100

Exchange margin required by you is 0.10%.

What will be the cancellation charges payable by the customer, if any?

SOLUTION. The sale contract will be cancelled at the ready TT buying rate.

Dollar/Rupee market spot buying rate	=	Rs.	49.2900
Less: Exchange margin at 0.10%	–	Re.	0.0493
TT buying rate for dollar	=	Rs.	49.2407

Rounded off, the rate applicable is Rs. 49.2400.

Dollar sold to customer at	Rs.	49.3450
Now bought from him at	Rs.	49.2400
Net amount payable by customer per dollar	Re.	0.1050

At Re. 0.1050 per dollar, for USD 2,50,000 the customer has to pay Rs. 26,250.

EXAMPLE 12.2. You had booked a forward purchase contract for US dollars 50,000 delivery 20th November at Rs. 49.2500. However, the customer advised you on the due date that the buyer of the underlying transaction had cancelled the order and that you should cancel the forward exchange contract.

Assuming US dollars were quoted in the local interbank market as under:

Spot	USD 1 Rs. 49.6125/6200
Spot/December	3400/3600

What will be the cancellation charges, if any, payable by or to the customer? Exchange margin required is 0.10%

Solution. The contract will be cancelled at the TT selling rate.

Dollar/Rupee market spot selling rate	=	Rs.	49.6200
Add: Exchange margin at 0.10%	+	Re.	0.0496
	=	Rs.	49.6696

Rounded off, the TT selling rate for dollar is Rs. 49.6700.

Dollar sold to customer (at TT selling rate) at	Rs.	49.6700
Dollar bought from him under forward contract at	Rs.	49.2500
Exchange difference payable to customer per dollar	Re.	0.4200

At Re. 0.4200 per dollar, exchange difference payable to customer for USD 50,000 is Rs. 21,000.

The customer will be paid Rs. 21,000 on cancellation of the forward contract.

12.2. EARLY CANCELLATION

If a *forward purchase contract* is required to be cancelled by the customer earlier than the due date it would be cancelled at the forward selling rate prevailing on the date of cancellation, the due date of this sale contract to synchronise with the due date of the original forward purchase contract.

For example, assume that on 12th September a three months' forward purchase contract is entered into with a customer for USD 10,000. The due date of the contract is 12th December. On 12th November, the customer comes to the bank and requires cancellation of the forward contract. The contract will be cancelled by the bank selling back to the customer USD 10,000 at its Forward TT selling rate for one month. The difference between the rate under the original forward purchase contract and forward TT selling rate applied on the date of cancellation is payable/receivable by the customer.

If a *forward sale* contract is cancelled earlier than the due date, the cancellation would be done at the forward purchase rate prevailing on that date with due date to fall on the due date of the original forward sale contract.

Example 12.3. A customer with whom the bank had entered into a 3 months' forward purchase contract for Sw. Fcs 10,000 at the rate of Rs. 27.2500 comes to the bank after two months and requests cancellation of the contract. On this date, the rate prevailing are:

Spot	CHF 1 = Rs. 27.3000/3500
1 month forward	27.4500/5200

(All merchant rates.)

What is the loss/gain to the customer on cancellation?

Solution. The contract would be cancelled at the 1 month forward sale rate of Rs. 27.52.

Franc bought from customer under original forward contract at	Rs.	27.2500
It is sold to him on cancellation at	Rs.	27.5200
Net amount payable by customer per Franc	Re.	0.2700

At Re. 0.27 per Franc, the loss to the customer on CHF 10,000 is Rs. 2,700.

Example 12.4. Your import customer requested you to sell to him DKK Rs. 12,50,000 six months forward T.T. to meet a payment due under in irrevocable letter or credit. You covered yourself in Singapore and quoted to your customer Rs. 6.2700. However, it transpired on the following day that the relative import was covered under a Government-to-Government agreement and Danish Kroners were not remittable abroad through a commercial bank. You were, therefore, required to cancel the forward exchange contract with a minimum cost to the customer. In the meanwhile US dollar had strengthened and Danish Kroner was quoted in the international market as under:

Spot	USD 1 = DKR 8.2800/2900
3 months forward	290/270
6 months forward	900/850

Local interbank market for 6 months forward
USD 1 = Rs. 49.6800/6925
Exchange margin is 0.10%.
What will be the cancellation charges payable by the customer?

Solution. The contract would be cancelled by buying six months forward from the customer at the prevailing rates. The difference between the rate at which the contract was originally fixed and at which it is cancelled would be recovered from the customer.

Dollar/Rupee six months forward buying rate	=	Rs.	49.6800
Less: Exchange margin at 0.10%	−	Re.	0.0497
	=	Rs.	49.6303
Dollar/Kroner market spot selling rate	=	DKR	8.2900
Less: Discount for six months	−	DKR	0.0850
	=	DKR	8.2050
Kroner forward buying rate (49.6303 ÷ 8.2050)	=	Rs.	6.0488
Rounded off, the rate applicable is Rs. 6.0500 per Kroner.			
Kroners sold to customer under original contract at		Rs.	6.2700
And bought from him under cancellation contract at		Rs.	6.0500
Difference payable by customer per Kroner		Re.	0.2200

Cancellation charges payable by customer for DKR 12,50,000 at Re. 0.2200 per Kroner is Rs. 2,75,000.

12.3. EXTENSION ON DUE DATE

An exporter finds that he is not able to export on the due date but expects to do so in about two months. An importer is unable to pay on the due date but is confident of making payment a month later. In both these cases, they may approach their bank with which they have entered into forward contracts to postpone the due date of the contract. Such postponement of the date of delivery under a forward contract is known as the extension of forward contract.

When a forward contract is sought to be extended, it shall be cancelled and rebooked for the new delivery period at the prevailing exchange rates.

FEDAI has clarified that it would not be necessary to load exchange margins when both the cancellation and re-booking of forward contracts are undertaken simultaneously. However, it is observed that banks do include margin for cancellation and rebooking as in any other case.

Example 12.5. You had booked a forward purchase contract for USD 2,00,000 at Rs. 49.5200 covering a TT remittance against a bill for collection and covered yourself in the local interbank market at Rs. 49.5650. However, on the maturity date your customer requested you to extend contract by one month.

Assuming the on-going market rates for US dollars are as under:

Spot	USD 1 = Rs. 49.6925/7075
One month forward	600/700
Two months forward	900/1000
Three months forward	1200/1300

What will be the extension charges payable by your customer bearing in mind that you require an exchange margin of 0.08% for TT buying and 0.10% for TT selling?

Solution. The forward purchase contract will be cancelled at the TT selling rate.

Interbank spot selling rate for US dollar	=	Rs.	49.7075
Add: Exchange margin at 0.10% on Rs. 49.7075	+	Rs.	0.0497
	=	Rs.	49.7572
Rounded off, the TT selling rate is Rs.49.7575			
Dollar bought from customer under original contract at		Rs.	49.5200
It is sold to him under the cancellation contract at		Rs.	49.7575
Exchange difference per dollar payable by customer		Re.	0.2375

Exchange difference for USD 2,00,000 is Rs.47,500 which will be recovered as cancellation charges from the customer.

The bank will book a fresh forward purchase contract for the customer:

Spot buying rate for dollar in interbank market	=	Rs.	49.6925
Add: One month premium	+	Re.	0.0600
	=	Rs.	49.7525
Less: Exchange margin at 0.08% on Rs.49.7525	–	Rs.	0.0398
Forward TT buying rate for Dollar	=	Rs.	49.7127

On extension, Rs. 47,500 will be recovered as cancellation charges from the customer and the fresh contract will be booked at Rs.49.7125.

Example 12.6. Your export customer has booked with you a Swiss Francs 1,00,000 forward sale (*i.e.*, your purchase) exchange contract delivery 31st August at Rs. 32.5200. However, on 30th August, he informed you that it has not been possible to deliver the Swiss Francs as anticipated payment had not come from Zurich. You were, therefore, requested to extend the contract for delivery 30th September.

Assuming that Swiss Francs were quoted in Singapore market as under:

Spot	USD 1 = Sw. Fcs. 1.5315/5330
One month forward	140/130
Two months forward	287/270
Three months forward	415/405

and US Dollars were quoted in the local interbank market as under:

Spot	USD 1 = Rs. 49.4225/4375
One month	1200/1100
Two months	2700/2500
Three months	4500/4300

What will the extension charges, if any, payable by the customer?

Exchange margin 0.10% on buying as well as selling.

Solution.

Cancellation

First, the contract will be cancelled at the TT selling rate.

Dollar/Rupee spot selling rate	=	Rs.	49.4375
Add: Exchange margin at 0.010%	+	Rs.	0.0494
TT selling rate for dollar	=	Rs.	49.4869
Dollar/Franc spot buying rate	=	CHF	1.5315
Franc/Rupee cross rate (49.4869/1.5315)	=	Rs.	32.3127
Rounded off, the rate is Rs. 32.3125.			
Bank buys Franc under original contract at		Rs.	32.5200
It sells Franc under cancellation contract at		Rs.	32.3125
Exchange difference per Franc payable by customer		Re.	0.2075

Exchange difference for CHF 1,00,000 is Rs.20,750 payable by customer as cancellation charges.

Rebooking

Fresh purchase contract will be booked for delivery 30th September.

Dollar/Rupee spot buying rate	=	Rs.	49.4225
Less: Discount for one month	–	Re.	0.1200
	=	Rs.	49.3025
Less: Exchange margin at 0.10%	–	Rs.	0.0493
	=	Rs.	49.2532
Dollar/Franc spot selling rate	=	Rs.	1.5330
Less: Discount for one month	–	Re.	0.0130
	=	Rs	1.5200
Franc/Rupee cross rate (Rs. 49.2532/1.5200)	=	Rs.	32.4034

The rate quoted would be Rs. 32.4025.

The forward contract would be extended at Rs. 32.4025 per Franc, after recovering cancellation charges of Rs. 20,750.

12.4. EARLY EXTENSION

When the request for extension is received earlier to the due date, it would be cancelled at the relevant forward rate (as in the case of cancellation) and rebooked at the current rate.

EXAMPLE 12.7. On 15th March, the bank entered into a forward purchase contract for US dollars 5,000 with its customer at the rate of Rs. 49.6000 delivery due on 15th June. It covered itself in the market at Rs. 40.6025. On 5th May, the customer requests the bank to postpone the date to 15th July. Calculate the extension charges recoverable from the customer assuming the following rates in the interbank market on 5th May:

Spot	USD 1 = Rs. 49.1300/1400
Spot/May	49.2300/2425
Spot/June	49.6300/6425
Spot/July	49.9300/9500

Exchange margin 0.10% on buying as well as on selling.

SOLUTION.

(*a*) *Cancellation*

The forward purchase contract will be cancelled at the forward sale rate for delivery June.

Interbank forward selling rate	Rs.	49.6425
Add: Exchange Margin at 0.10%	Re.	0.0496
	Rs.	49.6921

Rounded off, the rate applicable is Rs.49.6925.

Bank buys dollars under original contract at	Rs.	49.6500
It sells under the cancellation contract at	Rs.	49.6925
Difference per dollar payable by customer	Re.	0.0425

Exchange difference for USD 5,000 payable by customer is Rs. 213.

(*b*) *Rebooking*

The forward purchase contract will be rebooked with delivery 15th July. Since forward dollar is premium, the forward margin will be rounded off to lower month of June.

Forward market buying rate for June	Rs.	49.6300
Less: Exchange margin at 0.10%	Rs.	0.0496
	Rs.	49.5804

Rounded off, the rate quoted will be Rs.49.5800.

(*c*) *Summary*

The bank will recover Rs. 213 from the customer and rebook the contract at Rs. 40.5800 per dollar.

12.5. OVERDUE FORWARD CONTRACTS

As we have already seen, the customer has the right to utilise or cancel or extend the forward contract on or before its due date. No such right exists after the expiry of the contract.

FEDAI Rule 8 provides that a forward contract which remains overdue without any instructions from the customer concerned on or before its due date, shall on the 15th day from the date of maturity be automatically cancelled by the bank. The customer remains liable for the exchange difference arising therefrom, but if it results in profit it need not be passed on to the customer. In case of delivery subsequent to automatic cancellation, the appropriate current rate prevailing on such delivery shall be applied.

❑ Automatic Cancellation

The charge involved in cancellation of an overdue forward contract by the bank unilaterally is better explained by an illustration.

Example 12.8. On 1st January, the bank enters into a forward purchase contract with an export customer for USD 10,000 due on 1st March at an exchange rate of Rs. 49.6000 and covers its position in the market at Rs. 49.6500

The customer defaults to execute the contract on the due date. On 16th March, the bank cancels the contract unilaterally.

The following were the exchange rates prevalent:

On 1st March	Interbank TT rates	USD 1 =	Rs. 49.7500/7600
	1 month forward		Rs. 49.9500/9600
	Merchant TT rates	USD 1 =	Rs. 49.6700/9000
On 16th March	Interbank TT rates	USD 1 =	Rs. 49.7000/7100
	Merchant TT rates	USD 1 =	Rs. 49.6400/7800

Interest on outlay of funds is 12% p. a.,

Calculate the charges payable by the customer on cancellation.

Explanation. On 1st January when the bank makes a forward purchase from the customer at Rs. 49.6000 it covers its position by entering into a forward sale contract in the market at Rs. 49.6500.

Due to default by the customer on the due date, the bank enters into fresh spot contract with the market to meet its commitment under the cover contract at the market selling rate of Rs. 49.7600. Moreover, since the contract is not cancelled by the customer, the amount remains in the exchange position of the bank and to square its position the bank may enter into forward sale contract with the market for short period, say 15 days at the market one month forward buying rate of Rs. 49.9500

On 16th March when the bank cancels the contract, it removes the contract with the customer from the exchange position. It also buys spot from the market at Rs. 49.7100 and executes the forward sale contract with the market at Rs. 49.9500.

The transactions involved may be tabulated as below:

Date		With Customer		With Market
1st Jan	(a)	Forward purchase date 1st March at Rs. 49.6000	(b)	Forward sale due 1st. March at Rs. 49.6500
1st March		Default	(c)	Spot purchase at Rs. 49.7600
			(d)	Deliver under (b)
			(e)	Forward sale at Rs. 49.9500
16th March	(f)	Contract at Rs. 49.7800	(g)	Buy spot at Rs. 49.7100
			(h)	Deliver under (e)

(*i*) On the 15th day from maturity, an overdue forward purchase contract will be cancelled by the bank by selling back to the customer the relevant foreign currency at the TT selling rate. The cancellations would be done at the merchant rates rather than the interbank rates. If the exchange difference arising from such cancellation is payable by the customer, it shall be recovered form him. If the exchange difference is favourable to the customer, it is forfeited.

(*ii*) On 1st March, the bank made a spot purchase (*c*) and forward sale (*e*). The difference between (*c*) and (*e*) is the swap loss/gain. This swap loss is also payable by the customer to the bank. Swap gain, if any, is not payable to the customer..

(*iii*) On 1st March, the bank made a spot purchase (*c*) and delivered to the market under (*b*). The difference between (*c*) and (*b*) may be outlay/inflow of funds. Till settlement the bank is entitled to interest on outlay of funds, if any.

The charge for automatic cancellation would be:

(*i*) Exchange difference,
(*ii*) Swap loss; and
(*iii*) Interest on outlay of funds.

Solution.

(*a*) *Exchange difference :*

The forward purchase contract would be cancelled at the merchant TT selling rate on the date of cancellation. The rate applicable is Rs. 49.7800.

Bank purchased dollar under original contract at	Rs.	49.6000
It sells dollar under cancellation contract at	Rs.	49.7800
Exchange difference per dollar payable by customer	Re.	0.1800

Exchange difference for USD 10,000 payable by customer is Rs. 1,800.

(*b*) *Swap difference :*

On 1st March, the bank does a swap of buying spot at Rs. 49.7600 and selling forward at Rs. 49.9500. Since it buys low and sells high, there is no swap loss.

(*c*) *Interest on outlay of funds :*

On 1st March, the contracts executed are purchase at Rs. 49.7600 and sale at Rs. 49.6500. Outlay of funds per dollar is Re. 0.11. For USD 10,000 the bank is out of funds by Rs. 1,100 from 1st March to 15th March when the contract is cancelled. On this amount, the bank is entitled to recover interest at 12%.

Interest on Rs. 1,100 at 12% for 15 days is Rs. 5.

(*d*) *Charges on cancellation :*

Exchange difference	Rs.	1,800
Interest on outlay of funds	Rs.	5
Total charges on cancellation	Rs.	1,805

❑ Customer's request

Before an overdue forward contract is cancelled by the bank, the customer may request for its execution or cancellation or extension. Such a request is dealt with on the same principle as that for automatic cancellation.

Example 12.9. An import customer booked a forward contract with the bank on 10th April for USD 20,000 due 10th June at Rs. 49.4000. The bank covered its position in the market at Rs. 49.2800.

The exchange rates for dollar in the interbank market on 10th June and 20th June were:

	10th June	20th June
Spot	USD 1 = Rs.48.8000/8200	48.6800/7200
Spot/June	48.9200/9500	48.8000/8500
July	49.0500/0900	48.9300/9900
August	49.3000/3500	49.1800/2500
September	49.6000/6600	49.4800/5600

Exchange margin 0.10%.
Interest on outlay of funds 12%.
How will the bank react if the customer requests on 20th June:
(i) to cancel the contract,
(ii) to execute the contract, or
(iii) to extend the contract with due date to fall on 10th August.

Solution. (i) *Cancellation*

(a) *Exchange difference*

The forward sale contract will be cancelled at the spot TT purchase rate of the bank for dollar prevailing on the date of cancellation.

Dollar/Rupee market spot buying rate	=	Rs.	48.6800
Less: Exchange margin at 0.10%	–	Re.	0.0487
	=	Rs.	48.6313

Rounded off, the rate applicable is Rs. 48.6325

Bank sells dollar under the original contract at	Rs.	49.4000
It buys dollar under the cancellation contract at	Rs.	48.6325
Exchange difference per dollar payable by customer	Re.	0.7675

Exchange difference for USD 20,000 is Rs. 15,300.

(b) *Swap Loss*

On 10th June, the bank does a swap of spot sale of dollar at the market buying rate of Rs. 48.8000 and forward purchase for June at the market selling rate of Rs. 48.9500.

Bank buys at	Rs.	48.9500
It sells at	Rs.	48.8000
Swap loss per dollar	Re.	0.1500

Swap loss for USD 20,000 is Rs. 3,000.

(c) *Interest on outlay of funds*

On 10th April, the bank receives delivery under the cover contract at Rs. 49.2800 and sells spot at Rs. 42.8000.

Bank buys at	Rs.	49.2800
It sells at	Rs.	48.8000
Outlay per dollar	Re.	0.4800

Outlay for USD 20,000 is Rs. 9,600.
Interest on Rs. 9,600 at 12% for 10 days is Rs. 32..

(d) *Charges for cancellation*

Exchange difference	Rs.	15,300
Swap loss	Rs.	3,000
Interest on outlay of funds	Rs.	32
Total charges	Rs.	18,332

(ii) *Execution of contract*

Cancellation charges of Rs. 18,332 as computed above will be recovered. The contract will be executed at the spot TT selling rate calculated as follows:

Dollar/Rupee interbank spot selling rate	=	Rs.	48.7200
Add: Exchange margin at 0.10%	+	Re.	0.0487
	=	Rs.	48.7687

Rounding off, the rate applicable is Rs. 48.7675.

(iii) *Extension of contract*

Cancellation charges of Rs. 18,332 as computed above will be recovered. The contract will be extended at the current rate.

Dollar/Rupee market forward selling rate for August	=	Rs.	49.2500
Add : Exchange margin at 0.10%	+	Re.	0.0492
	=	Rs.	49.2992

The exchange rate applied for the extended contract is Rs. 49.3000.

12.6. ROLL-OVER FORWARD CONTRACT

In respect of transactions like deferred payment imports/exports, repayment of instalment and interest on foreign currency loans, the customer may require long-term forward cover, *i.e.*, for periods beyond six months. If suitable cover is available in the market, the bank may book forward contract for long terms. More often, the cover is made available on roll-over basis. That is, the initial contract may be made for a period of six months, and, thereafter, as each deferred instalment is delivered, outstanding balance of forward contract may be extended for further periods of six months each.

The rules relating to and charges for cancellation/extension of long-term forward contracts are the same as those for other forward contracts.

12.7. EXCHANGE CONTROL REGULATIONS

The general provision is that forward contracts involving rupee as one of the currencies, once cancelled shall not be rebooked although they can be rolled-over at ongoing rates on or before maturity. The restriction on cancellation and rebooking of forward contracts is subject to the following relaxations:

1. Forward contracts covering export transactions which may be cancelled, rebooked or rolled over at ongoing rates.
   A forward contract booked for exports may be cancelled if so desired by the customer. The exposure can again be covered by the customer with the same or another bank. Banks will have to ensure that a genuine exposure to the extent of the amount of the forward contract in respect of a permissible transaction continues to exist.
2. The facility of cancellation and rebooking of forward contracts is extended to transactions other than exports, subject to the condition that total forward contracts covering import/non-trade transactions rebooked shall not exceed the total of the unhedged exposures falling due within one year (April - March).
   For monitoring the limit, Authorised Dealers may obtain suitable declaration from the customer about the contracts rebooked with other banks.
3. A forward contract cancelled with one authorised dealer can be rebooked with another dealer subject to the following conditions:
   - the switch is warranted by competitive rates on offer, termination of banking relationship with the authorised dealer with whom the contract was originally booked, etc.,
   - the cancellation and rebooking are done simultaneously on the maturity date of the contract,
   - the responsibility of ensuring that the original contract has been cancelled rests with the authorised dealer who undertakes rebooking of the contract.

12.8. PROBLEMS FOR PRACTICE

PROBLEM 12.1. You have booked a forward sale contract for USD 1,50,000 at Rs. 49.5200 covering a TT remittance against a bill for collection received by you.

You covered yourself in the local interbank market at Rs. 49.4525. However, on the maturity date, the bill was not yet realised and your customer requested you to cancel the contract.

Assuming that ongoing market rate for US dollar were as under:

Spot	USD 1 = Rs. 49.3525/3750
One month forward	2400/2600
Two months forward	4200/4500

You require an exchange margin of 0.08%. What will be the cancellation charges payable by your customer? *[Ans. Charges for cancellation Rs. 31,125]*

PROBLEM 12.2. You had entered into a long-term forward sale contract for USD 2,00,00,000 (Twenty million US dollars) at Rs. 49.4000 in cover of a deferred payment import of machinery and equipment. The payment was required to be made in ten half yearly instalments of USD 20,00,000 (Two million US dollars) each.

The import customer finding extension charges, payable at the time of each extension, to be heavy, decided to cancel the contract. Hence after remittance of the fourth instalment you were requested to cancel the outstanding amount of USD 12 million. The forward contract was cancelled on the basis of ongoing market rates for US dollars in the local interbank market rates...

Assuming:

Spot	USD 1 = Rs. 49.6525/6650
One month forward	2000/2200
Two months forward	4000/4200
Three months forward	6000/6200
Six months forward	1.2000/2200

What will be the rate at which the forward contract will be cancelled if you require an exchange margin of 0.10%?

What will be the exchange difference payable to or by the customer?

[Ans. Customer will be paid Rs. 24,30,900]

PROBLEM 12.3. You had booked a forward purchase TT covering an export bill for Norwegian Kroner 5,00,000 at Rs. 6.4000 due 25th April and covered yourself for same delivery in the local interbank market at Rs. 6.4200. However, on 25th March the exporter sought cancellation of the contract as the tenor of the bill is changed.

Assuming the Norwegian Kroners were quoted against US dollars in Singapore market as under:

Spot	USD 1 = NOK 7.6075/6125
One month forward	90/95
Two months forward	155/170
Three months forward	245/260

and in the local interbank market US dollars were quoted as under:

Spot	USD 1 = Rs. 49.5825/5900
Spot/April	100/200
/May	300/400
/June	600/700

What will be the cancellation charges, if any, payable by the customer, bearing in mind that you require an exchange margin of 0.10%?

[Ans. Cancellation charges Rs. 60,000]

PROBLEM 12.4. On 2nd August, an import customer of your bank requested you to book a forward contract for J. Yen 50 million, when market was as under. Delivery required September.

USD/Re	49.3875/950	USD JPY	114.20/30
Spot/August	+ 3/ +6	Spot/August	00/01
Spot/September	+ 5/ +10	Spot/September	00/03

However, on 31st August, customer wants to cancel the same contract. Market on 31st August is as under:

USD/Re.	49.3925/75	USD JPY	115.38/45

Calculate the amount to be recovered/paid to the customer on account of cancellation, taking into account 0.15% margin to be loaded.

[Ans. Cancellation charges Rs. 3,43,750]

13 Exchange Dealings

When the foreign currency denominated assets and liabilities are held, by the banks or the business concern, two types of risks are faced. Firstly, the risk that the exchange rates may vary and the change may affect the cash flows/profits. This is known as *exchange risk*. Secondly, the interest rate may vary and it may affect the cost of holding the foreign currency assets and liabilities. This is known as *interest rate risk*. The present chapter discusses exchange risk management by banks. Exchange risk management by business concerns and interest rate risk management are dealt with in subsequent chapters.

13.1. DEALING POSITION

Foreign exchange is such a sensitive commodity and subject to wide fluctuations in price that the bank which deals in it would like to keep the balance always near zero. The bank would endeavour to find a suitable buyer whenever it purchases so as to dispose of the foreign exchange acquired and be free from exchange risk. Likewise, whenever it sells it tries to cover its position by a corresponding purchase. But, in practice, it is not possible to match purchase and sale for each transaction. So the bank tries to match the total purchases of the day to the day's total sales. This is done for each foreign currency separately.

If the amount of sales and purchases of a particular foreign currency is equal, the position of the bank in that currency is said to be 'square'.

If the purchases exceed sales, then the bank is said to be in 'overbought' or 'long' position.

If the sales exceed purchases, then the bank is said to be in 'oversold' or 'short' position.

The bank's endeavour would be to keep its position square. If it is in overbought or oversold position, it is exposing itself to exchange risk.

There are two aspects of maintenance of dealing positions. One is the total of purchase or sale or commitment of the bank to purchase or sell, irrespective of the fact whether actual delivery has taken place or not. This is known as the exchange position. The other is the actual balance in the bank's account with its correspondent abroad, as a result of the purchase or sale made by the bank. This is known as the cash position.

❑ Exchange Position

Exchange position is the net balance of the aggregate purchases and sales made by the bank in particular currency. This is thus an overall position of the bank in a particular currency. All purchases and sales whether spot or forward are included in computing the exchange position. All transactions for which the bank has agreed for a firm rate with the counterparty are entered into the exchange position when this commitment is made. Therefore, in the case of forward contracts, they will enter into the exchange position on the date the contract with the customer is concluded. The actual date of delivery is not considered here. All purchases add to the balance and all sales reduce the balance.

The exchange position is worked out every day so as to ascertain the position of the bank in that particular currency. Based on the position arrived at, remedial measures as are needed may be taken. For example, if the bank finds that it is

oversold to the extent of USD 25,000, it may arrange to buy this amount from the interbank market. Whether this purchase will be spot or forward will depend upon the cash position. If the bank has commitment to deliver foreign exchange soon, but it has no sufficient balance in the nostro account abroad, it may purchase spot. If the bank has no immediate requirement of foreign exchange, it may buy it forward.

Examples of sources for the bank for purchase of foreign currency are:

(*i*) Payment of DD, MT, TT, travellers cheques, etc.
(*ii*) Purchase of bills.
(*iii*) Purchase of other instruments like cheques.
(*iv*) Forward purchase contracts (entered in the position on the date of contract).
(*v*) Realisation of bills sent for collection.
(*vi*) Purchase in interbank/international markets.

Examples of avenues of sale are:

(*i*) Issue of DD, MT, TT, travellers cheques, etc.
(*ii*) Payment of bills drawn on customers.
(*iii*) Forward sale contract (entered in the position on the date of contract).
(*iv*) Sale to interbank/international markets.

Exchange position is also known as 'dealing position'.

❑ Cash Position

Cash position is the balance outstanding in the bank's nostro account abroad. The stock of foreign currency is held by the bank in the form of balances with correspondent bank in the foreign centre concerned. All foreign exchange dealings of the bank are routed through these nostro accounts. For example, an Indian bank will have an account with Bank of America in New York. If the bank is requested to issue a demand draft in US dollars, it will issue the draft on Bank of America, New York. On presentation at New York the bank's account with Bank of America will be debited. Likewise, when the bank purchases a bill in US dollars, it will be sent for collection to Bank of America. Alternatively, the bill may be sent to another bank in the USA, with instructions to remit proceeds to the credit of bank's account with Bank of America. In either case, the proceeds of the bill are credited, on realisation, to the bank's account with Bank of America. The purchase of foreign exchange by the bank in India increases the balance and sale of foreign exchange reduces the balances in the bank's account with its correspondent bank abroad.

The balance in the nostro account is kept in a current account which does not earn any interest for the bank. Therefore, keeping idle balances in the account would be wastage of foreign resources of the bank. On the other hand, if insufficient balance is kept in the account, deliveries that take place may render the account to be overdrawn for which the bank has to pay interest. The endeavour of the bank would, therefore, be to keep just adequate balance in the account to meet the obligations as and when they arise. A careful scrutiny of the transactions entered into during the day and those outstanding should be made to ascertain the probable amount that may be kept in the nostro account such that it is enough to meet the obligations without keeping excess balance.

Exchange and Cash Positions Compared

The exchange position and cash position may now be compared. The exchange position is concerned with the overall position of the bank with respect to a particular currency. Transactions enter into the exchange position on the date of purchase/sale or on the date the bank commits itself to purchase/sell, quoting a firm rate.

Comparison of Exchange Position and Cash Position

Transaction	*Exchange Position*		*Cash Position*	
	Purchase	*Sale*	*Credit*	*Debit*
1. Opening Balance (overbought)	√	..	..	..
2. Opening Balance (oversold)	..	√	..	..
3. Opening Balance (credit)	..	..	√	..
4. Opening Balance (debit)	..	..	..	√
5. Issue of TT	..	√	..	√
6. Issue of DD/MT	..	√	..	..
7. DD/MT issued encashed abroad	..	..	..	√
8. Nostro account debited for bills under an L/C	..	..	..	√
9. Sale to customer for bills received under L/C	..	√	..	..
10. Forward sale contract booked	..	√	..	..
11. Delivery under forward sale contract booked earlier	..	..	..	√
12. Cancellation of forward purchase contract booked earlier	..	√	..	..
13. Encashment of TT	√	..	√	..
14. Encashment of DD/MT (if reimbursement not provided)	√	..	√	..
15. Encashment of DD/MT (if reimbursement not provided)	√	..	..	..
16. Encashment of DD/MT (on provision of reimbursement)	..	..	√	..
17. Foreign bill purchased/negotiated	√	..	..	..
18. Realisation of foreign bill purchased/negotiated	..	..	√	..
19. Foreign bill taken for collection	..	..	..	..
20. Realisation of foreign bill taken for collection	√	..	√	..
21. Forward purchase contract booked	√	..	..	..
22. Delivery under forward purchase (TT) contract booked earlier	..	..	√	..
23. Realisation of proceeds of forward purchase (bills) contract	..	..	√	..
24. Cancellation of sale contract booked earlier	√	..	..	..
25. Closing Balance (overbought)	√	..	..	..
26. Closing Balance (oversold)	..	√	..	..
27. Closing Balance (credit)	..	..	√	..
28. Closing Balance (debit)	..	..	..	√

Fig. 13.1. Comparison of Exchange and Cash Positions

The cash position is concerned with the exact date on which the bank's overseas account is debited/credited. For example, a bill purchased by the bank will enter into exchange position on the date of purchase, but will be taken into account in the cash position only on the date it is realised and credited by the correspondent bank. Likewise, a forward sale contract enters into the exchange position on the date of contract itself, but will find a place in the cash position only on the date it is debited by the correspondent bank.

While the exchange position enables the bank to remain square and avoid exchange risk, the cash position enables it to keep just adequate funds at the foreign centre to meet its commitments as and when they arise without running into deficits or keeping excess funds unnecessarily and suffering consequent loss of interest.

It may be observed that steps taken to correct an imbalance in exchange position may or may not affect cash position. For instance, if the bank has overbought position and corrects it by selling forward, it would not affect the cash position. On the other hand, steps taken to correct balance in cash position would affect the exchange position. For instance, if the bank has overdrawn position in the nostro account it may correct the situation by buying TT in the market. Assuming that the exchange position was square previously, the purchase will make the position overbought. The bank will, therefore, correct the resultant imbalance in the exchange position by selling forward. Thus, we may say that correction of an imbalance in the cash position normally requires a swap deal, buying spot and selling forward, or *vice versa*.

Example 13.1. You are a dealer for your bank and find that when you open your books on the 20th November, your combined position in US dollars is overbought USD 70,000 while your dollar account in New York, as at 19th November is overdrawn USD 1,30,000. During the day, you receive advices from your branches in respect of the following transactions undertaken by them:

Documentary DDs purchased on 19th November	USD 25,000
TTs issued on 20th November (of which USD 20,000 is a delivery under a forward contract booked on 1st Sept.)	USD 50,000
TT dated 15th November from New York paid on 19th November	USD 10,000
Forward contracts booked on 19th November	
Bills selling for delivery—6 months (Import bills under LC)	USD 37,000
TT Purchase—delivery 1 month	USD 12,000
Purchase of 30 days sight bill—delivery 3 months	USD 10,000
Forward contracts cancelled on 20th November	
TT purchase due on that day	USD 15,000
In addition, you have effected deliveries under the following interbank contracts due on 20th November	
TT sale	USD 50,000
TT purchase	USD 20,000

(*i*) What would be your combined dollar position after taking the above transactions into account, and

(*ii*) What steps would you take to square your position while, at the same time, ensuring that your dollar account in New York is kept in sufficient funds to meet your immediate cash commitments and leave a credit balance of USD 10,000? (It is not, otherwise, necessary to match your cover purchases/sales with the actual delivery period of any of the transactions given above.)

SOLUTION.

(i) Exchange Position (combined dollar position)

	Purchases USD	*Sales* USD
Balance b/d (Overbought)	70,000	
Documentary DDs purchased	25,000	
TTs issued (excluding USD 20,000 under forward contract)		30,000
TT paid	10,000	
Forward sale—delivery 6 months		37,000
Forward Purchase—delivery 1 month	12,000	
Forward Purchase—delivery 3 months	10,000	
Forward purchase contract cancelled		15,000
	1,27,000	82,000
Balance c/d (Overbought)		45,000
		1,27,000

(ii) Cash Position

	Cr. USD	*Dr.* USD
Balance b/d (Overdrawn)		1,30,000
TT Issued		50,000
TT sale		50,000
TT purchase	20,000	
	20,000	2,30,000
Balance c/d (Overdrawn)	2,10,000	
	2,30,000	

Thus, to meet the immediate requirements at New York and leave a balance of USD 10,000, the bank will buy TT on New York for USD 2,20,000. This will increase the already overbought position of USD 45,000 to USD 2,65,000. This amount will be sold forward by the bank to square its position.

EXAMPLE 13.2. A dealer has the following 'dealing position' in Frankfurt. What must he do to make it square?

His account in Frankfurt is overdrawn DEM 3,75,000. He has purchased cheques which are in course of post and not yet credited to his account totalling DEM 3,28,000. He has forward contracts outstanding as follows:

Sales DEM 1,63,86,000
Purchases DEM 1,46,06,250

He has issued drafts not yet presented for payment for DEM 12,20,080. He has long bills purchased in hand not due for DEM 28,85,640

SOLUTION.

	Purchases DEM	*Sales* DEM
Balance (Overdrawn)		3,75,000
Cheques purchased	3,28,000	
Sales		1,63,86,000
Purchases	1,46,06,250	
DDs issued		12,20,080
Bills purchased	28,85,640	
	1,78,19,890	1,79,81,080
Balance (Overdrawn)	1,61,190	
	1,79,81,080	

The bank has oversold position of DEM 1,61,190. It will buy this amount (may be the nearest amount of DEM 1,60, 000 because it will have to buy in the interbank market where the deals are in round sums) to make its position square.

Example 13.3. You as a dealer have the following position in pound-sterling:

Opening balance in Barclays Bank International London	*GBP 20,000 O/D*
Opening currency position overbought	*5,000*
Purchased a telegraphic transfer	50,000
Issued a draft on London	20,000
TT remittance outward	25,000
Purchased bills on London	75,000
Forward sales	75,000
Export bills realised	45,000

What steps would you take if you are required to maintain a credit balance of GBP 10,000 in nostro account and square your exchange position?

Solution.

(*i*) *Exchange Position*

	Purchases GBP	*Sales* GBP
Opening balance—overbought	5,000	
Purchase of TT	20,000	
Issue of draft		20,000
Issue of TT		25,000
Purchase of bills on London	75,000	
Forward sales		75,000
	1,30,000	1,20,000
Closing balance—overbought		10,000
		1,30,000

(*ii*) *Cash Position*

	Cr. GBP	*Dr.* GBP
Opening balance—Dr.		20,000
Purchase of TT	50,000	
Issue of TT		25,000
Realisation of export bills	45,000	
	95,000	45,000
Closing balance—Cr.		50,000
		95,000

To maintain a balance of GBP 10,000 in nostro account, the bank should sell spot GBP 40,000. This would result in an exchange position of GBP oversold. To square the position, the bank has to buy GBP 30,000 for forward delivery.

[Export bills realised have been taken only in Cash Position because they would have been entered in Exchange Position on the date of purchase of bills.]

13.2. ACCOUNTING AND REPORTING

❑ Mirror Account

It may be recalled that nostro account is the account in foreign currency maintained abroad. The dealings between the banks would be in the currency in which the account is maintained. If Indian bank maintains a dollar account with Bank of America, the latter would be debiting or crediting the account of Indian bank in US-dollar. The bank in India, in its books, should maintain the accounts in Indian rupees, for the purposes of accounting in India. Therefore, the bank in India, in its ledger provides for recording the nostro account transactions in two currencies:

(a) The foreign currency concerned. This is useful to ascertain the actual balance kept abroad and to reconcile the balance in the account as per the ledger with the statement received from the foreign bank.
(b) Indian rupees. This column is written with the actual amount received or paid in Indian rupees by the bank on each transaction.

As we shall see presently, the above arrangement also helps in ascertaining periodically the profit or loss made on exchange dealings by the bank.

The account of the foreign bank as maintained in the bank books in India is known as the 'mirror' account or 'shadow' account. The name is derived from the fact that it is an exact replica of the entries in the nostro account, but on the opposite side, just as we see reflections in a mirror. When the bank makes purchase of foreign currency, the nostro account will be credited by the foreign bank. When it makes sale, it will result in a debit in the nostro account. In the mirror account, the purchase will be debited and sale will be credited.

The mirror account can be better understood when it is compared with the cash book maintained by customers of the bank. In the books of the bank, deposits into the bank are entered as credits and withdrawals are entered as debits. In the books of the customer, deposits into the bank are debits and withdrawals are credits. Statement of nostro account received from the foreign bank is the pass book, while the mirror account is similar to the cash book maintained by the customer.

❑ Value Date

The concept of value date is of great importance in exchange dealings. The foreign exchange transactions are undertaken on the principle of *valuer compensee* or 'value compensated'. That is, exchange of currencies take place on the same day so that neither of the parties to the transaction suffers interest loss. Thus, in a spot transaction entered into on Monday, the delivery should take place on Wednesday. The delivery of foreign currency by the seller and payment in the local currency should take place on the same day. If the selling bank delays and effects delivery only on Friday, it is liable to pay to the buying bank overdue interest for two days.

The concept of value date is also used in reckoning the exact date on which the account maintaining bank parts with funds. For example, let us suppose that a Middle East bank maintains a rupee account with an Indian bank at Mumbai. A draft issued by the Middle East bank is paid by Bangalore branch of the Indian bank on 12-10-199x. The advice of payment is received by the bank's Mumbai branch on 16-10-199x on which day it debits the nostro account of the Middle East bank. Though the account is debited on 16-10-199x, it will be valued dated 12-10-199x, *i.e.*, the balance will be reckoned as if the debit was made on 12-10-199x.

❑ Exchange Profit/Loss

The efficiency, or otherwise, of the dealing section is ultimately reflected in the profits that it generates to the bank. Therefore, ascertaining the profit arising from foreign exchange dealings is a useful exercise to be undertaken periodically. This exercise also serves as a good control over the operations of the foreign exchange department.

As the purpose of ascertaining the profits of exchange dealing differs from the accounting requirements, the periodicity at which they are ascertained need not agree with the accounting periods. The profit of exchange dealings may be computed monthly, quarterly or half yearly, depending upon the needs of the bank concerned and the infrastructure available.

Mirror Account (For US dollars)

Date	Particulars	US Dollar			Rate	Rupee		
		Dr.	Cr.	Balance		Dr.	Cr.	Balance
200x		USD	USD	USD	Rs.	Rs.	Rs.	Rs.
Jun 30	To Balance b/d	20,000		20,000Dr.	48.50	9,70,000		9,70,000Dr.
Jul 2	To FBP 151 of Delhi branch	6,000		26,000Dr.	48.47	2,90,820		12,60,820Dr.
5	By Bill under LC 141 of Mumbai		10,000	16,000Dr.	48.68		4,86,800	7,74,020Dr.
6	By DD issued by Chennai		2,000	14,000Dr.	48.64		97,280	6,76,740Dr.
10	To TT on Kochi	5,000		19,000Dr.	48.45	2,42,250		9,18,990Dr.
14	To FBN of Trivandrum	10,000		29,000Dr.	48.55	4,85,500		14,04,490Dr.
18	By TT on New York		25,000	4,000Dr.	48.60		12,15,000	1,89,490Dr.
25	To DD on Kolkatta	8,000		12,000Dr.	48.50	3,88,000		5,77,490Dr.
25	By Import bill on Bangalore		7,000	5,000Dr.	48.55		3,39,850	2,37,640Dr.
31	To P & L A/c (Exchange profit)				5.360			2,43,000Dr.
31	By Balance c/d		5,000	...	48.60		2,43,000	

Fig. 13.2. Determination of Exchange Profit

The main source of ascertaining the profits of the exchange dealing is the mirror account maintained in respect of nostro accounts abroad. The rupee column in the mirror account is filled in at the actual rates at which the purchase or sale is made. The final balance in the account is valued at the interbank rate. If the account shows a debit balance, it indicates an overbought position. It is valued at the rate at which the bank can dispose it of in the market, *i.e.*, the market buying rate. The balance in the account (rupee column) after valuing the closing balance in the above manner is the profit/loss made in the dealing. The method of ascertaining profits from the mirror account is illustrated in Fig. 13.2.

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The method described is an over-simplified account of profit ascertainment. The nostro account includes only those transactions for which deliveries have actually taken place. The calculation of exchange profit should also include the forward deals for which delivery has not yet taken place. In addition, the pipeline transactions (transactions done at the branches, but not yet reported to the dealing room) should also be considered. The forward transactions should be reduced to the spot rates by eliminating the forward margin.

❑ *R* Returns

All foreign exchange transactions, *i.e.*, all purchases and sales, made by an authorised dealer are reported to Reserve Bank in R Returns. R Returns serve two important purposes:

(*i*) They are the principal source for compilation of the balance of payments data of the country. They are utilised for preparing certain very valuable data relating to the external trade and payments of the country.

(*ii*) They serve as a means of *post facto* scrutiny in Reserve Bank to ensure that authorised dealers have exercised correctly the powers delegated to them under general or specific authority.

For the purpose of submission of R Returns offices and branches of authorised dealers are classified into three categories:

Category A: Those maintaining independent foreign currency accounts in their own names.

Category B: Those not maintaining independent foreign currency accounts but having powers of operating on accounts maintained by Category A.

Category C: All others. They handle foreign exchange transactions through Category A or B.

R Returns are required to be submitted by branches/offices falling under Category A or B.

R Returns should be submitted twice a month, at close of business as on the 15th and the last day of the month. If the concerned day is a holiday, the return should be submitted as at close of business on the preceding working day. The returns should be sent as to reach Reserve Bank within seven days from the close of reporting period.

For each currency there are two *R* Returns—*R* Return (Nostro) and *R* Return (Vostro).

Each *R* Return contains details of purchase and sales of the currency under specific classification. Many of the documents/statements to be submitted to Reserve

Bank are submitted as annexures to the R Return. Some of the important documents/statements accompanying R Return are:

(i) Remittance from A1 and A2 together with enclosures,
(ii) R Supplementary Return along with duplicates of GR/PP forms.
(iii) Supplementary statement of purchases of foreign exchange and debits to non-resident bank accounts (other than exports) of equivalent of USD 50,000 and above.
(iv) Exchange control copies of import licences which have been fully utilised/expired.
(v) Fully utilised exchange permits of Reserve Bank.

13.3. FOREX RISK MANAGEMENT

The Dealing Room is rightly identified as a profit centre for a bank. In these days of reducing spread between the lending and borrowing rates, banks have to look to other sources to improve their bottom lines. Foreign exchange is one area where the potential is vast. The progressive liberalisation being introduced in the Indian foreign exchange market has improved the scope for dealers to show their skills and earn for their banks. But, at the same time, it may not be forgotten that any scope for profits is associated with the risks of losing. It is more so in the case of foreign exchange dealing where the vagaries of the market can play havoc. Unbridled enthusiasm has to be monitored so that the bank does not expose itself to unduly huge risks.

Risk in Forex Dealing

The following are the major risks in foreign exchange dealings:

(a) Open Position Risk,
(b) Cash Balance Risk,
(c) Maturity Mismatches Risk,
(d) Credit Risk,
(e) Country Risk,
(f) Overtrading Risk,
(g) Fraud Risk, and
(h) Operational Risks

1. Open Position Risk

The *open position risk* or the *position risk* refers to the risk of change in exchange rates affecting the overbought or oversold position in foreign currency held by a bank. Hence, this can also be called the *rate risk*. The risk can be avoided by keeping the position in foreign exchange square. The open position in a foreign currency becomes inevitable for the following reasons:

(a) The dealing room may not obtain reports of all purchases of foreign currencies made by branches on the same day. Each bank has few dealing rooms mainly in metropolitan centres. The dealings with the customers are executed by the branches of the bank spread over the entire country. The branches are required to inform to the dealing room concerned immediately over telecommunication whenever a purchase or sale exceeding a limit, say equivalent of USD 1,000 takes place. Deals for smaller values will be taken into account by the dealing room when the reports are received through mail on a later date. Under this system, imbalance may arise because:

(i) Smaller purchases and sales are not taken into account;
(ii) When communication system fails, even larger deals may also not be reported immediately; and
(iii) There may be wrong reporting or failure to report by branches.

(b) The imbalance may be because the bank is not able to carry out the cover operation in the interbank market. This may be due to fact that counter party for the tenor and volume as required by the bank may not be available. Moreover, operations in the interbank are done in round sums, which necessarily leaves odd amounts in the exchange position uncovered.

(c) Sometimes the imbalance is deliberate. The dealer may foresee that the foreign currency concerned may strengthen. In that case, he would try to keep an overbought position; when the currency strengthens he can sell at a profitable rate. Conversely, when the expectation is that the foreign currency will weaken, he will acquire an oversold position; he can acquire the currency later at a cheaper rate and thus make a profit.

There is, however, a limit up to which the bank can keep 'open' position. If the bank keeps a large open position and its expectation about the movement of the currency fails, the result would be disastrous.

Internal Control The appreciation of the various risks involved in exchange dealings has led to adoption of certain controls by the banks. Each bank fixes a '*day-light limit*' or '*intra-day limit*' for each currency. This is the limit up to which the dealer can deal himself without reference to higher authorities. For instance, a bank may fix the daylight limit for US dollar as USD 5 million. That means the dealer can purchase and sell dollars so long as the balance outstanding at any time during the day is not exceeding USD 5 million. In addition, the bank also fixes an '*overnight limit*', *i.e.*, the extent to which the currency position can be kept open at the end of the day. Normally, the overnight limit would be much less than the daylight limit. While the daylight limit ensures that the bank does not acquire very large position in the currency which it may find it difficult to cover in the market, the overnight position puts a ceiling on the exchange risk to the bank. Apart from the above limits on individual currencies, the bank would also place a aggregate limit on the foreign exchange position for all the currencies put together. This would be smaller than the total of individual overnight limit for each currency.

Cut Loss Limit This limit is fixed to restrict loss due to adverse movement in the exchange rates. The cut loss limit for dollar may be fixed at 5 paise. Suppose the dealer holds overbought position of USD 1 million at a cost of Rs. 48.86 per dollar. If the market rate for dollar moves down to less than Rs. 48.81, he should immediately square his position so that the loss can be restricted to 5 paise per dollar or Rs. 50,000. Otherwise, the continuous decline in dollar rate would result in larger losses. The limit may be fixed with reference to the absolute amount of loss. In that case, if the exposure is higher in value, the per dollar difference may be reduced to see that the absolute loss is not exceeding, say, Rs. 50,000.

Exchange Control Regulation The Exchange Control Manual stipulates that the authorised dealers should fix open position limits in each currency in accordance with the guidelines issued by Reserve Bank. Before laying down such limits, authorised dealers should get them approved by Reserve Bank. Net overnight position in the rupee should not exceed the limit laid down by Reserve Bank from time to time. According to the guidelines, the banks should maintain on an on-going basis Tier I capital (*i.e.*, paid-up capital, statutory reserves and other disclosed free reserves at 5% of the open position limit approved by Reserve Bank. Further, in general, overall open position limit should have a reasonable relation to the capital of the bank.

2. Cash Balance Risk

Cash balance refers to actual balances maintained in the nostro accounts at the end of each day. Balances in nostro accounts do not earn interest; while any overdraft involves payment of interest. The endeavour should, therefore, be to keep the minimum required balance in the nostro accounts. However, perfection on this count is not possible. Depending upon the requirement for a single currency more than

one nostro account may be maintained. Each of these accounts is operated by a large number of branches. Communication delays from branches to the dealer or from the foreign bank to the dealer may result in distortions. The banks endeavour to obtain the statement of accounts from foreign banks on a daily basis through telecommunication and monitor closely the balances in nostro accounts. Reconciliation of balances of nostro accounts almost on a continuous basis also helps in this regard.

Exchange Control Regulation The Exchange Control permits authorised dealers to maintain with overseas correspondents, upto levels approved by the top mangement. They are free to manage the surplus in these accounts through overnight placements/investments with overseas branches and corresondents subject to adherence to the gap limits approved by Reserve Bank.

Authorised dealers are required to regularly reconcile the balances in nostro accounts. No entry above USD 10,000 each should remain unreconciled beyond six months.

3. Maturity Mismatches Risk

This risk arises on account of the maturity period of purchase and sale contracts in a foreign currency not coinciding or matching. The cash flows from purchases and sales mismatch thereby leaving a gap at the end of each period. Therefore, this risk is also known as *liquidity risk* or *gap risk*.

Mismatches in position may arise out of the following reasons:

(*i*) Under forward contracts, the customers may exercise their option on any day during the month which may not match with the option under the cover contract with the market with maturity towards the month end.

(*ii*) Non-availability of matching forward cover in the market for the volume and maturity desired.

(*iii*) Small value of merchant contracts may not aggregate to the round sums for which cover contracts are available.

(*iv*) In the interbank contracts, the buyer bank may pick up the contract on any day during the option period.

(*v*) Mismatch may deliberately created to minimise swap costs or to take advantage of changes in interest differential or the large swings in the demand for spot and near forward currencies.

The mismatch can be corrected by undertaking a suitable swap. The risk involved is that the cost of swap may turn out to be higher than that provided for.

Internal Control At monthly intervals the purchases and sales are aggregated maturity-wise and the net balance arrived at. The following gap limits are prescribed:

(*a*) A monthly gap limit for each currency. This is called the individual gap limit.

(*b*) A cumulative gap limit for all maturities for each currency which would be less than the total of monthly gap limits.

(c) Cumulative gap limit for all currencies put together which would be less than the total of cumulative gap limit for all currencies.

Maturity Limit Apart from the above, the bank may also fix the maximum period upto which forward cover can be offered to the customer. This depends upon the maximum maturity for which cover will be available in the market.

Exchange Ccontrol Regulations It is stipulated that the authorised dealers should, as far as possible, avoid outright forward or swap transactions which result in maturity mismatches which are in excess of their aggregate gap limit. (Aggregate gap limit is defined as the sum total of the gaps in each currency arrived at by adding gaps in each month ignoring the plus or minus sign. In other words, it is the gross gap for all the months put together. In the cumulative gap limit mentioned above, monthly gaps are added considering the plus and minus signs. It is the net gap cumulatively for all months.)

4. Credit Risk

Credit risk is the risk of failure of the counterparty to the contract. Credit risk is classified into (*a*) contract risk, and (*b*) clean risk.

Contract Risk arises when the failure of the counterparty is known to the bank before it executes its part of the contract. Here the bank also refrains from the contract. The loss to the bank is the loss arising out of exchange rate difference that may arise when the bank has to cover the gap arising from failure of the contract.

Clean Risk Arises when the bank has executed the contract, but the counterparty does not. The loss to the bank in this case is not only the exchange difference, but the entire amount already deployed. This arises, because, due to time zone differences between different centres, one currency is paid before the other is received.

Internal Control The risk is controlled by fixing counterparty limits, both for banks and merchant customers. Limits are fixed on the aggregate outstanding commitments and separately for the amount of funds to be settled on a single day.

5. Country Risk

Also known as 'sovereign risk' or 'transfer risk', country risk relates to the ability and willingness of a country to service its external liabilities. It refers to the possibility that the government as well other borrowers of a particular country may be unable to fulfil their obligations under foreign exchange transactions due to reasons which are beyond the usual credit risks. For example, an importer might have paid for the import, but due to moratorium imposed by the government, the amount may not be repatriated.

Internal Control The country risk analysis is made by taking into account the socio-economic and political situation of the country and a limit for exposure for that country is fixed.

6. Overtrading Risk

A bank runs the risk of overtrading if the volume of transactions indulged by it is beyond its administrative and financial capacity. In the anxiety to earn large profits, the dealer or the bank may take up large deals, which a normal prudent bank would have avoided. The deals may take speculative tendencies leading to huge losses. Viewed from another angle, other operators in the market would find that the counterparty limit for the bank is exceeded and quote further transactions at higher premiums. Expenses may increase at a faster rate than the earnings. There is, therefore, a need to restrict the dealings to prudent limits:

Internal Control The tendency to overtrading is controlled by fixing the following limits:

(*a*) A limit on the total value of all outstanding forward contracts; and

(*b*) A limit on the daily transaction value for all currencies together (turnover limit).

7. Fraud Risk

Frauds may be indulged in by the dealers or by other operational staff for personal gains or to conceal a genuine mistake committed earlier. Frauds may take the form of dealing for one's own benefit without putting them through the bank accounts, undertaking unnecessary deals to pass on brokerage for a kick back, sharing benefits by quoting unduly better rates to some banks and customers, etc. The losses from such fraudulent deals can be substantial.

Internal control: *It* is imperative that dealers be well supervised, honest and well trained. Proper selection and proper training therefore play an important role. The following procedural measures are taken to avoid frauds:

(a) Separation of dealing from back-up and accounting functions.
(b) On-going auditing, monitoring of positions, etc., to ensure compliance with procedures.
(c) Regular follow-up of deal slips and contract confirmations.
(d) Regular reconciliation of nostro balances and prompt follow-up of unreconciled items.
(e) Scrutiny of branch reports and pipe-line transactions.
(f) Maintenance of up-to-date records of currency position, exchange position and counterparty registers, etc.

8. Operational Risks

These risks include inadvertent mistakes in the rates, amounts and counterparties of deals, misdirection of funds, etc. The reasons may be human errors or administrative inadequacies. The deals are done over telecommunication and mistakes may be found only when the written confirmations are received later. But reversing such mistakes may involve exchange rate and interest losses for the bank. If nostro reconciliation is not proper, the mistakes may remain undetected for long periods. By the time they are found out, the relevant records may not be available any more.

Internal control. The internal control measures are same as that for preventing frauds.

❑ Measure of Value at Risk (VAR)

One aspect of exposure to volatile assets like foreign exchange, shares and derivatives is the total outlay of funds required. The other and more important aspect is the losses likely arise due to volatality in prices. For instance, if a bank has an open position of USD 1 million acquired at an average cost of Rs.43 per dollar, the total funds outlay would be Rs. 43 crores. Supposing the exchange rate is likely to vary by 50 paise per dollar, the value at risk is Rs. 50 lakhs. It means that the loss likely to arise to the bank for holding dollar balance of USD 1 million is Rs. 50 lakhs.

The loss that is likely to arise due to holding of a volatile asset is known as the value at risk. The likely change in prices are calculated statistically, based on the trend observed in the past. FEDAI has come out with a VAR model in respect of foreign exchange exposure for use by its member banks. The salient features of the model are as follows:

1. A data base was built by initially from 8th June 1995 to 28th June 1996 as regards 1 month, 3 months and 6 months forward rates.
2. Using Lotus spread sheet, overnight variations in swap rates were worked for 1 month, 3 months and 6 months.
3. Standard deviation of overnight variations in swap rates was calculated. In other words, variation in swap rates in paise terms for every dollar was calculated. This is the volatility for the relevant periods.
4. The resultant figure was multiplied by 2 to achileve 95% level of confidence. Since we reckon only losses, statistically this effectively gives 97.5% level of confidence. This means that there is only 2.5% chance of actual losses exceeding the VAR arrived at.
5. Using the above parameters, FEDAI calculated VAR at Rs.10.39 lakhs per USD 1 million. The caculations are updated every day and communicated to banks. Banks are to mlultiply each day's aggregate gap by the figures furnished by FEDAI.

ANNEXURE 13.1

RBI'S GUIDELINES FOR INTERNAL CONTROL OVER FOREIGN EXCHANGE BUSINESS OF THE BANKS

ORGANISATION OF THE DEALING DEPARTMENT

General

Foreign exchange dealing is a highly specialised function and has to be performed by well-trained personnel. Typically, a Dealing Department should consist of dealers, and back office staff who are responsible for the follow-up of the deals made by the dealers. The need for effective control over the dealing operations is of great importance as possibilities exist for manipulation of exchange rates, dealing position, mismatches etc.

Segregation

The supreme principle of operational procedures in the area of trading activities is the clear functional separation of Dealing, Bank Office (Processing and Control), Accounting and Reconciliation.

In respect of banks which trade actively and offer the whole range of derivative products dealing activities may be segregated as under:

(1)	Front Office	—	Dealing Room
(2)	Mid-Office	—	Risk Management: Accounting Policies and Management Information System
(3)	Back Office	—	Settlement, Reconciliation, Accounting.

Selection and Trading of Dealers

Heavy responsibility rests upon the dealers as the manner of handling the inter-bank foreign exchange business of the bank can make all the difference to the bank and its customers. Adequate care therefore needs to be exercised while selecting and grooming the dealers. Managements should provide opportunities to the dealing room staff to get continuously updated on global market trends in forex and derivatives trading and risk control.

While drafting personnel from other banks or organisations as dealers their antecedents should be carefully verified from the standpoint of integrity.

Electronic Data Processing (EDP)

The data processing systems used must be appropriate to the nature and volume of activities and programmed to ensure functional separation. Access rules for performing distinct functions should be defined in detail and drawn up by persons unconnected with the dealing activity.

Where data is recorded direct in an EDP system, it must be ensured that dealers are enabled to enter transactions solely through identification. The trading date, time and and transaction serial number must be entered automatically by the system which must be impossible for the dealer to alter. If the dealer deviates from the specified norms when entering transaction data, this must be approved in each case by an official not connected with the dealing office. Deals concluded after the back office has closed recording for the day (late deals) are to be marked as such and included in that day's position. A late deal slip must be passed immediately to an official unconnected with the dealer.

1. Source : RBI

Duties of the Dealers

The dealer has to operate in the interbank market according to the guidelines laid down by the Management. Ideally, dealers may confer before work starts, on the trend in the overnight market in the light of the 'newsbag' and the bank's own business and arrive at tentative conclusion valid for the day. It is essential that efficient communication channels be provided for dealers to facilitate consultations with designated authorities.

Dealing Procedure

The dealers should have no accounting work of any kind to perform, as they should at all times concentrate on the market by maintaining contact with other banks, brokers, as well as banks abroad. Deals struck should be recorded on printed 'Deal Slips'. The deal slips should indicate the name of the broker (if any), and the counter party bank, currency, amount, time, rate and due date, under authentication of the dealer. The deal slips should be passed on without delay to the back office for further processing. Banks are free to devise the format of the slips. In an automated system, separate deal slips are not required.

Voice Recording

Experience has shown that recourse to taped conversation proves invaluable to the speedy resolution of differences. It is, therefore, desirable to introduce voice recorders in the dealing rooms. The types may be preserved for at least two months and where a dispute has been raised, until the issue is resolved. Access to the equipment and tapes should be subject to strict control.

Rotation of Dealers

Dealers should not be kept for too long on dealing duties, a period of five to seven years being considered reasonable for effecting a change. Further, a system of an annual compulsory two-week (or longer) break should be introduced so that no dealer remains at the job continuously.

Code of Conduct

Dealers should furnish an undertaking to conform to the Code of Conduct prescribed by FEDAI.

Accounting Department

The Accounting Department should ensure the following :

(a) Confirmation of contracts is obtained for all deals from counter party bank and duly verified for correctness and in no case the dealers sign the confirmation. (In regard to Cash/Tom/Spot contracts, confirmation may not be insisted upon, if the amounts thereof have been received in the nostro accounts)

(b) Discrepancies noticed are rectified on the same day.

(c) In respect of computer generated deal confirmation slips, which are not signed, banks issuing such confirmation execute an stamped agreement in favour of the counterparty banks assuming responsibilities for errors/ omissions.

(d) The evaluation of foreign exchange profits and losses are undertaken at the end of each month notwithstanding the practice of passing accounting entries at quarterly or longer rests.

(e) A statement of true currency position is submitted to the Management after reckoning the effect of all transactions in the pipeline on the last Friday of each month.

(f) The Position and Funds Registers are continually updated on the basis of deal slips and the report of business flowing in from the branches, to assist

the efficient transmission of information to the dealing room and the Management.

(g) Rate-Scan reports are prepared at least thrice a day (viz. at opening hours, afternoon and closing hours) and deals at wide variance with the on-going market rates are enquired into.

Profit budgeting

The bank should make a realistic assessment taking into account the cost of infrastructure of the dealing room and reckon it for the annual profit planning.

DEALING THROUGH EXCHANGE BROKERS

Exchange Brokers-Prohibitions

Exchange brokers being intermediaries, are prohibited from acting as principals and maintaining position in foreign currencies. Banks should, therefore, refrain from doing anything which may result in the broker taking over the function of the dealers.

Deals through Broker-Confirmation

Broker's notes should be received promptly before the close of business on the day on which the deals are concluded and exceptionally before the opening hours of the succeeding day. These should be checked and reconciled the same day.

Nomination of Brokers

Nomination of brokers for deals not done through their medium is not permitted.

Broker's Panels

As a general rule, authorised dealers should not discriminate between recognised brokers for business offered at competitive terms. Ideally, at least 5/6 brokers should be empanelled and the panel should be revised periodically, taking into account the nature and volume of business done through the brokers, their market reputation, credit worthiness etc.

Complaints

Any complaint from any source against dealers must be promptly investigated.

Serious complaints alleging acceptance by the dealers of gifts and other favours (or any other gratification) should be put up to appropriate authorities for necessary action. All such cases should be reported to the Central Office of the Exchange Control Department and the Department of Banking Operations and Development of the Reserve Bank of India, indicating the nature of action taken.

Payment of Brokerage Claims

The Accounting Department should maintain a broker-wise record showing details of the exchange dealing made by the dealers. The staff of the dealing department should not have anything to do with the scrutiny, passing or payment of brokerage claims.

Brokerage Statements

A monthly statement showing broker-wise payments together with a statement for the preceding twelve months should be put up to the management. Changes in the panel of brokers may also be indicated in the report.

Malpractices by Brokers

Complaints relating to malpractices by brokers should be promptly brought to the notice of the Foreign Exchange Dealer's Association of India and the Exchange Control Department of Reserve Bank of India, Central Office.

RISK CONTROL AND RISK MANAGEMENT

Introduction

In the wake of the major relaxation in Exchange Control Regulations and the freedom given to authorised dealers to offer new forex products, a fresh focus on risks rather than on products seems appropriate. Greater emphasis, therefore, will have to be laid on recognising and managing risk in its entirety rather than each component thereof.

Requirements of the system

The risk control and risk management system must be designated in accordance with the scale, complexity and risk content of the trading activities being conducted or envisaged.

Responsibilities of the Senior Management

Transactions in different hedging products (forward and derivatives) have to be closely overseen by senior management. To begin with, the policies in this regard should be clearly laid down and control processes guiding the activities put in place. The policies should detail the type and nature of the activity authorised, articulate the risk tolerance of the bank through comprehensive risk limits, and require regular risk position and performance reporting within the following broad parameters which should be subject to periodical review :

(a) the business strategies on which trading in the individual product groups is based.
(b) the markets in which trading is allowed,
(c) the nature, scope, legal framework and documentation of trading activities,
(d) the list of counterparties with whom trade may be conducted,
(e) the procedures for measuring, analysing, monitoring and managing the risk.
(f) ceilings for risk positions according to the type of business or risk organisational unit or portfolio,
(g) the procedure for reacting to (i) any overshooting of the limits and (ii) the extreme market developments,
(h) the functions and responsibilities of individual members of staff and work units,
(i) internal accounting and external/internal reporting,
(j) staffing and technical equipment,
(k) the internal control and monitoring system,
(l) the maintenance of confidentiality in respect of trades.

It is essential that there must be a written acknowledgement of these guidelines from the members of the staff confirming that they have noted the relevant instruction applicable to them.

The bank should have an effective process of evaluation and review of the risks involved in various trading activities undertaken by the dealers, in respect of all hedging products. Some of these risks are discussed below;

Credit Risk

Credit risk (pre-settlement and settlement) is the risk of loss due to inability or unwillingness of the counterparty to meet its obligation. This risk can be effectively managed through fixing of counter party limits, appropriate measurement of exposures, ongoing credit evaluation and monitoring, and following sound operating procedures.

(a) Pre-settlement Risk :

Pre-settlement Risk is the risk of loss due to counterparty defaulting on a contract during the life of a transaction. This exposure is also referred to as the replacement

cost. The level of this exposure varies through the life of the hedging product and is known with certainty only at the time of default. A key tool for effective management of this risk is the fixation of exposure limits on counterparties.

(b) Settlement Risk

Settlement risk is the risk of loss arising when a bank performs on its obligation under a contract prior to the counterparty does so. This risk frequently arisen in international transactions because of time zone difference. The failure to perform may be due to operational breakdown, counterparty default or legal impediments. Banks should, therefore, monitor and control settlement risk very effectively.

Liquidity Risk

Liquidity risk is the risk that a bank will be unable to meet its funding requirements or execute a transactions at a reasonable price.

Market liquidity risk is the risk of a bank not being able to exit to offset position quickly at reasonable price.

Gap Risk/Interest Rate Risk

These are risks owing to adverse movements in implied interest rates or actual interest rate differentials that arise through transactions involving foreign currency deposits, forward contracts, currency swaps, forward rate agreements, forward delta equivalent of currency option trades, and through numerous other currency and interest rate derivatives.

Legal Risk

In addition to the foregoing risks, there is legal risk which exists in all kinds of social markets. It is probably more so in foreign exchange and interest rates in their inherent volatility. It is, therefore, extremely important that banks as also to corporates dealing in these products take such steps as would sufficiently protect them from the legal standpoint.

The surest way to do so is to insist on exchange of internationally accepted master Agreements between the parties to be supported by other relevant documentation.

Operational Risk

The data processing system used must be appropriate to the nature and volume trading activities. A written contingency plan has to ensure, among other things, that in the event of a breakdown of the equipment, back-up facilities can be deployed at a short notice.

The Risk Management Process

Banks should have a comprehensive and accurate risk measurement procedure covering both trading and non-trading activities. This procedure should enable the management to assess exposures on a consolidated basis. It should be easily understood by the dealers back office staff, senior management and the Board of Directors. Such a procedure will assists in limiting and monitoring risk taking activities at all levels.

Limiting Risks

Global limits should be set up for the bank's local interbank business as well as its transactions in the overseas market. The limit system should be consistent with the bank's overall risk management process and the adequacy of its capital to undertake such activities. At present, the open exchange position limit and the Gap limits for maturity mismatches fixed by each bank require approval of the Reserve Bank.

Management has to set an upper limit for losses, bearing in mind the bank's capital and earnings performance. Based on the risk control analysis and the upper

limit for losses, a system of risk-curbing limits is to be set up which should be related both to credit risks and to market price risks. Overall limits are to be set and approved by the management for each category of risks.

Appropriate value-at-risk models need to be developed for quantifying the extent of market risk for a given level of confidence. For credit risk management, the nominal exposures should be monitored on a real-time basis. However, for managing pre-settlement risk, the nominal exposures need to be converted into actual credit exposures by applying a suitable conversion factor. The banks may for the sake of operational convenience, use only a small number of conversion factors, each of a broad group to transactions. For settlement risk, the nominal exposure is equal to actual credit risk.

The bank should ensure that every dealer is advised promptly of the limit allocated to him.

All deals done should be accounted for against the corresponding limits. All the individual positions are to be aggregated into overall risk positions at the closing of business each day with a view to ensuring that the total so recorded does not exceed the overnight limit authorised by the management/RBI. The limits when exceeded should be promptly reported to appropriate senior management and got approved. In the Indian context, pipeline transaction and operations in foreign currency notes could significantly distort the exchange position given the large spread of branches. Banks should, therefore, have an adequate control system which significantly reduces such distortions.

Reporting

A timely, accurate and comprehensive management information system should be in place. The monitoring and reporting should be undertaken by officials who are not directly concerned with the trading activities. Exposures and profit and loss statement should be submitted to the senior management. In times of volatile market conditions, such reports should be submitted more frequently so that the senior management is fully apprised of the level of activities and the risk involved.

Documentation and Record Keeping

Banks may enter into the following Master agreements with counterparty banks and with clients for the products as defined below :

(a)	Spot and Forward Foreign Exchange	–	International Foreign Exchange Master Agreement (IFEMA)
(b)	Foreign Exchange Options	–	International Currency Options Market Agreement (ICOM)
(c)	All other including	–	International Swap Dealers Association Derivatives Master Agreement (ISDA)

Banks should also obtain board resolution from their corporate clients specifically authorising their officials to deal and execute contract (including derivatives).

While the documents stated above are to be in force till altered by mutual consent, banks should obtain specific confirmation for each transaction which should detail the terms of the contract such as amount, rate, value date etc. duly signed by the authorised signatories.

Bank should also establish processes (cheklists, tickler files, etc) to ensure proper documentation to support these transactions and to monitor and control receipt of the documents.

Preservation of Records

Subject to the existing statutory retention periods and provisions, all business, control and monitoring records for the current year and at least for the past year should be preserved.

EVALUATION OF FOREIGN EXCHANGE PROFITS AND LOSSES

Methods of Evaluation

The Union Standard Accounting Procedure for evaluation of profit/loss of foreign exchange transactions drawn up by FEDAI and approved by the RBI should be strictly adhered to and valuation undertaken at least at the end of each month and on the balance sheet date.

The evaluation should disclose the actual profit/loss under different heads such as exchange trading, interest income, commission/s etc.

RECONCILIATION OF NOSTRO BALANCES

Importance of Reconciliation

Reconciliation of Nostro Account is an essential control function and is intended to ensure that every transaction undertaken by the bank in its Nostro account has been correctly executed.

The basic records for reconciliation are the bank statement which should be received at last weekly end, the Mirror account. Reconciliation must be done choosing the same date for Mirror accounts and foreign bank statement. Action on unreconciled items must be taken on an on-going basis and any delay in this regard will render reconciliation more difficult, particularly, because the correspondent banks/branches abroad employ computerised accounting system and micro-filming procedure. Back references quite often also involve additional costs apart from further avoidable delay.

To minimise the number of unreconciled items, it is the practice of banks to put through transaction in suspense account such as Export bills purchased, Export bills discounted, Drafts/Travellers cheques issued, Advance bills received. Inward bills/drafts etc. As a further measure for simplification, some banks have permitted more branches to maintain independent Nostro account with different correspondent banks. While it is advisable for banks with a large network to adopt both measures, the management at each office maintaining Nostro account should be required to exercise the requisite control over reconciliation and the suspense account.

The records of reconciliation must be held under safe custody and preserved for a sufficiently long period for reference.

It should be ensured that no set-off of debit and credit items has been made/ any unreconciled item written off or appropriated to profit and loss except in terms of the authorisation in the Exchange Control Manual or the prior approval of the Control.

Management Control

A monthly report should be submitted by Reconciliation Department indicating the progress made in reconciliation of Nostro account balances highlighting special features such as large unreconciled items, age-wise grouping of items etc.

MANAGEMENT OF RISKS ARISING IN RUPEE (VOSTRO) ACCOUNT

Control over Vostro account too covers various aspects, viz., funds flow into the account, observance of discipline in credit lines extended to the correspondent bank, concealed over-draft (and recovery of interest thereagainst), apart from periodical evaluation of credit risks.

Bank should assess their credit risks periodically say, at least once in twelve months vis-a-vis their correspondent banks whether or not they maintain Rupee accounts.

The credit risks arising form drawings on branches can be immeasurable unless proper control is exercised over the flow of the paid draft etc. to the Account-maintaining office from the drawee branches. Such risks can be minimised by adoption of one or more of the following measures.

(i) Reduction in the number of branches on whom drafts etc. can be drawn.
(ii) Imposition of suitable limits for drawing or for aggregate during a day.
(iii) Securing draft etc. issused advices from the correspondent.
(iv) Decentralisation of Vostro account by opening subsidiary or independent accounts at other important offices.
(v) Arrangements for advice over telex/telephone of large payments by paying branches.
(vi) Prompt value-dating.

Special Aspects for Vostro Account Monitoring

The Exchange Control regulations require close monitoring of funds flow in Vostro account with a view to averting hot money flows on the one hand and speculative dealing in the Rupee on the other. Apart from this, the accounts should be monitored for quickly identifying sudden changes in volume of operations, changes in the nature of operations, etc. So that discreet enquiries can be made about the causes for the changes. Any unusually large operations (whether credits or debits) in inactive or the less active Vostro account should be promptly looked into to ensure that they are genuine operations.

Confirmation of Balances

It is an essential feature of customer service to the overseas banks maintaining Vostro account to send out certificates of balance and obtain confirmation thereof periodically. It should be ensured that the confirmation duly signed by the authorised signatory of the bank are received in time and are kept on record.

CONTROL OVER MISCELLANEOUS ASPECTS OF DEALING OPERATIONS

Dealing Hours

The dealing hours will ordinarily be the recognised working hours of the bank at the respective centres. But if dealers are required to work longer hours it is essential that the Managements lay down the extended working hours.

Substitution of Names of Banks in Interbank Contracts

Substitution of one bank by another in interbank contracts by brokers is not a recognised practice as broker operate on the specific instructions of the dealers and not vice versa. Substitution is therefore, prohibited.

Auditing

Internal Audit

The nature and scope of internal audit varies widely between banks. However, its work will generally be designed to ensure that established procedure are adhered to and are operating effectively. Thus, an important part of its work will be to review the adequacy and timeliness of key management reports, such as those relating to limit excesses and maturity periods, and to ensure that appropriate action is initiated in response to this information. Other tasks of the internal audit department will include statutory and regulatory compliance reviews, data processing control reviews and bank office efficiency reviews. For the internal audit function to be beneficial, it is essential that its reports are submitted promptly to senior management.

The officers drafted for audit should have the requisite expertise, knowledge and experience.

System Audit

Special audit of the Dealing Room and the system in operation should be conducted at least once in a year. Typically, the areas tested during this audit should include the following :

(i) Dealing-room procedure to ensure that all deals executed are promptly captured by the accounting system.
(ii) Reconciliation of foreign exchange positions between the dealers record and the accounting system.
(iii) Review of incoming deal confirmations.
(iv) Full scrutiny of sample deals.

Compliance with the minimum requirements is to be checked at irregular, appropriate intervals by the auditors. The main audit areas listed below should be subjected to a risk-oriented audit once a year.

(i) limit system
(ii) determination and reconciliation of positions and results
(iii) changes in the EDP systems
(iv) completeness, correctness and timeliness of the internal reporting system.
(v) functional separation
(vi) degree to which transactions are in the line with market conditions.
(vii) confirmations and counter-confirmations.

14 Futures and Options

APART from the traditional role of buying and selling foreign currencies on spot and forward basis, foreign exchange markets offer also other instruments like options, futures and swaps. Along with forward contracts, these new instruments are called *financial derivatives* as their value is derived from the value of some other underlying financial contract or asset. Of these new instruments, currency futures and options are designed basically to afford protection from exchange risk. The salient features of these two instruments are discussed in this chapter. Swaps and interest rate futures are used for protection against interest rate risk. They are discussed in a subsequent chapter.

14.1. CURRENCY FUTURES

A futures contract is a form of forward contract in that it conveys the right to purchase or sell a specified quantity of a foreign currency at a fixed exchange rate on a specified future date. Whereas in a forward contract the quantum of foreign currency and the due date are determined by the customer, in a futures contract these are standardised. While forward contract can be entered into by a person with any bank at any place, the futures contract can be entered into only with the financial futures exchanges. Thus, a futures contract may be defined as *an agreement entered into with the specified futures exchange to buy or sell a standard amount of foreign currency at a specified price for delivery on a specified future date.*

❑ Features

The salient features of a futures contract, which also distinguish it from forward contract, are as follows:

Futures Exchanges A forward contract can be entered into with any bank, and hence termed an over-the-counter product. A futures contact can be traded only on a recognised futures exchange. There are over 50 futures exchanges spread over the world. The important among them are the International Monetary Market (IMM) – part of Chicago Mercantile Exchange, and London International Financial Futures Exchange (LIFFE). Futures trading began at IMM of Chicago Board of Trade in 1972, which continues to be the leading futures market of the world.

Size of Contract The size of the transaction is standardised. For instance, at LIFFE, the contract in sterling can be only in multiples of GBP 62,500 and that in Deutsche mark in multiples of DEM 125,000. Similarly, at Chicago Mercantile Exchange, the standard size of a futures contract is GBP 62,500, (Canadian dollar) CAD 100,000, DEM 125,000, FRF 2,50,000, JPY 12,5000,000 and so on. These figures represent the value of one futures. In all futures contracts, the stated currency is the foreign currency that is being bought or sold against US dollar.

Delivery Dates The due dates of the contracts fall on a specified day in specified months in a year, generally on quarterly basis. For instance at Chicago exchange, the specified months are March, June, September and December and the delivery date is third Wednesday of the respective month. The month during which a contract expires is referred to as the spot month. All trading stop two business days prior to the delivery date to enable the participants deliver the currencies, as in the case of spot market.

Price Movements The price for the futures is quoted as so many units of US dollar per unit of foreign currency. The value of the futures will be the price per unit of foreign currency multiplied by the size of the contract. For instance, the

Mark futures may be bought at a price of USD 0.58. Since the standard size of marks futures is DEM 125,000, its value is USD 0.58 x 125,000 = USD 72,500.

The exchange may fix the minimum size of price movements, called *tick*. For instance, the tick may be USD 0.0001 for Mark, which amounts to a tick value of USD 12.50 per contract of DEM 125,000. The exchange may also fix the maximum intra-day movements of the price. If the price varies beyond the limit prescribed, as compared to the closing price of the previous day, the trading may be suspended to assess the situation. The exchange may permit further trading after the margin accounts are properly adjusted.

Trading by Members Buyers or sellers of futures contracts place orders with exchange brokers or exchange members. These orders are communicated to the floor of the futures exchange. The price for a given number of contracts will be negotiated by open outcry in the trading pit. The deal is struck when someone is willing to buy and some other is willing to sell at the agreed price. The price keeps changing depending upon the demand and supply. For each contract, there is one person who buys the futures (or takes a long position) and another who sells (or takes a short position). The number of outstanding two-sided contracts at any given time gives the *open interest*.

Dealing with Clearing House Although two members conclude a deal between themselves, one buying and the other selling, the clearing house of the futures exchange is interposed between the deals and both the deals are with the clearing house only. Thus the member who buys the futures has to accept delivery from the clearing house and the member who sells has to deliver the foreign exchange to the clearing house. This arrangement safeguards the interests of the members against the failure of the counterparty.

Margins As stated above, the clearing house assumes the counterparty risk in the futures contract. In order to ensure their liquidity and thereby safety for the clearing house, the members are required to keep with the clearing house margin ranging from 2.5% to 10% of the contracts outstanding in their names, in the form of cash, treasury bills or letters of credit. The margin that is required to be deposited at the time of entering into the contract is the *initial margin*. Another level of margin, lesser than the initial margin, is also prescribed which is known as the *maintenance margin*. The margin money will be adjusted (*i.e.*, balance reduced or increased) with the change in the current value of futures. If the margin money is reduced below the maintenance level, the member is expected to bring in additional amount and restore the margin at least to the initial level.

Marking to Market As noted above, although the contracts are to be delivered on the due date, the value of each outstanding contract is determined every day by reference to the closing quotation and any excess or shortage is adjusted in the margin account of the concerned member. This process of revaluing the contract based on the ruling price for futures is known as *marking to market*. By marking the contract to market and adjusting the margin money accounts, the clearing house ensures the continued liquidity of the members and minimise for itself the counterparty risk.

Example. For a futures contract in Canadian dollar, the initial margin and maintenance margin prescribed by the exchange are USD 4,000 and USD 3,000 respectively. A contract is concluded at a price of USD 0.75. The settlement price in the exchange at the end of four subsequent days are as follows:

Day 1	—	USD 0.745
Day 2	—	USD 0.730
Day 3	—	USD 0.740
Day 4	—	USD 0.755

At the end of each day, the margin accounts of both the buyer and the seller will be adjusted based on the settlement price for the day. Where the margin goes

below the maintenance level, the buyer/seller will be required to reimburse to bring the balance to the initial level. If the margin is more than the initial level, the member concerned is free to withdraw the excess. The adjustments to be made in the margin money of buyer and seller is tabulated below:

Opening Price: USD 0.750 **Contract Value: USD 75,000**

Particulars	Day 1 USD	Day 2 USD	Day 3 USD	Day 4 USD
Settlement Price	0.745	0.730	0.740	0.755
Contract Value	74,500	73,000	74,000	75,500
Margin Money Account of Buyer:				
1. Opening balance	4,000	3,500	4,000	4,000
2. Amount adjusted for change in value of contract	-500	-1,500	1,000	1,500
3. Adjusted balance	3,500	2,000	5,000	5,500
4. Amount deposited/withdrawn	—	2,000	-1,000	-1,500
Closing Balance	3,500	4,000	4,000	4,000
Margin Money Account of Seller:				
1. Opening balance	4,000	4,000	4,000	3,000
2. Amount adjusted for change in value of contract	500	1,500	-1,000	-1,500
3. Adjusted balance	4,500	5,500	3,000	1,500
4. Amount deposited/withdrawn	-500	-1,500	—	2,500
Closing Balance	4,000	4,000	3,000	4,000

The buyer of futures contract gains by an increase in the value of the contract. His margin account is increased by this value. Correspondingly, the seller loses and his margin account is reduced by the value. This is only a notional gain/loss because the contract has to be settled at the ruling price for the contract. The gain/loss on the margin account will be compensated by the loss/gain in the value of the contract. This is explained in the next paragraph.

On the date of settlement, the buyer pays the price for the contract at the ruling rate for the futures which will be same as the spot rate. In our example, if the spot rate for Canadian dollar on settlement date is USD 0.80, he would pay USD 80,000 and take delivery of CAD 100,000. It may appear that he has paid USD 5,000 higher than contracted price. But the fact is that, over the period of existence of the contract, if the amounts deposited and withdrawn from the margin account on various dates due to marking to market are reckoned, it will be seen that there is a net surplus of USD 5,000 in the margin account, which will be paid by the clearing house to the buyer. Thus the net price amounts to the same as the contract price. However, the cash flows in the form of margin moneys withdrawn and deposited on different dates involve interest element. To the extent the interest was a net receipt or payment will add to or reduce the cost of hedging with futures.

Liquidity One salient feature of futures that commends it as an hedging instrument is its liquidity. The buyer of the future need not hold it till maturity. On any intermediary date he can sell to another and wind up his position with the exchange. Similarly a seller can enter into a purchase deal before the due date and square his position. In fact it is for this reason that futures is sometimes described as a bet on the future price of the currency, rather than an obligation to buy the currency. Most of the futures contracts are not delivered on the due date, but extinguished by counterdeals. As the delivery date approaches, the open interest (number of outstanding two-sided contracts) falls steeply.

Delivery If the contract is held up to the due date, it will be settled by exchange of currencies.

❑ Futures in India

The current exchange control regulations do not permit futures trading in currencies in India.

14.2. OPTIONS

An option confers on the buyer the eligibility to buy or sell a sum of foreign currency at a pre-determined rate on a future date, without investing him with an obligation to do so. On the due date, the buyer of the option may elect to buy/sell as per his entitlement or he may choose to let it go unused. Either of the decision is binding on the seller, who has no such discretion.

Essentially, an option contract serves the similar purpose as a forward exchange contract, *viz.*, to firm up the future payment/receipt in a foreign currency with regard to exchange rate in terms of the local currency. The difference between the forward contract and the option contract is that, under the forward contract, the customer is expected to deliver/receive the foreign exchange on the due date at the forward rate irrespective of the spot rate prevailing. Under an option contract, on the due date, the customer can make a reassessment of the situation and seek either execution of the contract or its non-execution as may be advantageous to him.

❑ Features of Option Contracts

Parties There are two parties to an option contract – the option buyer and the option seller. *Option buyer* is the holder of the right under the contract either to buy or sell one specific currency against another specific currency. Normally it would be the exporter or importer or the corporate treasurer who would be buying the option from the option seller. *Option seller*, also known as the *writer of the option*, is the one who makes the right available to the buyer. He should deliver or accept delivery of the currency concerned when the right is exercised by the option buyer. Normally the writer of the option will be the bank which provides this instrument to its customers. The seller of the option is always at a disadvantageous position because the buyer will exercise his right only if the prevailing exchange rate is favourable to him. This also means that the rate is unfavourable to the seller.

Call and Put Options A contract under which the option buyer has the right to purchase the specified currency is the *call option*. A contract conferring the right to the buyer to sell the specified currency is the *put option*. Generally the US dollar is the base currency and the other currency of the contract is the foreign currency that is being bought or sold. For instance, in a dollar/yen call option, the buyer acquires the right buy yen against dollar. Similarly, in a dollar/mark put option, the buyer acquires the right to sell mark against dollar.

Premium The consideration for the seller to offer the right to the buyer is the premium. Thus *premium* is the fee payable by the buyer of the option to the seller at the time of entering into the contract. The premium paid is not refundable whether the buyer ultimately exercises his right or not.

Strike Price The exchange rate at which the currencies are agreed to be exchanged under the contract is the *strike price*. The market price for option is not a single price. Varying prices maybe quoted, each at a different premium. The premium charged would vary according to the market perception about the future exchange rate for the currency. For instance, the quotation and premium for option in the market for Deutsche mark for delivery in March may be quoted as follows:

Strike price (Quotation) in Cents	Premium in Cents	
	Call	Put
65	0.10	0.30
66	0.15	0.25
67	0.20	0.22
68	0.23	0.20
69	0.24	0.19
70	0.25	0.18

A buyer of call option may buy mark at USD 0.65 by paying a premium of US 0.001 per mark. Or, he may opt for USD 0.68 at a premium of US 0.0023, and so on. The strike price and premium agreed between the buyer and seller will be applicable for the contract.

Maturity The date on which the contract expires is the maturity date.

Execution Based on the period when the buyer can exercise his right under the contract, options are classified into two types, *viz.*, American option and European option. Under an *American option*, the option buyer can exercise his right on any date during the currency of the contract, *i.e.*, any date on or before the maturity date. Under an *European option*, the buyer can exercise his right only on its maturity date. Since the first type of option means higher risk for the seller, the premium charged would vary accordingly.

❑ Types of Instruments

Three types of options are available. They are:

(*i*) OTC options
(*ii*) Exchange Traded Options
(*iii*) Options on Futures

Over-the-counter (OTC) Options are available with individual banks. They are tailor-made to the requirements of the buyer with regard to the maturity, price and size of the contract. The buyer of the option bears the counterparty risk, *i.e.*, the risk that the seller of the option, the bank may fail to fulfil its obligation under the contract. Normally this type of options is confined to contract of large volumes and between big players. Since this is non-standard variety the premium charged may also be higher.

Exchange traded Options are physical currency options traded at an organised exchange. That is, similar to the OTC option, the buyer acquires the right to buy or sell the foreign currency but for standard maturities and in standard amounts. Thus it is akin to futures contracts and traded on the exchange. The contract is with the clearing house of the exchange and hence the counterparty risk is minimised.

Options on Futures gives the buyer of the option the right to buy/sell specific number of futures on specified exchange. Depending upon the strike price prevailing the buyer may exercise his option or forgo it. If the buyer of a call option exercises his option, he will receive a long-future contract in the currency. That is, he will become the buyer of the future contract in the exchange. Then the future contract will be subject to other regulations like margin, marking to market, etc.

❑ Execution of Contracts

Whether the buyer will exercise his right under the contract depends upon the spot price for the currency prevailing on the due date of the contract. Based on the prevailing spot price, the option contract may be considered (*a*) In-the-money, (*b*) Out-of-the money, or (*c*) At-the-money.

In-the-money Options An option is in-the-money when it would be advantageous for the holder of the option to exercise his right. Thus, a call option is in-the-money if on the maturity date the spot price for the currency being bought is higher than the strike price under the option contract. For instance, let us say

that the strike price under the contract is USD 0.65 per mark and in the market spot price for mark is USD 0.67. It would be advantageous for the buyer of the option to exercise his option and obtain marks at USD 0.65 and thereby save USD 0.02 per mark. A put option, on the other hand, is in-the-market, if at maturity the spot price for the underlying currency is cheaper than the strike price under the contract. The difference between the option price and the spot price at maturity, which is in favour of the buyer is known as the *intrinsic* value of the option.

Out-of-the Money An option is out-of-the money, if it is not advantageous for the buyer to exercise his right. A call option is out-of-the market if the spot price for the currency bought under option is lower than the strike price agreed under the contract. A put option is out-of-the-money on the maturity date, where the spot price for the currency sold is higher than the strike price under the option contract. When the option is out-of-the money, the buyer does not exercise his right and the seller stands to gain by the premium he received under the contract.

At-the-money An option contract is at-the-money when the strike price is equal to the spot rate for the currency concerned on the due date of the contract. It makes no difference to either of the parties whether the buyer exercises his option or not.

❑ Use of Options

An exporter who expects to execute the contract and receive foreign exchange after six months may enter into a 'put option' for six months which entitles him to sell the foreign currency on maturity at an agreed predetermined price (strike price). If on maturity, the spot price for the currency is more favourable to the exporter he may choose not to exercise his right of selling under the contract. He can instead sell in the market at the spot rate.

Similarly, an importer may enter into a 'call option' entitling him to buy the foreign currency on a future date.

Option contract is useful especially in covering exchange risk under contingent conditions like when the company enters into a bid. The exchange risk will arise only if the contract is awarded and foreign currency exposure arises. Other methods of hedging, such as forward contracts, will prove costly if the contract is not awarded and forward booked has to be cancelled.

❑ Option Contracts in India

In India banks are allowed to write cross-currency options, after obtaining general permission from Reserve Bank and subject to the following conditions:

(*a*) Options should be sold to customers only to cover their genuine exposures.

(*b*) Options should be written on a fully covered basis, *i.e.*, the bank should buy from the overseas branch/bank/internationally recognised/approved option exchanges, an identical option for the same amount, strike price and maturity date as the one sold to its customer. Option positions should not be left open.

(*c*) Option premiums may be paid to the overseas sellers for options bought by the bank who, in turn, may charge the premium to the customer by keeping a spread. Premiums may be paid and received in foreign currency.

(*d*) Options written and options purchased should be marked to market at suitable periods, so as to coincide with the dates on which evaluation of foreign exchange positions is done.

(*e*) Appropriate accounting entries should be passed for options purchased and sold as well as premiums received and paid so that option exposures appear in the accounts as a contingent item.

(*f*) Limits should be set for customer exposures, counter-party limits for options purchased should also be laid down.

It may be noted that only cross-currency are permitted. That is, both the currencies involved are foreign currencies, *e.g.*, US dollar against deutsche mark. Options in a foreign currency against Indian rupee is not permitted.

Option contracts have not been used widely in India for the following reasons:

(*i*) Most of the exposures of the importers and exporters are in US dollars and non-availability of dollar-rupee option is a great drawback. The cross-currency option provides only partial cover against exchange risk.

(*ii*) Banks can write option only by covering themselves fully in the international markets. To the premium charged by international banks, they have to add their charges. This makes the instrument costly for the users.

❑ Range Forwards

Effective from September 19, 1996, corporates are allowed to freely book and cancel options. Authorised dealers have been permitted to offer risk reduction and cost-effective strategies such as 'range forwards' and 'ratio range forwards' to their customers. Both products, which are basically combinations of options, help the customer get a hedge on a cost-effective basis.

Range forwards involve simultaneous buying and selling of call or put options. For example, if an exporter expects to receive USD 1 million in 6 months' time and decides to receive it as yen and his break even is 105 yen per dollar, he may buy a USD put/yen option of USD 1 = Yen 105. (That is, he can sell dollar to the bank at this rate.) For buying the put option, the exporter pays a premium of say USD 50,000. This is the cost of the option. If the dollar appreciates and on the due date, the rate is USD 1 = Yen 120, he will not exercise the option and prefer to receive the higher value in yen at the spot rate. On the other hand, if the yen appreciates and the rate on the due date is USD 1 = Yen 100, he will exercise the option.

Suppose the exporter wishes to reduce the cost of option and is willing to limit his gains from possible appreciation of dollar. As an exporter he can write (*i.e.*, sell) a USD call/yen option to his bank for USD 1 million, say at a strike price of USD 1 = 110. Under this contract, the bank has the option to buy USD 1 million at the end of the sixth month. The customer can collect premium from the bank offering this option. If the premium received is USD 40,000, the net cost of both the options is USD 10,000 as against the previous cost of USD 50,000. If the option is written at the same premium as that paid on the put option, the cost to the exporter will be zero.

Let us say the exchange rate on the due date is USD 1 = Yen 120. The exporter will not exercise his option. But the bank will exercise its option to buy dollars at Yen 110. The customer will receive Yen 110 million from the bank for the export proceeds. On the other hand, if the exchange rate turns out to be Yen 100, the exporter will exercise his option and require the bank to pay his Yen 105 million against the remittance. It would not be advantageous for the bank to exercise its call option at this price. Thus under the range option, the exporter gets protection from exchange fluctuation in the range of Yen 105-110. He protects himself against dollar falling in value below this range; at the same time, he forgoes the opportunity of gaining from the dollar appreciating beyond this range. Thus, as against a simple option, in a range option, the cost of hedging can be reduced, but the potential of gaining is also limited.

Ratio range forwards is a more flexible variation of the range forwards. It is a combination of simple straight forward option and range forward options. The main difference is that the amounts of the option bought and sold are different. The *ratio of the two amounts can be so chosen as to bring down the net payment of premium even to zero.*

15 Exchange Risk : Transaction Exposure

An enterprise engaged in export/import trade will be affected by the change in the rate of exchange between the domestic currency and the currency in which the transaction is designated. For instance, an Indian company which exported to France ready-made garments when the Euro was quoted at Rs. 46.00 per Euro will suffer a loss if the Euro depreciates to Rs. 45.00 per Euro by the time the export proceeds are realised.

An international company which has a subsidiary abroad has the assets and liabilities of such subsidiary denominated in the local currency concerned, *i.e.*, the currency of the country where the subsidiary is situated. The overall financial position of the parent company would be affected by any change in the exchange rate between the domestic currency of the parent company and the currency of the country where the subsidiary is situated.

In both the cases mentioned above, it is essential that the business concern keeps track of the extent to which its funds are involved/exposed to the risk of exchange rate fluctuations and the extent of loss/gain that is likely to arise on account of the fluctuation in exchange rates.

15.1. MEANING AND CLASSIFICATION

❑ Exchange Exposure and Exchange Risk

Exchange exposure is defined as the extent to which transactions, assets and liabilities of an enterprise are denominated in currencies other than the reporting currency of the enterprise itself. The reporting currency is normally the national currency of the parent company. Exposure arises because the enterprise denominates transactions in a foreign currency or it operates in a foreign market. The exposure is measured by the value of the assets and liabilities or transactions denominated in foreign currency.

Exchange risk is defined as the net potential gains or losses which can arise from exchange rate changes to the foreign exchange exposure of an enterprise. It is possible that an adverse exchange rate movement may turn an otherwise profitable deal into a loss. For instance, if an export deal is struck with a profit margin of 10%, and meanwhile the foreign currency in which the deal is denominated depreciates by 15%, the result would be a loss of about 5%. It is also possible that the unexpected movement in the exchange rate is favourable and bring windfall profits. The concept of exchange risk covers both the possibilities.

Difference between Exposure and Risk

It would be evident from the definitions given above that exposure relates to the total value of assets, liabilities or cash flows of an enterprise denominated in foreign currency, while exchange risk relates to the excess or shortfall in the cash flows or value of assets or liabilities likely to arise on account of exchange rate fluctuations. Thus exposure relates to the absolute value of an asset or liability involved, and the risk relates to the changes in the value. It is the exposure that leads to risk, through exchange rate changes. However, it is observed that the term exposure is used in practice to refer to risk also.

❑ Types of Exposures

Three types of exchange exposure are recognised:

(*i*) Transaction or conversion exposure

(ii) Translation or accounting exposure

(iii) Operating or economic exposure

The nature of each of the above measures is shown in Fig. 15.1.

Transaction exposure is discussed in this chapter. The other two exposures are considered in the next chapter.

15.2. TRANSACTION EXPOSURE

Transaction exposure deals with changes in cash flows that result from existing contractual obligations. It refers to the risk associated with the change in the exchange rate between the time an enterprise initiates a transaction and settles it. For example, an exporter may quote a price of USD 10,000 based on exchange rate of Rs. 38 per dollar. He hopes to receive Rs. 3,80,000 on executing the order. If the contract is executed, say, after three months, and the exchange rate rules at Rs. 34 per dollar, the exporter will receive only Rs. 3,40,000 short of his expectations by Rs. 40,000. True, the rate may turn favourable and the exporter may gain also. However, the fact remains that the amount that will be received may not be the same as the amount originally anticipated. It is this uncertainty about the amount to be received on conversion that leads to the transaction exposure. The gain or loss that arises on account of exchange rate fluctuations when the foreign currency denominated transaction is settled and converted into the domestic currency is known as the transaction exposure. Since the gain or loss arises on converting the foreign currency into domestic currency it is also known as *conversion exposure*.

The transactions exposure arises whenever the enterprise has foreign currency denominated receivables payables, may be arising out of sale or purchase or borrowing or investment. The obligations of payment or receipt is entered into by the company before a change in the exchange rate, but settled after the change. The extent of exposure would include all unsettled payables and receivables for which commitments have been made by the enterprise, *e.g.*, unexecuted customer's orders.

The transaction losses or gains are absorbed in the profit and loss account for the year concerned, and thus affect the profit of the enterprise. For this reason it is believed that managing the transaction exposure is all that is required for exposure management. But this is a narrower view, as other aspects of exposure also affect the prospects and valuation of the company and should be given the consideration due to them.

15.3. MANAGING TRANSACTION EXPOSURE

The objective of a company in managing its transaction exposure is to avoid losses that may occur due to exchange rate fluctuations. At the same time, to the extent possible, it should not forgo likely gains from favourable changes in exchange rates. A company which wants to play safe and avoid totally the risk may go in for *hedging* each of its exposure. On the other end of the scale is a company which takes active interest in the study of the rate movements, ventures to speculate and accordingly devises strategies to gain out of the exchange rate movements. Cases are not wanting where a manufacturing company made huge profits from foreign exchange operations, sufficient enough to make up the losses made on its main activity and post respectable net profit. It is also true that a larger number of companies met their doomsday due to their perceptions on exchange movements proving wrong.

The exchange control regulations do not allow free-rein to companies in India to indulge in unlimited speculative activities in the foreign exchange market. For most companies in India, managing foreign exchange exposure has been to decide on hedging or keeping the position uncovered. A foreign exchange exposure is *hedged* or *covered*, when the company takes certain steps to insulate itself from the exchange rate movements. The basic idea in hedging is to create a position in the foreign currency in the direction opposite to the one that exists so that ultimately the

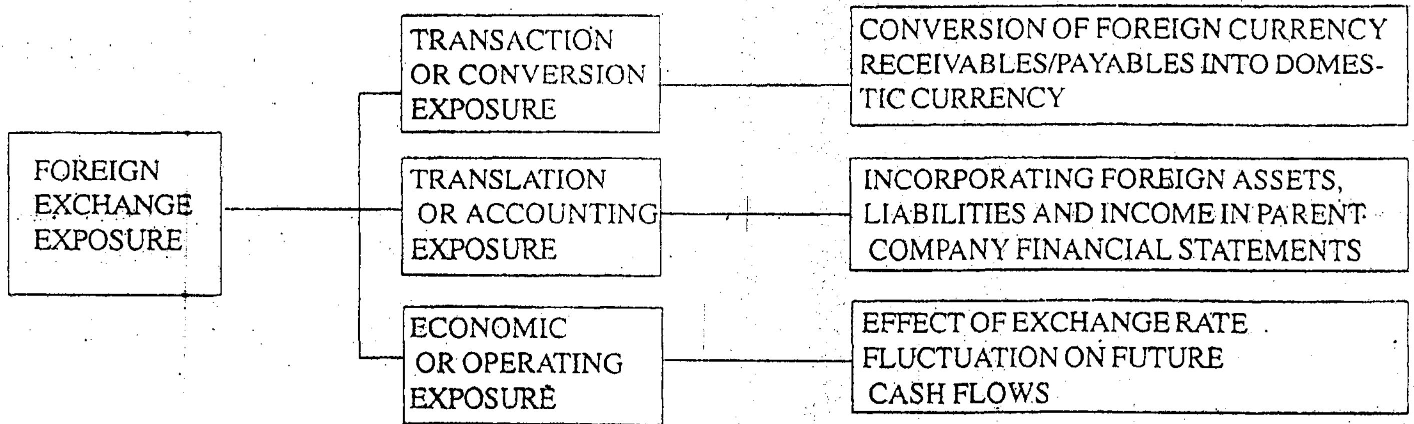

Fig. 15.1. Foreign Exchange Exposures.

balance becomes zero. Thus, the loss incurred from one position due to exchange rate change is offset or counterbalanced by a profit earned on the opposite position on account of the same exchange rate change. Following are the methods by which the transaction exposure can be hedged (external hedging methods):

(i) Forward contract hedge
(ii) Money market hedge
(iii) Options
(iv) Futures

The other method of managing transaction exposure is to avoid such exposure. In the following cases, transaction exposure is avoided by the company (internal hedging methods):

(i) Exposure netting
(ii) Currency invoicing
(iii) Foreign currency account
(iv) Leading and lagging

❑ External Hedge

1. Forward Contract Hedge

Forward contract has been most widely used form of hedging exchange rate risk. In a forward contract, the company arranges for disposing the foreign currency or acquire the foreign currency at a future date, when it is likely to be received or paid by it, at a predetermined exchange rate. Thus, an exporter who has receivable in US Dollar maturity after 6 months can sell this amount to his bank under a forward contract. On maturity, when the receivable realises this can be sold to the bank at the forward rate agreed, irrespective of the spot rate prevailing. Similarly, a company which has a payable in foreign currency may buy foreign currency from the bank and thus determine in advance its cost in rupees.

As we have already seen, the forward rate for a currency may be quoted at a rate above or below the spot rate. In either case, the hedger knows in advance the amount that will be realised or payable in domestic currency instead of keep guessing what the future exchange rate will be.

One measure of cost of hedging through forward contracts is the forward premium or discount, which represents the difference between the spot rate prevailing and the forward rate. For an exporter, the foreign currency at discount results in cost of hedging and when at premium results in negative cost. This is because, the foreign currency at premium brings him more domestic currency, and at discount lesser domestic currency. For an importer forward premium results in positive cost and forward discount negative cost. This measure of cost of hedging is useful in policy decision.

Another measure of cost of hedging, which is considered as the true cost of hedging, is the opportunity cost. This is difference between the forward rate booked and the actual spot rate prevailing on the date of execution of the contract. In an efficient market, the forward rate is expected to reflect the spot rate likely to prevail at the specified future rate. Therefore, the cost of forward contract should be zero. However, in practice, there exist some difference between these two rates and thus the cost of forward arises. It may be noted that this measure of cost of forward contract can be arrived at only on the maturity when the forward contract is executed. Only then we can know the spot rate prevailing. At the time of entering into the forward contract, the cost of hedging remains unascertainable. At the most, one can estimate the spot rate likely to prevail on the due date, and the probable cost of hedging can be worked out to aid decision-making.

2. Money Market Hedge

This is also known as spot market hedge. Under this method, the company which has an exposure in a foreign currency, covers it by borrowing or investing the concerned currency in the money market and square its position on the due date. For instance, let us say that an importer has to pay USD 1,00,000 after six months. The exchange rate of US Dollar is quoted as follows:

Spot	Rs. 48
6 months forward	Rs. 49

If he wants to hedge through forward market, he can book forward contract at Rs. 49, in which case on due date the cash outflow will be Rs. 49 lakhs.

The other way, he can cover his position is to purchase dollar immediately in the spot market and invest it in money market. The value of dollars* invested will be so decided that together with the interest earned, the amount received from the investment at the end of six months will be USD 1,00,000. Assuming an interest of 6% on the investment, the principal required to be invested can be calculated as follows:

1.03 x = USD 1,00,000*
x = 97,087.38

(* On USD 1, interest for 6 months is USD 0.03. Therefore, the amount at the end of 6 months is USD 1.03.)

At the end of six months, the investment of USD 97,087.38 will become USD 1,00,000 which can be used to pay for the import.

For buying USD 97,087.98 immediately, the company has to pay Rs. 46,60,194 at the spot rate of Rs. 48 per dollar. Either, the importer borrows this amount in the money market, paying interest or deploys his own funds, in which case, opportunity interest is involved. Assuming the interest for rupee funds is 10%, the amount requires to repay the borrowing after six months will be:

Principal	Rs. 46,60,194
Interest at 10% for 6 months	Rs. 2,30,097
	Rs. 48,90,291

By covering through money market, the company ends up with a cash outflow of Rs. 48,90,291 as against Rs. 49 lakhs under forward contract. It may be observed that the principles behind forward market hedge and money market hedge are similar. Forward margin is expected to reflect the interest differential between the centres of the two currencies involved. Where the forward margin truly reflects the interest differential, the cash outflow under both the methods should be the same. However, in the short run, the forward margin may differ from the interest differential. The hedger can decide between the two methods depending upon whichever method involved lower cash outflow or higher cash inflow.

3. Hedging with Options

Option gives the buyer a right, but not an obligation to buy or sell a specified amount of foreign currency on a specified future date. The disadvantage under forward contract is that the hedger cannot take advantage of any favourable changes in the exchange rate movement. For instance, an exporter who booked a forward contract for dollars at Rs. 38.00 has to accept the same rate for dollars when he delivers foreign exchange to his bank, irrespective of the spot rate prevailing. If the spot rate on the date of delivery is Rs. 40, yet the forward contract will be executed at Rs. 38. The hedger, therefore, incurs an opportunity loss of Rs. 2 per dollar under the forward contract. Option contract provides an opportunity to the hedger not only to cover this exposure, but also to gain from any favourable change in exchange rate. In the situation just narrated, if the exporter had booked option contract at Rs. 38 per dollar, he would prefer not to exercise the option. In that case, he can obtain from the bank Rs. 40 per dollar at the spot rate. Thus, option contract helps the hedger to avoid the loss and at the same time enjoy the gains.

But option contract is not available without any cost. Premium is paid up-front and is not recoverable whether the option is exercised or not. Therefore, the cost involved are (*i*) the premium paid and (*ii*) interest on the premium paid till the execution of the contract. Therefore, when the movement in exchange rate was as anticipated, and the option is exercised, the gain earned is less than that under forward contract by the amount of premium paid.

It is, therefore, suggested that where the exposure is definite and the direction which the exchange rate movement is going to take can also be anticipated with reasonable certainty, forward contract would be a better choice of hedging, as it does not cost anything to book a forward contract. Option contract is preferable under the following circumstances:

(*i*) Where the likelihood of the exposure becoming a reality is uncertain. For instance, where a company bids in a global tender denominated in foreign currency, the exposure will arise only when its bid is accepted and it is offered the contract. At the time of bidding itself, the company can book an option contract. If the contract is not awarded, the option can be allowed to expire. The option can be utilised if the contract is awarded and the exchange rate moves adversely.

(*ii*) Where the exposure is certain, but the direction the exchange rate will take is uncertain.

4. Hedging with Futures

Due to intense competition in the futures market, currency futures are available with thin margin. They may prove to be a good tool for hedging where large exposure is involved and is expected to mature near the due date of the futures contracts. However, as compared to the flexibility available under forward contract, futures do not commend themselves hedging device in many cases. In case of small exposures, hedging may not be suitable because of the standard size of the contract. Even if large exposure is there, due to the standard size of futures contracts a position of the exposure may remain uncovered. Transactions occur and fall due throughout the year, whereas futures contracts mature only at specified dates in each quarter. Of course, the futures may be sold when required but this may entail exchange loss.

In view of the above factors, futures is not a favoured as hedging tool. Moreover, futures are not available in India at present.

❑ Internal Hedge

1. Exposure Netting

If a company has both receivables and payables in a foreign currency, it need not hedge its receivables and payables separately, but do so only for the net position. For instance, if an Indian company has receivables of USD 5 million and payables of USD 4 million, the net exposure is of USD 1 million. The technique of exposure netting involves managing the size of receivables and payables in a foreign currency in such a way that they match or nearly match each other. This makes the company remain unaffected by any change in the exchange rate of the foreign currency concerned. The gain in receivables is offset by loss in payables, and *vice versa*.

In a company with multi-currency transactions, exposure netting can take different dimensions. The currencies are grouped into two (*i*) those whose value is likely to appreciate, and (*ii*) those whose value is likely to depreciate. The exposure due to receivables in a currency which is likely to appreciate may be offset by a payable in another currency which is also likely to appreciate. For instance, let us say that both US dollars and Deutsche Mark are expected to appreciate. The company has receivables of USD 5 million. It can manage its exposure by having equivalent amount as payable in mark. Similarly, the company's receivables in a

currency likely to depreciate may be offset by its payables in another currency which is likely to depreciate. Another way of netting is to have near equal amount of receivables in two currencies— one likely to appreciate and the other likely to depreciate.

Netting can be practised by multinational companies which have the leverage of manipulating the currencies in which the receivables and payables can be designated. After netting, other hedging techniques like forward cover may be adopted for the net position to get total cover.

2. Denomination in Local Currency

The exchange risk can be totally avoided if the transaction is denominated in local currency. In such a case, the exchange risk will be borne by the other party to the transaction. For instance, if exports from India are invoiced in Indian rupees, the obligation of the importer is to pay a fixed sum of rupees. The exporter is not affected by any movement in exchange rate. The importer, on the other hand, will be bearing the exchange risk entirely. He may have to pay more in terms of the currency of his country if that currency depreciates (or rupee appreciates). Similarly, if an import into India is denominated in Indian rupees, the importer is free from exchange risk, but it is borne fully by the exporter abroad.

Invoicing in local currency depends upon the relative bargaining capacity of the importer and exporter and the status of the currency concerned in the international market. It may be noted that most of the foreign trade of India is denominated in foreign currency, especially in currencies like US dollars, Pound sterling, Deutsche mark and Japanese yen. Denomination in rupees was found in trade with countries with which India had entered into bilateral trade agreements.

Denomination of the transaction in the currency of the importer or the exporter puts the other party at a disadvantage. To strike a balance, the transaction may be invoiced partly in the currency of the exporter's country and partly in the currency of the importer's country. Such a measure results only in sharing of the exchange losses between the two parties. It does not completely avoid the exchange risk. Similarly, denominating the transaction in a third currency, which is relatively stable (*e.g.* export from India to Indonesia is denominated neither in rupees nor in rupiah, but in US dollars) will only result in spreading the exchange risk between parties. It may be too naïve to expect that the company which succeeds in getting the transaction denominated in local currency will gain fully. The other party to the transaction is also aware of the foreign exchange trends and would like to build sufficient cushion into the price for the exchange rate fluctuation. For instance, the exporter from USA may offer his product at USD 1 per piece, when the spot rate is Rs. 40. If the sentiment is that rupee is going to depreciate and the quotation is required in rupees, he will quote a price higher than Rs. 40, to provide for exchange fluctuation. More appropriately, the US exporter may base his price on the forward rate for rupee for the expected period of sale and cover his position in the forward market. In such a situation, the Indian importer may not gain by insisting on quotation in Indian rupees.

3. Foreign Currency Accounts

To a trader who engages in both exports and imports or to a manufacturer exporter who imports sizeable portion of raw materials/components, the exchange risk can be minimised if an account is maintained abroad, in the currency of trade, through which all transactions can be routed. The arrangement has a dual advantage for the trader;

(*i*) Since exports can pay for imports, he is exposed to exchange risk only for the net balance.

(ii) In normal course, the bank will apply buying rate for exports and selling rate for imports, with the usual spread between the rates towards margin. The loss of exchange in converting from foreign currency into local currency is avoided.

In India under the Exchange Earners Foreign Currency (EEFC) account scheme, the beneficiary of an inward remittance is entitled to retain in foreign currency up to 50% of the remittance received. The balance in this account can be used by the account holder for all purpose permitted in the exchange control manual, including for imports. Thus, the loss of exchange in conversion can be avoided.

Reserve Bank of India permits exporters with good track record and net exchange earning of not less than Rs. 4 crores, to maintain foreign currency accounts abroad subject to certain terms and conditions. The benefit is similar to that under EEFC account.

4. Leads and Lags

Exporters and importers keep making estimates as to whether the currency will weaken (devalued) or strengthen (revalued) in future. According to these expectations, they may like to hasten or postpone the time of receipt or payment of foreign currency. This timing of payment of foreign currency depending upon the expectation of its change in value is known as 'leads and lags'.

When the foreign currency is expected to be devalued, the exporter would press for payment earlier than the normal. This is because if he receives payment in foreign currency after devaluation, the amount he receives in rupee terms will be less. On the other hand, when the currency is expected to be revalued, the importer who has to pay in foreign currency would settle the debt earlier than the normal date. Thereby, he would be paying less in terms of rupees when compared to the amount he will have to pay after the expected revaluation materialises. In both the cases, the exporter/importer is said to 'lead' the payment.

When the foreign currency is expected to be revalued, the exporters would like to delay the payments. Nor would they book forward contracts. If they receive payment after the revaluation, the value in terms of rupees would be higher. Conversely, when the foreign currency is expected to be devalued, the importers would like to delay the payment so that they may pay less in rupee terms, this postponing the payment is known as 'lag'.

When the foreign currency is facing the threat of devaluation, the exporters would secure early payment while importers would delay their payments. Therefore, there is an increase in supply and decrease in demand for the foreign currency. This will further aggravate the forces weakening the currency. If the currency faces imminent revaluation, exporters postpone payments while importers hasten their payments. The result is that the forces at work in strengthening the currency are further strengthened. Thus, the effect of 'leads and lags' is to further aggravate the forces causing change in the exchange rate of the currency.

As per the exchange control regulations in India, payments for exports and imports should be completed within six months from the date of shipment. Therefore, the period up to which the exporters and importers can indulge in 'leads and lags' is restricted to six months.

16 Exchange Risk : Translation and Economic Exposures

TRANSACTION exposure was discussed in the previous chapter. We cover translation and economic exposures in the present chapter. At present, translation exposure has only diluted effect on Indian companies. Economic exposure is least understood and hence not properly guarded against.

16.1. TRANSLATION EXPOSURE

Translation exposure arises when an enterprise has assets or liabilities denominated in foreign currency, and these have to be shown in books of accounts in the domestic currency. Actual conversion of currencies does not take place. For the purpose of accounting, the value of the assets and liabilities denominated in foreign currency have to be translated to that of the domestic currency, and hence this exposure. It is also known as *accounting exposure* as it relates only to book values, and does not involve cash flows as in the case of economic exposure. Accounting exposure arises when the enterprise has subsidiaries abroad. In many countries such multinational companies are required to consolidate the assets and liabilities of the subsidiaries with those of the parent company and present consolidated financial statements. The subsidiary of the company is a separate entity with its own assets and liabilities, managing its own cash flows and operating in a foreign country. However, when the parent company prepares its final accounts, the assets and liabilities of the subsidiary company are notionally merged with its own and presented as a consolidated statement so that the readers may have an overall picture of the enterprise.

For restatement of the values of the assets and liabilities and cash flows of the subsidiary in the domestic currency, the concern may apply either the historic or the current rate of exchange between the foreign currency concerned and the domestic currency. By historic rate is meant the exchange rate prevalent on the date the asset was acquired or liability was incurred. The same rate of exchange will be applied throughout the life of the asset/liability. Current rate refers to the rate of exchange prevalent on the balance-sheet date. If current rate is applied, the value of the asset/liability keeps changing in every balance-sheet.

Translation exposure is defined as the likely increase or decrease in the parent company's net worth caused by a change in exchange rates since last translation. This arises when an asset or liability is valued at the current rate. No exposure arises in respect of assets/liabilities valued at historical rate, as they are not affected by exchange rate differences. Translation exposure is measured as the net of the foreign currency denominated assets and liabilities valued at current rates of exchange. If the exposed assets exceed the exposed liabilities, the concern has a 'positive' or 'long' or 'asset' translation exposure, and the exposure is equivalent to the net value. If the exposed liabilities exceed the exposed assets and results in 'negative' or 'short' or 'liabilities' translation exposure to the extent of the net difference.

Translation loss or gain is measured by the difference between the value of assets and liabilities at the historic rate and current rate. A company which has a positive exposure will have translation gains if the current rate for the foreign currency is higher than the historic rate. In the same situation, a company with negative exposure will post translation loss. The position will be reversed if the currency rate for foreign currency is lesser than its historic rate of exchange.

The translation gain/loss is shown as a separate component of the shareholders equity in the balance-sheet. They do not affect the current earnings of the company.

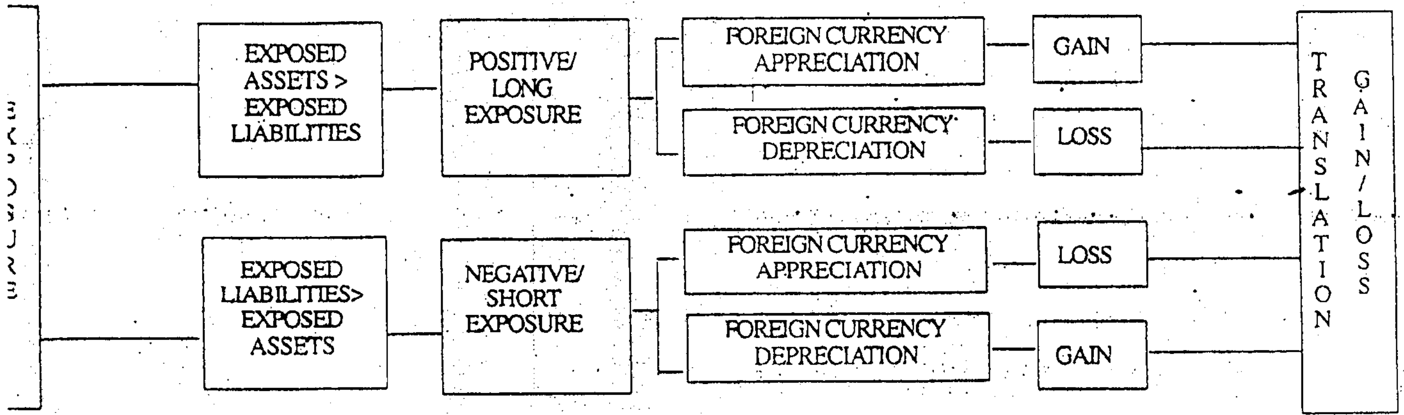

Fig.16.1. Translation exposure leading to Translation gain/loss

❑ Methods of Translation

There are principally four methods in use in deciding whether an asset/a liability should be translated or historical or current rate of exchange:

*(i) **Current/Non-current Method*** Under this method, the assets and liabilities of the subsidiary are classified into current and non-current categories. Current assets and liabilities are valued at current rate and non-current assets and liabilities at historical rates.

*(ii) **Monetary/Non-monetary Method*** Monetary assets and liabilities are those involving a claim to receive or an obligation to pay a fixed sum of foreign currency units. Examples of monetary assets are debtors and cash. Monetary liabilities include short and long term borrowings. Under this method, monetary assets and liabilities are valued at current rates. Non-monetary items like inventory, furniture, long-term investments are translated at historical rates.

*(iii) **Temporal Method*** This is similar to monetary/non-monetary inflow with the difference in respect of inventories and investments. Under this method, the inventory and investments are translated at current and investment rate if they are valued at the market price.

In all the above methods, the income and payments of the subsidiaries are translated at average rate of foreign currency for the reporting period. However, items of expenses based on assets carried at historical rate *e.g.*, depreciation, are translated at historical rates.

*(iv) **Current Rates*** Under this method all assets, liabilities, income and expenses are translated at current rates of exchange.

Exchange rate applied under different methods is tabulated in Fig. 16.2.

Asset/Liability	*Current Rate*	*Current/ Non-current*	*Monetary/ Non-monetary*	*Temporal*
Assets				
Current Assets				
Cash	Current	Current	Current	Current
Receivables	Current	Current	Current	Current
Inventory (at cost)	Current	Current	Historic	Historic
Inventory (at market vlaue)	Current	Current	Historic	Current
Non-current Assets				
Investments (at cost)	Current	Historic	Historic	Historic
Investments (at market value)	Current	Historic	Historic	Current
Fixed Assets	Current	Historic	Historic	Historic
Other Assets	Current	Historic	Historic	Historic
Liabilities				
Current Liabilities	Current	Current	Current	Current
Term Liabilities	Current	Historic	Current	Current

Fig.16.2. Methods of translation

A numerical example to provide better insight into the effect of the different methods of translation is provided in Fig.16.3.

The following points may be noted in interpreting Fig.16.3.

The first portion of the table shows the changes in the values of the balance-sheet items under different translation methods.

Only items other than shareholders equity are translated. The shareholders equity is the difference between assets and outside liabilities.

The second portion of the table shows the items subject to accounting exposure. These are the items translated at current rate.

The exchange differences is 10 cents per GBP. The translation loss/gain is obtained by multiplying the accounting exposure of the exchange difference.

It may be observed that the translation gain/loss equals the change in the shareholders equity, as compared with its historic cost. At historic cost, shareholders is USD 480. Under current rate method, it is USD 450, representing a translation loss of USD 30. Similar is the case with other methods.

❑ Translation Exposure for Indian Companies

At present, the Indian Companies Act does not require consolidation of the accounts of the foreign subsidiaries with those of the parent company. Holding companies in India are appending in their annual reports, the financial statements of the subsidiaries in the domestic currency of the country where the subsidiary is situated. The proposed amendment to the Companies Act may bring the provisions in India in line with international practice.

The problem of foreign currency translation arises to an Indian company in the following cases:

(*i*) translation of financial statements of foreign branches of parent entity, and
(*ii*) translation of liabilities incurred or assets acquired in foreign currency, *e.g.* foreign currency loan availed, where repayment is to be made in the same foreign currency.

The Accounting Standard 11, issued by the Accounting Standards Board of India, which came into effect from 1.4.1995 deals with accounting for the effects of changes in the Foreign Exchange Rate. Broadly, the standard requires the monetary items translated at the current rate, and non-monetary items at historical rates. In case of borrowings in foreign currency, they are first translated as the rates existing on the date of the transaction. On the balance-sheet, the loan as well as the fixed assets financed by them may be increased or decreased if the rupee has meanwhile depreciated/appreciated. Depreciation should be translated at the rates used for translating the respective asset. The implication can be seen from the following example.

Example. Company *A* acquires machinery for USD 1,00,000 on seller's credit for 3 years. On the date of purchase, the dollar is quoted at Rs. 35. The asset is debited with Rs. 35,00,000 and the loan already is credited with Rs. 35,00,000. At the end of the year, when the Balance-sheet is prepared the dollar has appreciated to Rs. 39. The fixed asset would be debited further with Rs. 4,00,000 and the loan account credited with similar amount. The depreciation at 10% will amount to Rs. 3,90,000, an increase of Rs. 40,000 over that chargeable at the rate prevalent on the date the asset was acquired. The declared profit of the company would be less by Rs. 40,000 not considering the effect of tax.

❑ Conversion to Transaction Exposure

A foreign currency loan repayable after a period exceeding the next balance-sheet date gives rise to translation exposure at the time of preparation of the balance-sheet. This has been explained above. At the time of repayment of the loan, where the foreign currency for repayment is acquired by utilising the local resources at the current exchange rate, a distortion in the cash flow may occur, due to change in the exchange rate. Thus, the translation exposure gets converted into transaction exposure.

16.2. MANAGING TRANSLATION EXPOSURE

The main technique used to manage the translation exposure is known as balance-sheet hedge. Some of the techniques used in managing transaction exposure are utilised here also. They include: forward cover, leading and lagging, and exposure netting.

Translation of Balance-sheet of British Subsidiary of a US Company

Historic Rate: GBP 1 = USD 1.60 Current Rate GBP 1 = 1.50 (Figures in millions)

	Balance Sheet	*Translated Balance-sheet*				*Exposure*			
		CR*	C/NC*	M/NM*	TEMP*	CR*	C/NC*	M/NM*	TEMP*
Assets:	GBP	USD	USD	USD	USD	GBP	GBP	GBP	GBP
Cash	100	150	150	150	150	100	100	100	100
Receivables	300	450	450	450	450	300	300	300	300
Inventory (Market Value)	500	750	750	800	750	500	500	--	500
Investments (Market Value)	200	300	320	320	300	200	--	--	200
Fixed Assets	400	600	640	640	640	400	--	--	--
Other Assets	100	150	160	160	160	100	--	--	--
	1600	2400	2470	2520	2450	1600	900	400	1100
Liabilities:									
Current Liabilities	700	1050	1050	1050	1050	700	700	700	700
Term Liabilities	600	900	960	900	900	600	--	600	600
Shareholders' Equity	300	450	460	570	500				
	1600	2400	2470	2520	2450	1300	700	1300	1300
Accounting Exposure (in GBP)						300	200	(900)	(200)
Translation gain (or loss) (in USD)		(30)	(20)	+90	+20				

(*CR=Current Rate; C/NC=Current/Non-current; M/NM=Monetary/Non-monetary; TEMP=Temporal)

Fig.16.3. A Balance-sheet translated

1. Balance-sheet Hedge

Balance-sheet hedge consists in bringing about a balance between the exposed assets and liabilities, so that the net exposure is zero. If the exposed assets are more than the exposed liabilities, the exposure can be made zero by increasing the liability in the functional currency of the subsidiary unit without a corresponding increase in the asset. The amount of adjustment needed will depend upon the method of translation adopted. To continue our example, the exposure of the US company is GBP 200 million under current/non-current method. When this method of translation is adopted, the liability of the British subsidiary should be increased by GBP 200 million, or its assets should be reduced by this amount. This can be done by borrowing GBP 200 million. This will increase the liability, but the asset will also increase by the same amount. To avoid increase in the asset, this amount should be immediately converted into dollars and transferred to the parent company as dividend or repayment of intra-company debt. Alternating the company can convert its cash into dollar and remit them to the parent company.

2. Exposure Netting

The technique is similar to the one adopted under transaction exposure. A multinational company may see to it that the positive exposure in a foreign currency due to incorporation of the balance-sheet of a subsidiary may to offset by the negative exposure in the same or similarly placed currency (*i.e.* having the likelihood of appreciation or depreciation, arising from another subsidiary.

3. Leading and Lagging

A company with a positive transaction exposure has to increase the exposed liabilities or decrease the exposed assets. This can be done by expediting the realisation of assets, (leading) or delaying the payment of liabilities (lagging). Leading and lagging is possible in the case of inter-subsidiary accounts receivable and payable. Delaying or expediting these payments and receipts brings the desired effect. When this is adopted for receivables or payables of outside concerns, the additional cost in the form of discount to be offered on receivables for early payment, and interest to be paid on late payment of payables should also be considered.

4. Forward Contract

Forward contract is a method adopted to minimise the translation loss arising out of translation exposure. A company with a positive exposure will sell forward the exposed currency to fall due on the next balance-sheet date. The gain (or loss) arising from the exposure will be offset by the loss (or gain) on the forward contract, when executed using spot market. A company with a negative exposure will buy forward the currency to get the same result. A forward contract undertaken to cover translation exposure, however, results in a transaction exposure, as the cash flows depend on the spot rate to prevail on the due date.

5. Other Methods

Transfer pricing and swaps are other methods of managing translation exposure.

16.3. ECONOMIC EXPOSURE

Economic or operating exposure relates to the effect of unexpected exchange rates on the future operating cash flows of the company. In financial management, a firm is valued by the net present value of the future cash flows. A change in the exchange rate may bring about changes in the cash flows of the company directly by affecting its revenues and costs and indirectly by affecting its competitiveness by the action of its consumers and competitors. As a result, the net present value may differ from the one anticipated.

The economic exposure is less clearly perceived but has wider ramification with far reaching effects than the accounting exposure. Accounting exposure is more readily seen and provided for. Economic exposure is insidious, more difficult to measure, and more difficult to manage.

As the economic exposure involves not only the action of the company, but that of competitors and consumers also, it is also known as *competitive exposure or strategic exposure*.

To understand the concept of economic exposure let us take the case of an Indian company exporting textiles to USA. Depreciation in the value of rupee against dollar will generally have the effect of making exports cheaper in dollar terms. The exports are expected to increase and bring more cash inflows. On the other hand, appreciation of rupee will have the effect of making exports costlier, bring down exports and reduce cash inflows. Even though the dollar/rupee exchange rate may not change, the company may face economic exposure when changes take place in the exchange rate of the competitors. To continue the example of Indian textiles the exports from India suffered because of depreciation in the currencies of other countries who were exporting textiles to USA. In the absence of corresponding depreciation of rupee, Indian exports became costlier.

❑ Unexpected Changes in Exchange Rates

In economic exposure, we talk of unexpected changes in exchange rates because the expected changes are reflected in the market quotations in the form of forward margin and is taken note of by the companies. In budgeting for the future, a company with foreign exchange exposure will base its calculations on the forward rates and not on the spot rates. Therefore, it is only the unexpected movements in exchange rates that affect the cash flows anticipated.

❑ Real *Vs* Nominal Exchange Rate Change

Real exchange rate between two currencies is the nominal exchange rate adjusted for difference in the inflation rate in the countries concerned. If the purchasing power parity (PPP) holds, the currency of the countries with higher inflation will depreciate in nominal terms, but the relative purchasing power of the currencies will remain the same. In other words, the real exchange rate will not change.

If the real exchange rate remains static, even though there is a change in the nominal exchange rate, the cash flows of the company will not be affected. This is because the relative purchasing powers of the currencies remain the same. There is no change in the competitiveness of the product due to price variations.

In reality, it is seen that the PPP holds only in the long run. In the short run, the exchange rates tend to vary in real terms giving rise to economic exposure.

A less obvious fact is that the nominal exchange rate remain unchanged when the real exchange rate has changed. This may be the case under fixed exchange rate system where the exchange rate is artificially kept constant. Despite there being no change in exchange rate, the domestic currency has increased/decreased in terms of purchasing power relative to the foreign currency. This will have an effect on the cash flows of the company.

❑ Impact on Cash Flows

Economic exposure operates through its effects on the future cash flows of the company. The major source of cash inflow is the sales revenue. Costs and financial charges constitute the cash outflows.

Cash Inflows · A company may find itself in any of the situations selling exclusively in foreign market selling partly in local market and partly in foreign market selling in the local market only.

Let us say that rupee appreciates in relation to dollars. In the case of the company selling exclusively in the foreign market, the effect would be that its product becomes

costlier and the exports may fall if the company revises its price in dollar terms to maintain the rupee realisation. It has to retain its market, the company may have to retain its price in dollar terms. In both the cases, the cash inflow will fall. In either case, it is assumed that the demand for the product is price-elastic. If the company faces no competition and its product is price-inelastic, the company can raise the price of the product and still retain its market. In that case, the exchange rate change will have no effect on the cash inflow of the company.

In case rupee depreciates, again the elasticity of demand and competition for the product will determine whether the company can take advantage of the depreciation and increase its inflows. If the demand is price-elastic, and in the absence of competitor reaction, the company can retain the same price in dollar terms and increase the profit in rupee terms. Or, it can lower its price slightly, and try to increase its sales volume. However, more often the competitors react by reducing their prices. In such a situation, the company have to lower its prices too, and the advantage gained may be lost. Moreover, the consumers are also aware of the depreciation of the rupee and may bargain for reduction in prices.

Let us take the case of a company which has both domestic and foreign market for its products. There is competition from other manufacturers in both the market. If the rupee appreciates, as seen already, the demand for the product in the foreign market may fall. In the domestic market, imports become cheaper and the customer may move to imported goods. Thus, in either market, the appreciation of rupee is likely to affect adversely the company's sales. However, since we are considering the real exchange rate changes, the appreciation of rupee means more purchasing power in the hands of the consumers in India. The higher purchasing power may encourage higher demand for all products in the country, including that of our company. Therefore, the appreciation of rupee may result in higher domestic sales. The increase in domestic sales may partially or fully offset the decline in demand abroad.

A company engaged only in domestic marketing may feel itself fully insulated against exchange rate fluctuations. But the fact is that appreciation of the domestic currency may encourage imports into the country and then the company may suffer low demand.

Cash Outflows The impact of real exchange rate change on the cash outflows depends on:

(i) sources of inputs—domestic and foreign
(ii) supplier reaction
(iii) government reaction

If the company is dependent on foreign sources, partly or fully, for its inputs, the impact of exchange rate is immediately felt. If the local currency depreciates the cost of inputs increases, involving higher cash outflows. Unless the company can pass on the increase in costs to the buyers in the form of increase in sales price, the net effect will be decline in the profits of the company. An appreciation of the currency will have the opposite effect of lowering the costs.

A company dependent on domestic resources is also bound to be affected by a change in the exchange rate. Depreciation of the domestic currency generally leads to inflation in the country, with consequent increase in wages and cost of other resources.

A multinational company which has production facilities in more than one country will have the flexibility of shifting its procurement or production base from the country whose currency is appreciated to other places. Thus, they can better manage the economic exposure.

Let us say that the company is importing the raw materials, and the supplier is supplying to buyers in more than one country. If the domestic currency depreciates, and the invoicing is done in that currency, the supplier will get less value for his

product than before. The supplier may divert his sales to other buyers unless the company offers high price.

Real exchange rate changes may induce the government to take certain steps like protectionistic trade legislation, tax concessions, control of capital flows, etc. which may have effect on the cash flows of the company, directly or indirectly through their effect on the economy.

❑ Measuring Economic Exposure

Since the exact impact the exchange rate change will have on the cash flows of the company is dependent on so many factors, measuring economic exposure becomes difficult. Many are the factors over which the company has no control. All that is possible is to estimate with certain basic assumptions regarding the impact likely on each item of the cash flow of the company. Following are some of the assumptions that can be made:

(*i*) all variables remain the same.
(*ii*) sales price will increase/decrease; costs will remain the same.
(*iii*) sales price will increase/decrease; costs will also increase/decrease but by a lesser degree.
(*iv*) sales volume will increase/decrease; sales price & costs will remain constant.
(*v*) sales price remain constant; costs will increase/decrease.

Depending on the assumptions made, different results on the measurement of economic exposure will arise.

16.4. MANAGING ECONOMIC EXPOSURE

Managing economic exposure is far more difficult than managing accounting exposure. In accounting exposure, the risk involved can be easily measured and provided for economic exposure is uncertain and strategies have to be framed as situation evolves, rather than anticipating and providing for them. Economic exposure affects sales, production and the vehicle that make these possible, *viz.*, Finance. Therefore, the strategies to manage economic exposure are also around these functions.

(*i*) Marketing
(*ii*) Production
(*iii*) Finance

❑ Marketing Strategies

The marketing strategies to manage economic exposure may comprise of:

(*a*) Market selection
(*b*) Pricing
(*c*) Product Decisions

Market Selection A company with markets in different countries may adopt market selection as a strategy when faced with exchange rate fluctuation. It may shift its emphasis from the market whose currency has depreciated to those whose currency have appreciated. For instance, if dollar appreciates in relation to rupees, the Indian company will find it easier to compete into the local manufacturers in USA by offering lower price.

Pricing Pricing decision is a complex phenomenon and depends mainly on the elasticity of demand for the product and the competition faced by the company. Pricing involves considerations as:

— whether to retain the market share or retain the profit margin
— how frequently can the price be changed.

The choices available to the company to retain the market share or the profit margin, in the wake of exchange rate fluctuations have already been discussed under the heading, "Impact on cash flows". The decision has to be taken by the company depending upon various factors like the product life cycle, how long the change will

persist, ease of entry for competition, consumers sensitivity, etc. The company's aim should be to maintain the overall profits, not losing sight of the long-term perspective of the decision taken.

Frequency of price adjustments is generally not advocated. Small changes are normally absorbed by the company. Changes are made only when it becomes absolutely necessary.

Product Decisions Exchange rate fluctuation may have an impact on the timing of launching of a new product. The ideal time for launching the product in the foreign market will be when the home currency has depreciated. The time will also be suitable for expanding the product line and cover wider customers. Product innovation and product adaptation are other methods adopted to add value to the product and catch the elite segment for whom cost may not be the major factor.

❑ Production Strategies

As we have already noted, a multinational company with production and sourcing bases in different countries can manage the economic exposure by choosing the right production and sourcing bases. The input can be procured from foreign countries, when the local currency appreciates in value. Production may be shifted from the nation whose currency has appreciated to plants in other countries. When the local currency appreciates and the product becomes uncompetitive, plant may be located in a third country where the cost of production is lower. Other methods adopted may be to increase the productivity by closing down uneconomic units, automating the processes, and negotiating on wages and productivity into with trade unions.

❑ Financial Strategies

Financial strategies consist in minimising the cost of borrowing by sourcing at the cheapest market and matching assets and liabilities in a currency so that the effect of exchange rate change is neutralised. These manipulations can be done relatively easily by a multinational company which has access to different markets. A domestic based company may find it difficult to adopt them. Some of the methods adopted for managing translation exposure can be used for managing economic exposure also. These include:

(*i*) balance-sheet hedge
(*ii*) leading and lagging
(*iii*) parallel loans and swaps
(*iv*) currency invoicing.

16.5. CONCLUSION

Transaction exposure is readily recognised and provided for by companies in India. The classical method used is the forward contract. Translation exposure is applicable to Indian companies only in a limited way. Economic exposure has wider ramifications, but least recognised. With the greater awareness, companies are now devoting more time in managing economic exposure also. In the world of competition and liberalisation, the survival and growth of business enterprises depends significantly on how well they recognise and manage effectively the exchange risk and exposure.

17 Interest Rate Risk

COMPANIES borrow or lend, in local currency or in a foreign currency, at specified rates of interest. Interest is the reward to the investor for parting with liquidity and undertaking certain risks towards non-payment by the borrower. To the borrower, it is the cost of acquiring purchasing power. Subsequent to the borrowing or lending, the interest rate structure in the market may change. This may have the effect of altering the future cash flows of the company or its future value. This is known as the *interest rate risk*. The concept of interest rate risk and the methods of managing it are discussed in this chapter.

17.1. THE CONCEPT OF INTEREST RATE RISK

Interest rate risk refers to the likely changes in the cash flows or future value of a firm on account of changes in the interest rates in the market The cash flows in connection with a financial asset or liability may relate to: (*a*) interest, and (*b*) the principal. The change in interest rate may affect both. Based on this fact, the interest rate risk is divided into two elements: (*i*) income risk and (*ii*) capital risk.

❑ Income Risk

There are principally two types of interest rates–fixed interest rates and floating interest rates. A fixed interest rate remains the same throughout the duration of the contract. An example of fixed interest rate is Government Bond for 5 years with coupon rate of 10%. A floating interest is fixed with reference to a benchmark rate and changes periodically with changes in the benchmark rate. Illustratively, the rate may be fixed for a long term with reference to LIBOR as the benchmark rate. The exact terms may be that interest be charged at 2% over LIBOR to be adjusted every six months. The rate of interest in this case is changing with changes in LIBOR. The effect of floating rate is to keep the interest rate in tune with the current trends. A long term investor can achieve the effect of floating rate by investing for a short term and rolling over the investment on due dates at the prevailing rates of interest.

A borrower at floating rate runs the risk that at future revisions the rate of interest may be higher and thus, the interest expenditure turns out to be higher. A lender at floating rate runs the risk of reduction in his income if the future interest rate is lower than the current rate.

For borrowing and lending at fixed rate, the risk is measured with respect to the opportunity cost. For instance, if the borrower agrees for an interest rate of 12%, and subsequently, the interest rate for a similar loan becomes 10%, for the future period, he pays interest at 2% higher than the rate paid by new borrowers. A person who has invested or lent at fixed rate loses opportunity income if the interest rate moves up.

This potential for losing the realised or opportunity income in the case of investments, and the potential for having to pay higher interest or losing the opportunity of paying lower interest constitutes the income risk.

❑ Capital Risk

Capital risk refers to the reduction in the value that a long-term financial asset may suffer due to change in interest rate. Suppose that a bank holds 12% Government Bond maturing after 5 years, bought at the rate of Rs. 98. If the Government issues a new bond carrying interest at 14%, the market value of 12% Government bond will fall. This can be explained as follows:

Currently, the 12% Government bond is yielding Rs.12.24 calculated as follows:

$$\frac{12}{98} \times 100 = 12.24\%$$

The 14% Government Bond issued at par returns a yield of 14%. Therefore, the market price of the existing 12% Government Bond will be readjusted to yield the current level of 14%. As a result, the market price may fall to Rs. 86;

as the following calculation shows: $\left(\frac{12}{x} \times 100 = 14\right)$

or $X = $ Rs. 85.6 or Rs. 86.

It may be noted that the capital risk arises when long-term assets are held for a short time. Banks especially buy government securities in the secondary market when they have surplus funds or to fulfil the liquidity requirements. These securities are disposed of when the need arises. Banks are, therefore, exposed to a great extent to capital risk due to interest rate changes.

❑ Asset and Liability Structure

For financial institutions like banks, the structure of their assets and liabilities assumes greater importance due to the interest rate risk. When both the assets and liabilities are interest bearing, there is additional dimensions to the interest rate risk. These are known as basis risk and gap exposure.

Basis risk arises when the interest on assets and liabilities are reckoned on different bases. For instance, suppose a bank lends six months at LIBOR plus 1% which is funded by the bank accepting six months term deposits. The bank expects to roll over both the loan and the deposit at the end of six months. It is possible that the variation in the LIBOR may not match with that for term deposits.

Gap exposure arises when the assets and liabilities mature for different periods. For instance, the bank may have committed for two years lending, but funding may be in the form of deposits for six months. At the time of renewal of deposits, the interest rate may vary which will not be accompanied by similar change in interest rate on advances.

17.2. MANAGING INTEREST RATE RISK

❑ Financial Swaps

Two firms in two different markets may have relative strengths in borrowing in two different currencies. Swap is an arrangement whereby a firm borrows in the currency in which it has advantage and exchanges the liability with another firm for an equivalent liability (at the time of the agreement) in another currency. For the same currency, the relative strengths of the firms may be with regard to the payment of interest. One firm may have advantage in borrowing at fixed rate of interest, while the other in floating rate. (Where the borrowing is at fixed rate, the rate of interest payable is the same throughout the currency of the loan. Under floating rate, the rate of interest is linked to a benchmark rate such as London Interbank Offered Rate or LIBOR and is revised every six months by reference to the LIBOR then prevailing.) Therefore, the swap may involve borrowing at floating rate and exchanging the liability for payment of interest with another firm borrowing at fixed interest rate. It is also possible that both currency and interest factors affect the choice for going for a swap. Based on these, swaps are classified into three types as follows:

Currency Swaps

Firm *A* in New York can borrow in dollars at 6% and in pound-sterling at 9%. Firm *B* in London can borrow in dollars at 8% and in pound-sterling at 7%. Firm *A* needs GBP 1 million which it can repay in 3 years. Firm *B* needs similar value

in US dollars. If both the firms raise the needed funds in the market, firm *A* has to pay interest of 9% and firm *B* interest of 8%. It would be to their mutual advantage if firm *A* raises the loan in dollars at 6% and firm *B* in pound-sterling and they exchange their liabilities. The arrangement would be as follows:

(*i*) On the date of the contract, firm *A* raises a loan of USD 1.6 million (assuming the spot rate to be GBP 1 = USD 1.6) and remits the amount to firm *B*. Firm *B* raises a loan of GBP 1 million and remits this amount to firm *A*.

(*ii*) Periodically, say every six months, firm *A* calculates interest on sterling liability at 7% and remits this amount to firm *B* to enable it to pay the interest on the sterling loan. Similarly, firm *B* remits interest in dollars to firm *A* at 6%.

(*iii*) On maturity, firm *A* remits GBP 1 million to firm *B* to adjust the loan raised by the latter. Similarly, firm *B* remits USD 1.6 million to firm *A*.

In practice, the arrangement may not be directly between firm *A* and firm *B*, but the transaction may be intermediated by a financial institution dealing in swaps.

Interest Rate Swaps

Firm *C* and firm *D*, both at London, are rated differently by the market and offered loans at different rates. Firm *C* can raise loan at 10% fixed or LIBOR plus 0.5%. Firm *D* can borrow at 11% fixed or LIBOR plus 0.75%. Although firm *D* has disadvantage both under fixed and floating rates of interest, it has comparative advantage under floating rate where the differential is only 0.25% as against 0.5% under fixed rate. Suppose that firm *C* wants to raise loan under floating rate and firm *D* would like to do so under fixed rate. It would be to their mutual advantage if firm *C* raises the loan at the fixed rate of 10% and exchanges the obligation for payment of interest with firm *D* which raises the loan at LIBOR plus 0.75%. It should be noted that under interest rate swap, the loan liability is not exchanged; only the periodical payment of interest is exchanged. The loan amount becomes the *notional value* based on which the interest is calculated.

In the above example, firm *C* may exchange the fixed interest liability at a rate slightly higher than the actual cost, say at 10.25%. Firm *D* may have to offer the exchange at a rate lower than its cost, say at LIBOR plus 0.25%. The net effect is that firm *C* is able to borrow at LIBOR, a gain of 0.5% and firm *D* borrows at 10.75%, a gain of 0.25%. The rates at which the rates are exchanged depends upon the relative bargaining capacity of the parties.

An interest rate swap is known as the *coupon swap* where the liabilities exchanged are involving fixed and floating rates of interest. In a *basis swap* the interest rates involved are both floating, but on a different basis, for instance, one may be linked to LIBOR and the other to treasury bill rate.

A coupon swap should not be confused with *Zero coupon swap*. A zero coupon swap is a special type swap where one of the counterparties makes a lumpsum payment instead of periodical payments over time. The lumpsum payment can occur at any time, up-front, at maturity, or during the life of the swap.

Cross-Currency Interest Rate Swap

This is a combination of currency swap and interest rate swap. For instance, a US firm which can borrow cheap dollar funds at floating rate may exchange the liability with a UK firm which borrows sterling funds at cheaper rates at fixed rates of interest.

Scope in India

The availability of swaps in India is discussed at the end of this section.

❑ Forward Rate Agreements

Under a forward rate agreement (FRA), the seller agrees to lend to the buyer a specified amount of funds, in a specified currency, for a specified period starting at a specified future date, at a predetermined rate of interest. For instance, a bank may agree to lend three months hence USD 1,00,000 at 6% for a period of six months. On the settlement date (three months from the date of contract), however, the bank does not actually lend this amount to the buyer. If the market rate on that date is higher than the agreed rate, the bank pays the difference to the buyer. If the market rate happens to be lower than the agreed rate, the buyer compensates the bank for the difference.

FRAs are available in international markets in all convertible currencies and with individual banks. The minimum principal amount is around 5 million units of a currency.

❑ Interest Rate Options

Interest rate options allow the buyer of the option to borrow or lend the specified amount of a specified currency at a specified future date at a specified rate of interest, without any obligation to do so. This product is available on payment of up-front fee called the premium. A *call option* invests the buyer with right to borrow and a *put option* invests him with right to invest.

An *interest rate cap* consists of a series of call options on interest rate covering a medium to long-term floating rate liability. For instance, a company which has borrowed a three-year foreign currency loan on which interest is payable half-yearly at LIBOR plus 1%, may enter into a series of five call options with maturity dates coinciding with the due dates for payment of interest commencing from second due date. The interest payable for the first six months is known and hence no option is required. If the rate of interest on a due date happens to be higher than the strike rate (agreed rate under the option), the company can exercise the option and hence limit the cost to the strike rate. If the rate of interest re-set at a due date turns out to be lower, the option may not be exercised thereby reaping the benefit of lower interest rate.

An *interest rate floor* is a series of put options meant to protect the lender against drop in the interest below a specified rate in a floating rate asset.

An *interest rate collar* is a combination of a cap and a floor.

❑ Swaps, FRAs and Interest Rate Options in India

These instruments have been made available to Indian corporates only in August 1996. The exchange control regulations in this regard are as follows:

(*i*) Indian corporates may approach authorised dealers for hedging of their foreign currency loan liabilities. Authorised dealers may offer the undernoted products to corporates either by booking the transaction overseas or on a back-to-back basis:

(*a*) Interest rate swaps*

(*b*) Currency swaps*

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* In August 1996 issue of *Credit Information Review* published by Reserve Bank, these instruments are defined as follows:

Interest Rate Swap An agreement between two parties to exchange a series of interest payments based on an agreed principal amount (often termed the 'notional' amount).

Currency Swap A transaction in which two counterparties exchange specific amounts of two different currencies at the outset and repay over time according to a pre-determined rule that reflects interest payments and possibly amortisation of principal.

(Contd. next page)

(c) Coupon swaps*
(d) Interest rate caps/collars (purchase)*
(e) Forward Rate Agreements.*

(ii) Before entertaining the corporate's request, authorised dealers should ensure that:
(a) the Reserve Bank has accorded final approval for the conclusion of the underlying loan transaction;
(b) the notional principal amount of the hedge does not exceed the outstanding amount of the foreign currency loan;
(c) the maturity of the hedge does not exceed the remaining life to maturity of the underlying loan; and
(d) the Board of Directors of the corporate has approved (one-time) the financial limits and authorised designated officials to conclude the hedge transaction.

(iii) Corporate shall also be permitted to unwind from a hedge transaction.

(iv) Authorised dealers should also ensure that the corporates submit the following:
(a) A report showing complete details of the transactions concluded (booked as well as cancelled) duly countersigned by the authorised dealer to the Regional Office of the Reserve Bank under whose jurisdiction they are situated, within a week from the date of conclusion of the transaction.
(b) A quarterly report to the corporate's Board furnishing details of all such transactions and copy thereof along with a copy of the Board's resolution.
(c) An annual certificate from the statutory auditors that the company has complied with all the prescribed terms and conditions.

(v) Payment of up-front premia, if any, as well as other charges incidental to the hedge transaction may be effected by authorised dealers without prior approval of Reserve Bank.

(vi) Authorised dealers should ensure that the hedge transactions are allowed to be put through solely for the purpose of liability mangement and on no account should stand alone' deals be permitted.

(from previous page)

Coupon Swap It is the same as an interest rate swap but as applied to a debt instrument.
Caps and Collars These are optional instruments which provide a kind of insurance cover for Libor fluctuations.
Forward Rate Agreement It is a forward contract on interest rates between two parties, typically a bank and a borrower, with the bank fixing Libor for the borrower at an agreed future date.

18 Incoterms (International Commercial Terms)

A TRADE contract imposes certain rights and obligations on the buyer and seller, these rights and obligations varying in accordance with the convenience of the parties concerned and as agreed by them. Certain specific terms have been evolved, known as 'trade terms' or 'contract terms', such as Free on Board (FOB); Cost, Insurance and Freight (CIF), each of which carries a specific set of rights and obligations between the parties. While quoting the price, the seller takes into account not only the cost of production but also additional costs and risks involved as per the trade terms agreed. For instance, the price quoted for a consignment on CIF basis will be higher than that on FOB basis as the former requires insurance and freight charges to be incurred additionally.

The existence of difference in interpretation of trade terms in different countries has been a cause of friction in international trade leading to misunderstanding, disputes and references to courts with all the waste of time and money. The Incoterms (International Commercial Terms) were evolved by the International Chamber of Commerce to provide a set of international rules for the interpretation of the chief terms used in foreign trade contracts. Incoterms were published first in 1936 and subsequently amended and added to in 1953, 1967, 1976, 1980 and 1990. The latest 2000 version defines 13 contract terms, providing an up-to-date set of rules broadly in the line with the current international trade practices.

❑ Scope

The adoption of Incoterms is optional. Merchants wishing to use these rules should specify that their contracts will be governed by 'Incoterms 2000'. Further, special provision in the individual contract between the parties will override anything provided in the rules.

Regarding the scope of Incoterms, the introductory part of the offical publilication states that:

(*a*) The scope of incoterms is limited to rights and obligations of parties to the contract of sale.

(*b*) It applies to delivery of tangible goods and not intangibles such as computer software.

(*c*) It does not relate to other contracts required for international sales, such as contracts of carriage, insurance and financing. However, choosing a particular incoterm has an implication on these contracts.

(*d*) Incoterms deal only with specific terms of contract of sale such as packing, clearance, transportation and delivery of goods. A great number of problems that may arise in such contracts like transfer of ownership and other property rights, breaches of contract and exemptions from liability in certain cases are not covered by Incoterms.*

❑ The Terms

Arranged in the ascending order of obligations to the seller, the contract terms defined are as under:

* Emphasis added.

Contract Terms	Standard abbreviation
*E - Term**	
1. Ex Works	EXW
F - Terms	
2. Free Carrier Carriage Unpaid	FCA
3. Free Alongside Ship	FAS
4. Free on Board	FOB
C - *Terms*	
5. Cost and Freight	CFR
6. Cost, Insurance and Freight	CIF
7. Carriage Paid to	CPT
8. Carriage and Insurance Paid to	CIP
D - Terms	
9. Delivered at Frontier	DAF
10. Delivered Ex Ship	DES
11. Delivered Ex Quay	DEQ
12. Duty Unpaid	DDU
13. Delivered Duty Paid	DDP

According to the mode of transport for which they are used, the contract terms may be classified as follows :

Sea and inland waterway	*All modes including multimodal*
1. Free Alongside Ship	1. Ex Works
2. Free on Board	2. Free Carrier
3. Cost and Freight	3. Carriage Paid to
4. Cost, Insurance and Freight	4. Carriage and Insurance Paid to
5. Delivered Ex Ship	5. Delivered at Frontier
6. Delivered Ex Quay	6. Delivered Duty Unpaid
	7. Delivered Duty Paid

The main reason for the 1990 revision of the Incoterms was the desire to adapt terms to the increasing use of Electronic Data Interchange (EDI). The revision provided that in all the contract terms where the seller has to send a transport document to the buyer, when the seller and buyer have agreed to communicate electronically, the transport document may be replaced by an equivalent EDI message.

Incoterms have been further revised for the new millennium in line with developments in commercial practice. Published in September 1999, Incoterms 2000 may be used to define the responsibilities of buyer and seller in contracts effective from January 1, 2000. The current revision concentrated on ensuring that the wordings used clearly and accurately reflect the trade practice. Wherever possible, the same expressions as appear in UN Convention on Contracts for International Sale of Goods (CISG) have been used. Moreover, substantive changes have been made in two areas:

(*a*) The customs clearance and payment of duty obligations under DAS and DEQ; and

(*b*) The loading and unloading obligations under FCA.

* Significance of grouping of the terms as E term, F terms, C terms and D terms is discussed at the end of this chapter.

18.1. CONTRACT TERMS FOR CARRIAGE BY SEA TRANSPORT

❑ FAS—Free Alongside Ship (...named port of shipment)

> *'Free Alongside Ship' means that the seller delivers when the goods are placed alongside the vessel at the named port of shipment. This means that the buyer has to bear all costs and risks of loss of or damage to the goods from that moment. (Incoterms 2000)*

The price quoted under this contract includes charges up to placing the goods alongside the ship in the seller's country. The seller's obligation is to bring the goods to the named port and place them alongside the vessel nominated by the buyer. The buyer has to bear all costs and risks of loss of or damage to the goods from that moment.

The buyer has to contract the sea carrier and arrange for the transportation. He should intimate the seller about the name and loading-berth of the ship and the delivery dates. The seller should obtain the export licence or other official authorisation, where applicable and carry out customs formalities*. He should tender to the buyer dock or warehouse receipt or warrant which evidences the delivery of goods alongside the ship. He has to bear the cost of any checking operations such as checking quality, measuring, weighing and counting which are necessary for delivering the goods alongside the ship.

The seller may arrange for booking the cargo with the shipping company and obtain a bill of lading. In such cases, the cost should be borne by the buyer. The seller may also provide at the buyer's request and cost, the certificate of origin and any other documents that the latter may require.

Documents. The documents that the seller has to submit to the buyer are :

(*a*) Dock or Warehouse Receipt or Warrant,
(*b*) Invoice, and
(*c*) Any other document as required by the buyer.

❑ FOB—Free on Board (...named port of shipment)

> *'Free on Board' means that the seller delivers when the goods pass the ship's rails at the named port of shipment. This means that the buyer has to bear all costs and risks of loss of or damage to the goods from that point. (Incoterms 2000)*

The price quoted under this contract charges up to preparation of goods for export and placing them on board the named vessel in the seller's country. The buyer should arrange for the space in the vessel and intimate the seller so that the latter may arrange to take the goods to the port at the appropriate time and get them placed on the vessel. The right in the goods passes on to the importer the moment goods are placed on the vessel as per his instructions and hence any loss of or damage to the goods after this stage should be borne entirely by the buyer. The buyer has to pay freight at destination and arrange for insurance covering the journey. As regards the loading charges at the port in the seller's country, the seller has to bear to the extent they are not included in the freight.

The seller's duty is to arrange to prepare the goods, pack them, place them on the vessel as per the terms of the contract and obtain a bill of lading evidencing shipment. He has to bear the cost of any checking operations like checking quality, measuring, etc., which may be necessary for delivering the goods. He has to obtain export licence and pay export taxes and fees that may be required. If the buyer requests, he has to provide him with a certificate of origin, the cost of which has

* Earlier versions of Incoterms required the buyer to arrange for export clearance under FAS term.

to be borne by the buyer. Further, he may assist the buyer, at buyer's risk and expense, in other matters relating to the contract.

The term FOB is normally followed by the name of a port in the seller's country. For example, an Indian seller may quote FOB Chennai. It means the price quoted is for delivery of goods at Chennai port. If no port is mentioned in the terms, the buyer has the right to ask for shipment at any port in India. Therefore, he may require the seller to ship from Mumbai, which may mean additional cost to the seller.

Documents to be submitted under FOB contract are :

(*a*) Freight to pay or freight collect bill of lading,
(*b*) Invoice, and
(*c*) Other documents as required by the buyer.

❑ CFR—Cost and Freight (...named port of destination)

> *'Cost and Freight' means that the seller delivers when the goods pass the ship's rail in the port of shipment.*
>
> *The seller must pay the costs and freight necessary to bring the goods to the named port of destination, BUT the risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time of delivery, are transferred from the seller to the buyer. (Incoterms 2000)*

The price quoted under this contract includes the cost of the goods and freight charges up to the named destination. That means, the contract term should indicate the port of discharge up to which the freight is included. For instance, for delivery at New York the contract terms should be CFR New York.

The seller has to prepare, pack, transport up to the port and arrange to place the goods on board a vessel and obtain clean freight paid bill of lading. The obligation of arranging for the contract of carriage rests with the seller. He has to pay for checking operations and pay unloading charges to the extent they are included in the freight. He has to obtain export licence and carry out all formalities necessary for the exportation of the goods. He may furnish the certificate of origin, consular invoice and any other document at the cost and request of the buyer.

The buyer has to arrange to receive the goods at the destination. He has to arrange for insurance of the goods during transportation. He has to pay unloading charges to the extent they are not included in freight. He has to reimburse the expense incurred by the seller in providing documents like certificate of origin at his request.

Though under CFR contract, the seller pays charges up to the destination, the risk of loss of or damage to the goods passes to the buyer the moment the goods are placed on board the ship in the seller's country. Thus, the seller bears the cost up to the destination, but the buyer acquires the interest in the goods from the time they are loaded on board a ship in the seller's country.

Documents to be furnished under this contract are :

(*a*) Freight paid bill of lading,
(*b*) Invoice, and
(*c*) Other documents as required by the importer.

❑ CIF—Cost, Insurance and Freight (...named port of destination)

> *'Cost Insurance and Freight' means that the seller delivers when the goods pass the ship's rail in the port of shipment.*
>
> *The seller must pay the costs and freight necessary to bring the goods to the named port of destination, BUT the risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time of delivery, are transferred from the seller to the buyer. However, in CIF the seller also has to procure marine insurance against the buyer's risk of loss of or damage to the goods during the carriage. (Incoterms 2000)*

The price quoted under this contract includes cost of goods, freight charges up to named destination and insurance covering the voyage. In other words, all expenses incurred up to the port of destination are borne by the seller. Unless otherwise specified in the contract, insurance for 110% of contract price with minimum cover of the Institute Cargo clauses shall be obtained. In other respects, the duties of the seller and buyer are similar to that under CFR contract. Similarly, the risk in the goods passes on to the buyer the moment they are placed on board a vessel in the seller's country.

Documents to be furnished under this contract are :

(*a*) Freight paid bill of lading,
(*b*) Insurance policy,
(*c*) Invoice, and
(*d*) Other documents as required by the buyer.

Variants of CIF Contract. There are two variants of CIF contract in use. They are, however, not recognised under Incoterms :

(*i*) Cost, Insurance, Freight and Commission (CIF & C). This is similar to CIF contract except that the price includes in addition commission payable to agents for the contract.

Documents :

(*a*) Freight paid bill of lading,
(*b*) Insurance policy,
(*c*) Statement of commission paid,
(*d*) Invoice, and
(*e*) Other documents as required by the buyer.

(*ii*) Cost, Insurance, Freight, Commission and Interest (CIFC & I). In addition to the price under CIF contract, this includes commission payable to the agents and interest of the transaction.

Documents :

(*a*) Freight paid bill of lading,
(*b*) Insurance policy,
(*c*) Statement of commission paid,
(*d*) Invoice, with details of interest, and
(*e*) Other documents as required by the buyer.

❑ DES—Delivered Ex Ship (...named port of destination)

> *'Delivered Ex Ship' means that the seller delivers when the goods are placed at the disposal of the buyer on board the ship not cleared for import at the named port of destination. The seller has to bear all the costs and risks involved in bringing the goods to the named port of destination before discharging. (Incoterms 2000)*

The price quoted includes all expenses up to carriage of goods by ship to the named destination. Thus, the price quoted may be same as the price under CIF contract. But the essential difference between Ex Ship contract and other contracts discussed above is the time at which the risk for loss of or damage to the goods is passed to the buyer. The responsibility, under the Ex Ship contract, of the seller is to make available to the buyer the goods at the named destination. Therefore, the risk is borne by the seller till the goods are carried to the port of destination. The risk is transferred to the buyer from the time he takes delivery of the goods. In other respects, the duties of the seller and the buyer are similar to those under the CIF contract.

Documents to be submitted under Ex Ship contract are:

(*a*) Freight paid bill of lading,
(*b*) Invoice,

(c) Insurance policy, and
(d) Other documents as required by the buyer.

❑ DEQ—Delivered Ex Quay (Duty paid) (...named port of destination)

> *'Delivered Ex Ship' means that the seller delivers when the goods are placed at the disposal of the buyer not cleared for import on the quay (wharf) at the named port of destination. The seller has to bear costs and risks involved in bringing the goods to the named port of destination and discharging the goods on the quay (wharf). The DEQ term requires the buyer to clear the goods for import and to pay for all formalities, duties, taxes and other charges upon import. (Incoterms 2000)*

This is in effect an extension of the Ex Ship contract. The seller has to bear the additional risks and cost to bring the goods ashore and make them available to the buyer on the wharf at the destination named in the sale contract. That means, he has to prepare the goods, pack them, arrange for checking operations, transport and insure them. The risk of loss or damage to the goods passes to the buyer from the time the goods are placed at the quay. The buyer's duty is to take delivery of the goods from the quay or wharf at the port of destination. The buyer has to obtain the import licence and bear the cost of any import duty, cost of customs clearance and any other taxes to be paid on imports.* If the parties wish to include in the seller's obligation all or part of the costs payable upon import of the goods, this should be made clear by adding explicit wording to this effect in the contract of sale.

Documents to be submitted by the seller :
(a) Delivery order,
(b) Invoice, and
(c) Other documents as required by buyer.

18.2. CONTRACT TERMS FOR CARRIAGE BY ANY MODE OF TRANSPORT

❑ EXW—Ex Works (...named place)

> *'Ex Works' means that the seller delivers when the goods are placed at the disposal of the buyer at the seller's premises or another named place (i.e., works, factory, warehouse, etc.) not cleared for export and not loaded on any collecting vehicle.*
>
> *This term, thus, represents the minimum obligation for the seller, and the buyer has to bear all costs and risks involved in taking the goods from the seller's premises. (Incoterms 2000)*

The price under this contract represents the minimum since the goods are delivered at the seller's premises. The price excludes all other expenses. The obligation of the seller is to make the goods available at his premises, *i.e.*, works or factory.

The seller should bear all costs and risks in packing the goods, arranging for checking operations like checking quantity, measurements, weighing and counting, that may be necessary for the purpose of placing the goods at the disposal of the buyer. He should give reasonable notice to the buyer as to when the goods would be at his disposal. If the buyer so desires and at his risk, the seller may render assistance in getting documents that may be required for exportation and/or importation of the goods. The seller is not responsible for loading the goods on vehicle provided by the buyer. If the parties the seller to be responsible for the

* Under earlier versions of Incoterms the duty to obtain import clearance was on the seller.

loading of the goods on departure and to bear the risks and all the costs of such loading, this should be made clear by adding explicit wording to the effect in the contract of sale.

The buyer has to bear the cost and risk involved in bringing the goods from the seller's works to the desired destination. All costs, taxes, etc., both at the seller's country and the buyer's country have to be borne by the buyer.

Documents :

(*a*) Invoice, and

(*b*) Other documents as required by the buyer.'

❑ FCA—Free Carrier (...named place)

> *'Free Carrier' means that the seller delivers the goods, cleared for export, to the carrier nominated by the buyer at the named place. It should be noted that the chosen place of delivery has an impact on the obligations of loading and unloading the goods at that place. If delivery occurs at the seller's premises, the seller is responsible for loading. If delivery occurs at any other place, the seller is not responsible for unloading. (Incoterms 2000)*

This term corresponds to FOB under sea transport. The seller fulfils his obligation to deliver when he has handed over the goods, cleared for export, into the charge of the carrier named by the buyer at the named place or point. If the named place is the seller's premises, delivery is completed when the goods have been loaded on the means of transport provided by the carrier. If any other place is mentioned, the seller carries the goods there and places the goods at the disposal of the carrier without unloading from the seller's means of transport. If no precise point is indicated by the buyer, the seller may choose within the place or range stipulated where the carrier shall take the goods into his charge.

'Carrier' means any person who, in a contract of carriage, undertakes to perform or to procure the performance of carriage by rail, road, sea, air, inland waterway or by a combination of such modes. If the buyer instructs the seller to deliver the cargo to a person, *e.g.*, a freight forwarder who is not a carrier, the seller is deemed to have fulfilled his obligation to deliver the goods when they are in custody of that person.

Except for the mode of transport and place of delivery, the respective positions of seller and buyer are similar to that under FOB contract.

Documents required are :

(*a*) A transport document,

(*b*) Invoice, and

(*c*) Other documents as required by the buyer.

❑ CPT—Carriage paid to (...named place of destination)

> *'Carriage paid to...' means that the seller delivers the goods to the carrier nominated by him but the seller must in addition pay the cost of carriage necessary to bring the goods to the named destination. This means that the buyer bears all risks and any other costs occurring after the goods have been so delivered. (Incoterms 2000)*

This contract term can be compared to the CFR term used for carriage by sea transport. The price quoted includes cost of goods and freight charges.

The seller has to prepare the goods, pack them, pay for checking operations and take them for transportation to the carrier. If there are more than one carrier, the seller's obligation is fulfilled when he delivers goods to the first carrier. The risk for loss of or damage to the goods passes to the buyer when they are delivered to the first carrier. The formalities for export, like obtaining licence,

payment of export duty, has to be borne by the seller. If customary, the seller should provide the buyer with the usual transport document.

The buyer, on receipt of intimation from the seller, may arrange for insuring the goods. He should arrange for getting import licence and pay import duties. If he required the seller to furnish him with certificate of origin or any other document, he should reimburse the seller for the expenses.

Documents to be submitted by the seller are :

(*a*) Freight paid waybill,
(*b*) Invoice, and
(*c*) Other documents as required by the buyer.

❑ CIP—Carriage and Insurance Paid to (...named place of destination)

> *'Carriage and Insurance paid to...' means that the seller delivers the goods to the carrier nominated by him but the seller must in addition pay the cost of carriage necessary to bring the goods to the named destination. This means that the buyer bears all risks and any other costs occurring after the goods have been so delivered. However, in CIP the seller also has to procure insurance against the buyer's risk of loss of or damage to the goods during the carriage. (Incoterms 2000)*

This term corresponds to CIF contract under sea transport. In addition to the obligations under 'Carriage Paid to' contract, the seller should arrange for insurance for the goods and furnish the buyer with the insurance policy or other acceptable document. Therefore, the price quoted includes cost of the goods, freight charges and insurance premium.

The cargo insurance should be on such terms that the buyer would be entitled to claim directly from the insurer. Unless otherwise agreed it should be for 110% of the contract value with minimum cover of the Institute Cargo Clauses. When required by the buyer, the seller shall provide at the buyer's expense war, strikes, riots and civil commotion risk insurances if procurable.

In all other respects, the responsibilities of the seller and the buyer are same as under 'Carriage Paid to' contract.

Documents to be furnished :

(*a*) Freight paid waybill,
(*b*) Insurance policy,
(*c*) Invoice, and
(*d*) Other documents as required by the buyer.

❑ DAF—Delivered at Frontier (...named place)

> *'Delivered at Frontier' means that the seller delivers when the goods are placed at the disposal of the buyer on the arriving means of transport not unloaded, cleared for export, but not cleared for import at the named point and place at the frontier, but before the customs border of the adjoining country. The term 'frontier' may be used for any frontier including that of the country of export. (Incoterms 2000)*

Under this contract, the seller's obligations are fulfilled when the goods have arrived at the frontier, but before the customs border of the adjoining country. To avoid misunderstanding, the parties may indicate (*i*) the countries separated by that frontier, and (*ii*) the name of place of delivery. For example, "Delivered a Franco-Italian Frontier (Mondane)".

The seller should arrange for packing the goods, checking operations where required, procure exchange control authorisation required for exportation of the goods, contract for transportation of the goods to the place named in the contract and bear all risks and expenses up to this stage. If no particular point (station,

pier, quay, wharf, warehouse as the case may be) as the named place of delivery is stipulated in the contract, the seller may choose any point for delivery. He should provide the goods at the frontier. The document may be a transport document or warehouse warrant. He may assist the buyer, at the latter's request and, cost in obtaining other documents that may be required.

The buyer should arrange for taking delivery of the goods at the frontier. He should obtain import licence and pay import duties, taxes and fees that may be required for this purpose.

Documents :

(*a*) Document of transport or warehouse warrant,
(*b*) Invoice, and
(*c*) Other documents as required by the buyer.

❑ DDP—Delivery Duty Paid (...named place of destination)

> *'Delivered Duty Paid' means that the seller delivers the goods to the buyer, cleared for import, and not unloaded from the arriving means of transport at the named place of destination. The seller has to bear all the costs and risks involved in bringing the goods thereto including, where applicable, any 'duty' (which term includes the responsibility for and the risk of the carrying out of customs formalities and the payment of formalities, customs duties, taxes and other charges) for import in the country of destination. (Incoterms 2000)*

—While the term "Ex Works" signifies the seller's minimum obligation, the term "Delivered Duty Paid", when followed by words naming the buyer's premises, denotes the other extreme—the seller's maximum obligation. The seller has to do all that is necessary to place the goods at the premises of the buyer. He has to prepare the goods, pack them, arrange for their transportation, comply with the export and import formalities, arrange for the internal transport in the buyer's country and ultimately place the goods at premises of the buyer. Till that time the risk in the goods also rests with the seller. If the buyer has indicated a place other than his premises as the destination for the goods, the seller should provide the buyer with a customary document of transport warehouse, warrant, dock warrant, delivery order or the like, as the case may be, to enable the buyer to take delivery of the goods. The seller retains the risks of the goods till they reach such destination. The seller should reimburse the buyer for any assistance rendered by the buyer in getting import licence, etc.

The buyer's only duty is to take delivery of the goods at the destination.

If the parties wish that the seller should clear the goods for import but that some of the costs payable upon the import of the goods should be excluded—such as value added tax (VAT) and/or other similar taxes—this should be made clear by adding words to this effect in the contract of sale.

Documents :

(*a*) Document of transport, if required,
(*b*) Invoice, and
(*c*) Other documents if required by the buyer.

❑ DDU—Delivered Duty Unpaid (...named place of destination)

> *'Delivered Duty Unpaid' means that the seller delivers the goods to the buyer, not cleared for import, and not unloaded from the arriving means of transport at the named place of destination. The seller has to bear all the costs and risks involved in bringing the goods thereto, other than, where applicable, any 'duty' (which term includes the responsibility for and the risk of the carrying out of customs formalities and the payment of formalities, customs*

duties, taxes and other charges) for import in the country of destination. Such 'duty' has to be borne by the buyer as well as any costs and risks caused by the failure to clear the goods for import in time. (Incoterms 2000)

This term is similar to DDP except that the seller's obligation excludes obtention of import licence, payment of duties, taxes and other official charges payable upon importation. If the parties wish the seller to carry out customs formalities and bear the costs and risks resulting therefrom, this has to be made clear by adding words to this effect.

Documents :

(*a*) Transport document,
(*b*) Invoice, and
(*c*) Other documents if required by the buyer.

18.3. COMPARISON OF INCOTERMS

Having briefly surveyed the thirteen incoterms, an attempt is made in the Table (page 209) to compare the salient features of the different terms. Allied terms have been combined together to facilitate comparison.

It would also be advantageous and easier at this stage to understand the significance of the terms as E term, F terms, C terms and D terms.

E term is a *departure* term. The seller's responsibility is only till the goods remain at his place.

F terms signify that the *main carriage is unpaid*. The seller must hand over the goods to a nominated carrier *free* of risk and expense to the buyer.

C terms signify the *main carriage is paid*. The seller must bear certain *costs* even after the critical point for the division of the risk of loss of or damage to the goods has been reached.

D terms signify the *arrival* of goods at *destination*.

COMPARISION OF INCOTERMS 2000

LL CASES
r should:
ıpply the goods
ıck the goods
rrange for checking
perations for
uality, quantity, etc.
r should:
ay the price
ay preshipment
spection charges,
non-mandatory
ake delivery at
estination.

	EXW	FCA	FAS	FOB	CFR CPT	CIF CIP	DES DAF	DEQ	DDU	DDP
1. Mandatory preshipment inspection	B	S	S	S	S	S	S	S	S	S
2. Loading at seller's premises	B	S	S	S	S	S	S	S	S	S
3. Local transport in seller's country	B	B*	S	S	S	S	S	S	S	S
4. Unloading at premises of main carrier	B	B	S	S	S	S	S	S	S	S
5. Export licence	B	S	S	S	S	S	S	S	S	S
6. Export clearance	B	S	S	S	S	S	S	S	S	S
7. Arrangement for contact of carriage	B	B	B	B	S	S	S	S	S	S
8. Loading into the carrier	B	B	B	S	S	S	S	S	S	S
9. Risk during voyage	B	B	B	B	B	B	S	S	S	S
10. Freight charges	B	B	B	B	S	S	S	S	S	S
11. Transport insurance	–	–	–	–	–	S	–	–	–	–
12. Import licence	B	B	B	B	B	B	B	B	B	S
13. Import clearance	B	B	B	B	B	B	B	B	B	S
14. Unloading at place of destination	B	B	B	B	B	B	B	S	B	B

, in case the named place is other than the seller's premises. – indicates no obligation under Incoterms.
= Buyer's reponsibility, S = Seller's responsibility, EXW = Ex Works, FAS = Free Alongside Ship, FOB = Free on Board,
A = Free Carrier, CFR = Cost and Freight, CPT = Carriage Paid to, CIF = Cost, Insurance and Freight, CIP = Carriage
l Insurance paid to, DES = Delivered Ex Ship, DAF = Delivered at Frontier, DEQ = Delivered Ex Quay, DDU = Delivered
ty Unpaid, DDP = Delivered Duty Paid.

19 Letters of Credit—Meaning and Mechanism

19.1. METHODS OF SETTLING DEBTS IN INTERNATIONAL TRADE

Depending upon the relative bargaining power of the importer and exporter, and having in view the requirements of the exchange control in the countries concerned, payment for the international trade may take place in any one of the following methods:

1. Advance Remittance

The exporter may require that the importer should make full payment in advance for the goods to be exported. This is possible where the goods enjoy sellers' market. The exporter would despatch the goods after he receives the full payment from the importer. Or, he may even manufacture the goods only after he receives the payment. This is the most beneficial term of payment that the exporter can expect, but it is at the cost of the importer.

The importer has to fully rely on the integrity of the exporter and his capacity to execute the order in time. The transaction is financed solely by the importer which entails additional cost to him. The entire risk of the transaction is shouldered by him. The credit insurance that is available to an exporter is not available to an importer. Because of these factors exchange control regulations in many countries do not allow advance remittance on imports into their countries. In India too, the facility of advance remittance on imports is allowed only in selected cases on fulfilment of the conditions stipulated.

2. Open Account

The situation recommending open account business is the reverse of that for advance remittance. Under this method goods are despatched directly to the buyer who takes delivery of them without making payment. He is free to dispose of the goods as he pleases. It is arranged that he will make payment to the seller at a predetermined future date, say, two months after each shipment. Open account as a method of settlement is possible where the commodity commands buyer's market.

While the open account business is most advantageous to the importer, the exporter bears the entire risk and meets fully the financial requirement of the trade. The exporter loses control over the goods and relies on the integrity of the importer to receive payment. The credit risk to some extent is minimised because many countries have developed credit insurance schemes to protect exporters. In India we have Export Credit Guarantee Corporation undertaking this function. But exchange control regulations in India place severe restrictions on open account business for exports.

3. Consignment Sale

The exporter may have his selling agents abroad to whom the goods are despatched. They receive the goods without making any payment. The goods are sold by the selling agents on behalf of the exporter and as and when the sale proceeds are received they are remitted to the exporter. Throughout, the goods remain at the risk of the exporter. The difference between open account system and consignment sale is that in the former case it is an absolute sale to the importer while in the latter case the importer receives the goods on behalf of the exporter. The ownership of goods in the case of consignment sale remains with the exporter. Consignment sale is prevalent in export of traditional goods from India.

4. Bill for Collection

The methods mentioned above are biased in favour of either party, *viz.*, the exporter or the importer. A need arose for such a system which would enable the exporter not to part with the goods or the control over the goods till he receives payment and the importer does not pay until he gets the possession or control over the goods. A method which could fulfil this condition was the exporter drawing bill of exchange on the importer for the goods exported. The goods are despatched to the importer's country but the relative documents are sent through a bank for collection. The bank hands over the documents to the importer only on receiving from the latter the value of the goods as advised by the exporter.

The bill of exchange system of collecting the export proceeds is no doubt impartial when compared to open account system and advance remittance system. Still the exporter faces the risk of non-payment by the importer. Even if the exporter does not lose control of the goods, in case of repudiation by the importer, he has to bear additional costs.

5. Letter of Credit

When the exporter draws a bill of exchange on the importer he faces the risk of repudiation of the contract by the importer. A superior method of settlement of debt was devised which could assure the exporter that if he exports the goods as per the contract entered into with the importer and produces evidence to that effect, he would receive payment without default.

Letter of credit is an undertaking by the importer's bank that if the exporter exports the goods and produces documents as stipulated in the letter; the bank would make payment to the exporter. Thus the obligation of the importer under the contract is supplemented by a superior obligation of a bank to make payment. The exporter now looks to the bank which opened the letter of credit for payment instead of relying on the importer.

19.2. MECHANISM OF LETTER OF CREDIT

Article 2 of the Uniform Customs and Practice for Documentary Credits (UCP) defines a letter of credit as to mean "any arrangement, however named or described, whereby a bank (the issuing bank), acting at the request and on the instructions of a customer (the applicant) or on its own behalf,

(*i*) is to make a payment to or to the order of a third party (the beneficiary), or is to accept and pay bills of exchange (drafts) drawn by the beneficiary; or

(*ii*) authorises another bank to effect such payment, or to accept and pay such bills of exchange (drafts); or

(*iii*) authorises another bank to negotiate, against stipulated documents, provided that the terms and conditions of the credit are complied with."

A clear understanding of above definition will be facilitated if one understands how a letter of credit operates. A summary of stages in the operation of a letter of credit is given below.

Fig. 19.1 brings out clearly the operation of a letter of credit. A description of the stages marked in the chart is furnished below:

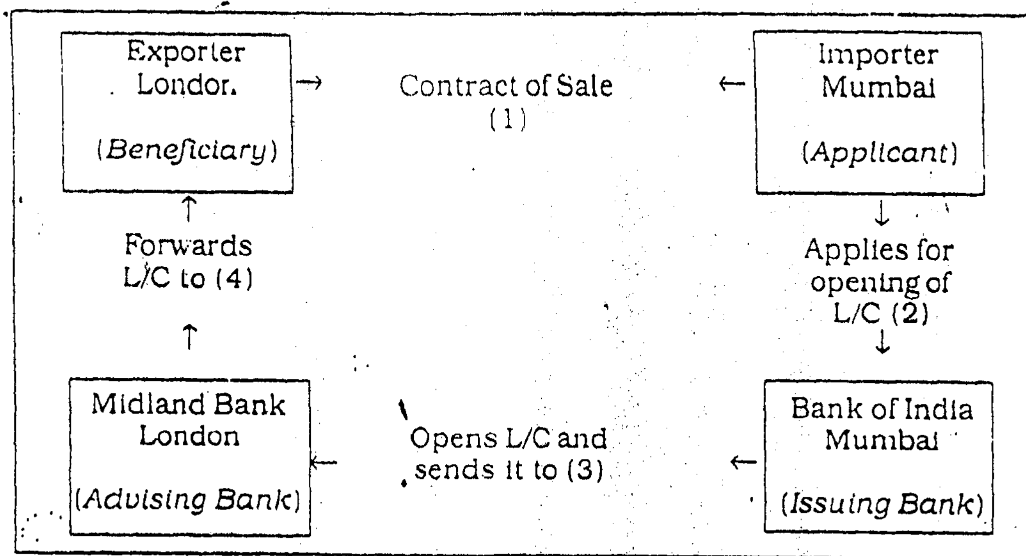

Fig. 19.1 (*a*). Opening of Letter of Credit.

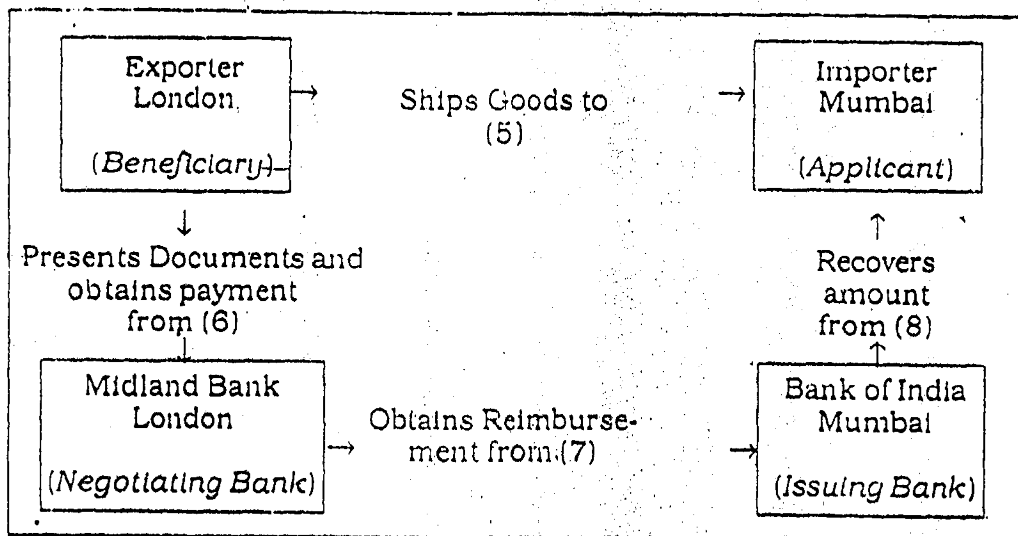

Fig. 19.1 (*b*). Utilisation of Letter of Credit

1. The transaction originates when the exporter in London and the importer in Mumbai enters into a contract of sale. The contract covers all important particulars such as the description, value and quantity of goods, the due date for shipment, method of payment, etc. One of the stipulations is that a letter of credit should be opened in favour of the exporter.
2. The importer applies to his bank (Bank of India) requesting and authorising the bank to open a letter of credit in favour of the exporter and pay bills drawn by the exporter under the letter of credit. The application would stipulate the conditions, especially with regard to the documents to be submitted by the exporter along with the bill.
3. On the strength of the application from the importer, the bank issues a letter of credit. It is addressed to the exporter and contains an undertaking by the bank that bills drawn under the credit would be paid by it provided the conditions stipulated therein are met.

It should now be clearly understood that though the sale contract forms the basis of the letter of credit, the banks who deal with it are bound only by the stipulations in the credit; the contract of sale in no way affects them. Article 3 of UCP provides: "Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the credit."

4. Though the letter of credit is addressed to the exporter, it would normally be sent to the correspondent bank of Bank of India in London (Midland Bank) with a request to forward it to the beneficiary. The necessity arises because the exporter would not know the signature of the officials of Bank of India and hence he would not be in a position to satisfy himself about the genuineness of the credit. When it is sent to the Midland Bank which, in the capacity of a correspondent bank, is in possession of the signature of the officials of Bank of India, the signatures on the credit are verified before it is forwarded to the exporter.
5. Within the stipulated date of shipment, the exporter ships the goods to a port in the importer's country (Mumbai) and obtains bill of lading from the shipping company.
6. The exporter draws a bill of exchange on Bank of India along with the bill of lading and other documents required, presents them for negotiation to his bank (say, Midland Bank). Since it is a bill under letter of credit and payment is assured, any bank in the exporter's country would be willing to pay against it.
7. The exporter's bank verifies the documents to make sure that they satisfy the conditions stipulated in the letter of credit and pay the amount to the exporter. Then the documents are forwarded to Bank of India for payment.
8. On receipt of the documents and after verifying that they satisfy the requirements of the letter of credit, Bank of India makes payment to Midland Bank. The amount of the bill would be recovered by the bank from the importer and the documents would be delivered to him.

   By this time it would have been understood that "in credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate" (Article 4). Thus, though the seller under a letter of credit is assured of payment, the buyer has no guarantee that the required goods have been exported. To overcome this difficulty the credit may specify some other documents to accompany the bill, *viz.*, weight list, packing list, quality certificate, etc. As we shall see later, these documents do afford, but limited, protection to the importer.

❑ Parties to a Credit

In the above credit, the importer is the *applicant* for the credit; Bank of India which issues the letter of credit is the *issuing* or opening bank; the exporter is the *beneficiary* under the credit; Midland Bank is the *intermediary bank* which acts as the *advising bank* while forwarding the letter of credit to the beneficiary and as *negotiating bank* while paying against the bill drawn under the letter of credit.

Under Article 2 of UCP (see previous page), the letter of credit can be opened by the bank on behalf of the importer or on its own behalf. Hence the letter of credit can be opened by a bank for its own transactions, in which case the *applicant* and the *issuing bank* can be the same party.

Article 2 also states that for the purpose of the Articles of UCP, branches of a bank in different countries are considered another bank. Hence a letter of credit opened by a branch of a bank in the importer's country can be advised by a branch of the same bank in the exporter's country.

19.3. ADVANTAGES OF LETTER OF CREDIT

A letter of credit offers advantages both to the exporter and the importer. The advantages accruing to either of the parties differ depending upon the nature of credit opened. However, there are certain common benefits accruing from the use of credit of whatever type which are discussed below.

❑ To the Exporter

1. The letter of credit provides the sort of assurance that an exporter likes before he embarks on manufacturing the goods for export. In an international deal, the exporter and the importer rarely meet and it is clinched only through exchange of correspondence. The exporter, therefore, requires to ensure himself that on shipping the goods he will receive the payment promptly. There is always the risk of the importer failing to pay. The risk is greater if the antecedents of the importer are not known. The letter of credit protects the exporter against failure of the importer to pay. A superior undertaking of a bank under the letter of credit assures the exporter that when the documents are tendered as per the terms of the credit, payment would be made to him. Thus it also helps the seller to expand the business by enabling him to conclude deals which in the absence of credit he would be hesitant to do.
2. The exporter is absolved of the botheration of knowing in detail the exchange control regulations of the importer's country and is also insured to some extent against changes in such regulations. The bank which issues the credit would take care to see that the goods covered by the letter of credit would be permitted to be imported under the exchange control regulations. Even in case there is a subsequent change in government policies, the government would think twice before restraining the bank from executing its commitment under the letter of credit.
3. The letter of credit helps easing the financial position of the exporter. The exporter can easily discount the bills under a letter of credit with his bank. As such bills carry an undertaking to pay by a bank, bills drawn under letter of credit are readily discounted by banks. Thus the exporter gets payment immediately on shipping the goods. Moreover, on the strength of the letter of credit, the exporter may raise loans from his bank for procurement and processing of raw materials and their export (preshipment finance).

   All the advantages mentioned above are in addition to those available under a bill transaction. For instance, the exporter does not lose his right over the goods till the issuing bank pays against the documents.

❑ To the Importer

1. The letter of credit enables the importer to purchase materials (especially in seller's market) without making full advance payment. Further, on the strength of the superior credit of the bank, he is able to finalise contracts which the seller may not agree had he to rely only on the importer.
2. If he takes certain safeguards, like calling for packing certificates, etc., the quality and quantity of the goods consigned is assured.
3. Provided the buyer has a big credit with his bank he may get goods released by the bank under trust (without payment) and pay for them on sale.

❑ Disadvantages/Limitations

A letter of credit is not a cent per cent safe deal either for the exporter or for the importer. To the *exporter*, the undertaking of the issuing bank is only conditional. The documents tendered should strictly comply with the requirements of the credit.

It is only the bank that would decide if the documents are as per the terms of the credit; any slight variation or non-fulfilment or excess detail in the documents tendered give scope for the bank to claim that the documents are not as per the terms of the credit. Moreover the credit does not protect the exporter from the governmental action that may deter payment.

To the *importer*, the major disadvantage is that it does not ensure that he would be receiving the goods of the specific condition and order. In letter of credit transactions, all parties deal with documents and not in goods. He stands committed to reimburse the issuing bank when documents as required are tendered to him. But this does not ensure the receipt of proper goods. Though the risk is safeguarded by calling for special documents like packing list, etc., the risk of falsification of documents still remains.

But it should be understood that the limitations do not in any way undermine the advantages that accrue from using letter of credit in international dealings. They only point out the areas where the parties cannot find protection by using letter of credit; nor do they get the desired protection by using any other method.

19.4. UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS

In the sphere of international trade the letter of credit occupies an important place as a method of payment. But a uniform interpretation of the terms used in the credit was not possible for the parties concerned with the transaction due to differences in the usages and terminologies prevailing in the different countries.

The Uniform Customs and Practice for Documentary Credits (UCP) was evolved by the International Chamber of Commerce with a view to serving as a set of rules governing letters of credit which would be accepted universally by all the countries. This paved the way for common understanding of the terms by all parties involved, *viz.*, banks, traders, shipowners, insurers, etc.

The UCP first appeared in 1933, but it did not receive universal acceptance, especially by the United Kingdom and Commonwealth countries. It was revised in 1962 and the revised rules were adopted by 175 countries and territories in the world, including the U.K. Hence it could be said that it had received universal acceptance, However, keeping with the policy of the International Chamber of Commerce (ICC) to keep the text updated, it was revised in 1974, 1983 and 1993. The 1993 revision comes into force from 1st January 1994.

Prior to 1962 the UCP were primarily designed to safeguard the banker when the buyer gave incomplete or imprecise instructions. In the 1962 revision—the first to achieve global acceptance—stress was laid on the buyer's duty to specify what he wanted, setting out "international banking customs and other rules that facilitate banking functions".

The 1974 revision gave effect to changes in documentation and procedures caused by the progress of trade facilitation and the revolution in maritime transport—containerisation and the resultant development of combined transport.

For the 1983 revision note was taken of:

(*i*) the continuing revolution in transport technology, and the geographical extension of containerisation and combined transport;

(*ii*) the increasing influence of trade facilitation activities on development of new documents and new methods of producing documents;

(*iii*) the communication revolution, replacing paper as a means of transmitting information (data) relating to a trading transaction by methods of automated or electronic data processing (ADP/EDP); and

(*iv*) development of new types of documentary credits, such as deferred payment credit and the standby credit.

The follwing quotation from Preface to UCP 1993 revision brings out the need for current revision:

"This revision was required to address new developments in the transport industry and new technological applications. It is also intended to improve the functioning of the UCP. Some surveys indicate that approximately fifty per cent of the documents presented under the Documentary Credit are rejected because of discrepancies or apparent discrepancies. This diminishes the effectiveness of the Documentary Credit and can have a financial impact on those involved in the product. It may also increase the costs and reduce the profit margins of importers, exporters and banks. The marked increase in litigation involving Documentary Credits has also been of great concern."

The present revision aims to "(1) simplify the UCP 400 (1983 revision) Rules; (2) incorporate internationl banking practices, as well as to facilitate and standardise developing practices; (3) enhance the integrity and reliability of the Documentary Credit undertaking, through the presumption of irrevocability and clarification of the primary liability, not only of the issuing bank, but also of the confirming bank; (4) address the problems of non-documentary conditions; and (5) list, in detail, the elements of acceptability for each category of transport document."

The UCP is not a piece of law and does not bind the parties unless they subject themselves to it. But in almost all countries where the UCP has been adopted, including India, it is the practice to make it an integral part of the transaction by including the following clause in the letter of credit:

"Except so far as expressly stated, this credit is subject to the 'Uniform Customs and Practice for Documentary Credit', 1993 Revision, International Chamber of Commerce Publication No. 500."

With the addition of the above clause, the parties are bound by the provisions of the UCP except to the extent of certain variations that may be stipulated in the credit itself. Article 1 of UCP provides that the provisions of UCP apply to all documentary credits where they are incorporated into the text of the credit. They are binding on all parties thereto unless otherwise expressly stipulated in the credit.

The UCP has attained universal acceptance to such an extent that in case of dispute law courts refer to it for interpretation of related terms.

20 Types of Letters of Credit

A LETTER of credit may be a clean credit or a documentary credit. A documentary credit requires the documents of title to goods and other documents to accompany the bill drawn under the credit. No such documents are necessary for a clean letter of credit.

Under a clean letter of credit, the documents of title to goods (bill of lading, for example) are sent by the exporter to the importer direct. Only the bill of exchange drawn on the importer is offered to the bank for purchase. Neither the exporter nor the bank retains control over the goods covered by the transaction. For the bank it remains an unsecured advance. For this reason, clean letter of credit is normally not found in commercial transaction. They are used for transfer of funds between banks. In exceptional cases they may be accepted from first class customers.

Almost all commercial letters of credit (issued for financing foreign trade) are documentary credits. Therefore, the UCP deals only with documentary credits. A documentary credit may be classified under the following types depending upon the particular provisions it contains:

1. Payment, Acceptance and Negotiation Credits
2. Revocable and Irrevocable Credits
3. Confirmed and Unconfirmed Credits
4. With Recourse and Without Recourse Credits
5. Fixed and Revolving Credits
6. Transferable Credits
7. Back-to-back Credits
8. Red Clause and Green Clause Credits
9. Standby Credits.

20.1. PAYMENT, ACCEPTANCE AND NEGOTIATION CREDITS

Article 10 (*a*) stipulates: "All credits must clearly indicate whether they are available by sight payment, by deferred payment, by acceptance or by negotiation." Thus a letter of credit may be—

(*a*) Payment credit (or, sight payment credit);
(*b*) Negotiation credit;
(*c*) Acceptance credit; or
(*d*) Deferred payment credit.

❑ Payment Credit

A payment credit provides that payment will be made to the beneficiary against the documents to be submitted by him. The documents are not accompanied by a bill of exchange; if there is one, it is drawn on the paying bank. In certain countries even sight drafts attract stamp duty. To avoid stamp duty the parties may agree for a payment credit. Therefore payment credits normally avoid drawing bills of exchange.

In a payment credit the issuing bank nominates a bank in the exporter's country as the paying bank. If the paying bank accepts its nomination, its position is that of an agent of the issuing bank. When the documents under the credit are presented to it, it pays the beneficiary. It gets reimbursement from the issuing bank for the amount paid.

❑ Negotiation Credit

In a negotiation credit the documents are accompanied by a sight draft (bill of exchange). The bill of exchange may be drawn on the issuing bank or any other bank stipulated in the credit. The bank which negotiates documents under the credit purchases the bill of exchange and pays the amount to the beneficiary who tenders the documents. The negotiating bank is reimbursed by the issuing bank.

It may be noted that 1993 Revision of UCP provides [Article 9 (*a*) (*iv*) and 9 (*b*) (*iv*)] that a credit should not be issued available by draft(s) on the applicant. If the credit nevertheless calls for draft(s) on the applicant, banks will consider such draft(s) as an additional document. This provision stresses the point that the obligation to pay under a letter of credit is primarily that of the issuing bank.

Article 10 (*b*) provides that unless the credit stipulates that it is available only with the issuing bank, all credits must nominate the bank which is authorised to negotiate. In a freely negotiable credit, any bank is a nominated bank. Thus the negotiating bank may be

(*i*) specifically nominated by the credit; or
(*ii*) any bank where the credit is freely negotiable.

(*i*) ***Restricted Letter of Credit :*** The issuing bank may restrict the negotiation of documents under the letter of credit to a specified bank in the exporter's country. The letter of credit contains a provision: "Negotiation under this credit restricted to... Bank" (name of the bank). The exporter may submit the documents for negotiation to the bank specified in the credit. If the exporter's bank is not the negotiating bank under the credit, it may still purchase the documents, depending upon the credit enjoyed by the customer with his bank. The exporter's bank which purchases the documents has to present them to the negotiating bank, to whom the credit is restricted, to obtain payment.

Where a letter of credit is restricted to another bank, the exporter's bank does not readily agree to purchase the documents under the credit because (*i*) it is not a foreign exchange transaction for the bank; it has to present the documents to the bank nominated in the credit and obtain payment in Indian rupees; (*ii*) it is not a negotiating bank and, therefore, does not enjoy the privileges of negotiating bank under Uniform Customs and Practice.

Restriction of letter of credit may be resorted to by the opening bank under instructions from the applicant of the credit, or it may be done to confine business to a favoured bank (of the same group or a correspondent bank). If the beneficiary wishes to negotiate the documents through his own banker, he may require suitable amendment of the credit removing the restriction.

(*ii*) ***Open Letter of Credit :*** The letter of credit contains an open invitation to bank to negotiate documents under the credit. The commitment of the issuing bank may read as follows: "We hereby engage with drawers and/or *bonafide* holders that drafts drawn and negotiated in conformity with the terms of this credit will be duly honoured on presentation."

❑ Acceptance Credit

An acceptance credit calls for a usance bill of exchange of a specified period to be drawn under the credit. For instance, the letter of credit may require the exporter to draw '90 days' bill. The advantage under an acceptance credit is that the buyer need not pay immediately; he pays only on the due date of the bill. The seller gets the bill accepted by the bank and, in case he is in need of funds, discounts it with his bank. Thus the seller can also get payment immediately. The duty of the issuing bank under this credit is not only to see that the bill is accepted but also to ensure payment on maturity.

If the bill is drawn on the accepting bank in the exporter's country, the accepting bank will accept the bill and return it to the beneficiary. The documents are

forwarded to the issuing bank. If the beneficiary is in need of funds he may discount the bill with any other bank or finance house. Since it is a banker's acceptance, the bill will be discounted readily by other banks and at favourable rates.

On receipt of documents, the issuing bank will deliver them against Trust Receipt or on clean basis. It may also hold them until the steamer arrives, arranges clearance and then stores the goods under its control. A loan against pledge of goods may be given for the importer to pay for the goods on maturity of the bill to be repaid by the sale proceeds of the goods.

❑ Deferred Payment Credit

A deferred payment credit carries an undertaking of the issuing bank to pay or to arrange for payment on the date(s) determinable in accordance with the stipulations of the credit. It is like an acceptance credit with the exception that no drafts are drawn. It is thus considered inferior to acceptance credit from the beneficiary's point of view because he does not get a banker's acceptance which he could discount and raise finance.

Deferred payment credit may be used where the beneficiary wishes to allow the importer time to pay for the documents. The documents will be delivered to the importer immediately. This type of credit is also used to finance import of plant and machinery and capital goods on deferred payment basis. The exporter in such cases can ask the importer to—

(i) effect remittance of the agreed advance payment, and to submit a 'Deferred Payment Guarantee' from his bank for the deferred instalments, or

(ii) open a deferred payment letter of credit providing for advance payment against shipping documents and payment of deferred instalments as and when due.

Deferred payment letter of credit is easier to operate and, therefore, the exporter may prefer this to deferred payment guarantee.

20.2. REVOCABLE AND IRREVOCABLE CREDITS

A credit may be either (i) *revocable*, or (ii) *irrevocable*. The credit should therefore clearly indicate whether it is revocable or irrevocable.

A *revocable credit** is one which can be cancelled or amended by the issuing bank at any time without prior notice to the beneficiary. The cancellation, or amendment, however, takes effect against the bank which has negotiated bills under the credit only on receipt of notice of such cancellation, or amendment. The issuing is liable for bills negotiated conforming to the terms and conditions of the credit before the notice of revocation is received by the negotiating bank.

Since there is no definite undertaking by the issuing bank in a revocable credit, there is not much of a benefit under the credit to the exporter. If the credit is advised to him by the opening bank direct, it may be cancelled by the issuing bank at any time without prior notice. Therefore, till he receives payment from the issuing bank the exporter is not sure whether the credit is current. He would find it difficult to

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*Article 8.

(a) A revocable credit may be amended or cancelled by the issuing bank at any moment and without prior notice to the beneficiary.

(b) However, the issuing bank is bound to—

(i) reimburse another bank with which a revocable credit has been made available for sight payment, acceptance or negotiation—for such payment, acceptance or negotiation made by such bank prior to receipt by it of notice of amendment or cancellation, against documents which appear on their face to be in compliance with the terms and conditions of the credit;

(ii) reimburse another bank with which a revocable credit has been made available for deferred payment, if such bank has, prior to receipt by it of notice of amendment or cancellation, taken up documents which appear on their face to be in compliance with the terms and conditions of the credit.

negotiate the bill with any bank in his country. The bank in the exporter's country is not aware if the credit is cancelled and hence runs the risk of payment being refused by the issuing bank and hence would be reluctant to negotiate the bill.

If the credit is advised through a bank, generally there would be a clause under which the issuing bank binds itself liable to reimburse the negotiating bank on any bills negotiated before the notice of cancellation is received by it. Therefore, such bills have better reception from the negotiating banks. Still, the exporter has the risk that the credit may be cancelled at any time after he procures the goods but before he presents the bill for negotiation.

A revocable credit does not confer the benefit that an exporter expects when he requires a letter of credit to be opened in his favour, *viz.*, assured payment when he ships the goods. The exporter agrees to a revocable letter of credit only when he has to choose between a revocable credit and no credit at all. In the plywood industry, the production depends upon a number of factors. The actual production may not agree with the sample provided to the importer. In such cases the importer allows partial shipment and on verifying the first consignment he would like to cancel the contract if the supply is not as per the sample. Only a revocable credit can satisfy the requirements.

A revocable credit indicates its nature by a specific clause, addressed to the advising bank, on the following lines:

"When advising the beneficiaries kindly make it clear to them that credit is revocable and therefore subject to cancellation...We hereby undertake to reimburse you for all drafts honoured by you in accordance with the terms of the credit, prior to your receiving notice of cancellation."

An *irrevocable credit** constitutes a definite undertaking of the issuing bank to accept and/or to pay bills drawn on it or another bank or make payment (without a bill) provided the terms and conditions of the credit are complied with. An irrevocable credit can neither be amended nor cancelled without the agreement of all parties concerned.

Under an irrevocable letter of credit, the exporter can be safe with the knowledge that the bills drawn under the credit will be honoured by the issuing bank provided the conditions of the letter of credit are fulfilled. Any amendment or cancellation of credit is not effective unless the exporter also consents to such an amendment or cancellation. Bills drawn under an irrevocable credit are readily negotiated by banks.

The difference between a revocable credit and an irrevocable credit is quite clear. While a revocable credit can be cancelled or modified without the consent of the exporter, it is not possible in the case of irrevocable credit.

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* Article 9 (*a*)

An irrevocable credit constitutes a definite undertaking of the issuing bank, provided that the stipulated documents are presented to the nominated bank or the issuing bank and that the terms and conditions of the credit are complied with:

(*i*) if the credit provides for sight payment—to pay on the maturity date(s) determinable in accordance with the stipulations of the credit;

(*ii*) if the credit provides for acceptance:

(*a*) by the issuing bank—to accept draft(s) drawn by the beneficiary drawn on the issuing bank and pay them at maturity; or

(*b*) by another drawee bank—to accept and pay at maturity draft(s) drawn by the beneficiary on the issuing bank in the event the drawee bank stipluated in the credit does not accept draft(s) drawn on it, or to pay draft(s) accepted but not paid by such drawee bank at maturity;

(*iii*) if the credit provides for negotiation—to pay without resource to drawers and/or *bona fide* holders, draft(s) drawn by the beneficiary and/or document(s) presented under the credit. A credit should not be issued available by draft(s) on the applicant. If the credit nevertheless calls for draft(s) on the applicant, banks will consider such draft(s) as an additional document(s).

If the credit does not indicate whether it is revocable or irrevocable, it shall be deemed to be irrevocable [Article 6 (c)]. Prior to 1993 revision of UCP such credits were treated as revocable.

❑ Amendments to Credits

Let us see what is an amendment of the credit. After a credit has been issued, it may be felt necessary to alter some of the stipulations of the credit or delete some or add some more. All these modifications are communicated through the same bank that advised the credit. There can be more than one amendment to the credit. The credit issuing bank intends that all the amendments form an integral part of the original credit issued.

The issuing bank shall be irrevocably bound by an amendment issued by it from the time of issuance of such amendment [Article 9 (*d*) (*ii*)]. However, the beneficiary may elect not to accept the amendment in which case the liability of the issuing bank remains as per the credit originally advised. The terms of the original credit will remain in force for the beneficiary until the beneficiary communicates his acceptance to the amendment to the bank advised such amendment [Article 9 (*d*)(*iii*)].

The beneficiary should give notification of acceptance or rejection of amendment. If the beneficiary fails to give such notification, the tender of documents to the nominated bank or issuing bank, that conforms to the credit with amendment, will be deemed to be notification of the acceptance by the beneficiary of such amendment and as of that moment the credit will be amended. [Article 9 (*d*) (*iii*)]. By implication, if the beneficiary without giving the notification tenders documents conforming to the original credit, it will be deemed to be his rejection of the amendment.

One advice of amendments may contain more than one factor. For instance, Amendment No. 1 to a letter of credit may (*a*) increase the amount from GBP 5,000 to GBP 5,500, and (*b*) expiry date of the credit revised from 11-11-1993 to 10-10-1993. The beneficiary should either accept both (*a*) and (*b*) or reject both. Partial acceptance of the amendment contained in one and the same advice of amendment is not allowed and consequently will not be given any effect [Article 9 (*d*) (*iv*)]. Thus the beneficiary cannot accept (*a*) and reject (*b*). However, the beneficiary has the right to accept one amendment and reject another. Thus he may accept Amendment No. 1 issued on 25-2-1993 but reject Amendment No. 2 issued on 27-2-1993.

If a bank uses the services of an advising bank to have the credit advised to the beneficiary, it must also use the services of the same bank for advising an amendment [Article 11 (*b*)].

20.3. CONFIRMED AND UNCONFIRMED CREDIT

When a letter of credit is advised to the beneficiary through a bank in the beneficiary's country, it may request the other bank to add its confirmation or merely advise the credit to the beneficiary without adding its confirmation. If the advising bank adds confirmation to the credit, it becomes a *confirming bank* and the credit a *confirmed credit*.

Confirmation is a definite undertaking of the confirming bank, in addition to the undertaking of the issuing bank, to accept and/or pay bills or make payment (without bills) provided the terms and conditions to the credit are satisfied. When the advising bank confirms a credit, it undertakes to negotiate bills drawn under the credit without recourse to the drawer.

All confirmed credits are also irrevocable letters of credit. It is so because no bank in the exporter's country would be willing to undertake a liability on a revocable credit on which there is no definite undertaking by the issuing bank.

A confirmed irrevocable credit is the best form of credit available to the exporter as it has the following added advantages:

(*a*) It insures the exporter not only against the failure of the importer but that of the issuing bank also. Though a letter of credit bears the superior credit of a bank in the importer's country, the exporter may not know the financial standing of the issuing bank. When the credit is confirmed by a bank which he knows well, he is more secure.

(*b*) It also saves the beneficiary from changes in the Government policies or disturbances in the political situation of the importer's country. Irrespective of these changes the beneficiary is assured of payment by the confirming bank.

When the advising bank does not add its confirmation, but merely forwards the credit to the beneficiary, the credit remains unconfirmed. The advising of the credit through a bank serves in such a case to get the signature of the issuing bank on the credit authenticated by the advising bank. There is no additional undertaking by the advising bank.

The advising bank will add its confirmation only when there is a specific request from the issuing bank. It will not do so solely at the request of the beneficiary. The request from the issuing bank to add confirmation may be in the credit itself or in the covering letter. Unless the issuing bank specifies otherwise in its confirmation, authorisation or request, the advising bank will advise the credit to the beneficiary without adding its confirmation [Article 9 (*c*) (*ii*)].

The request for confirmation would normally come from the correspondent bank which opens the letter of credit. The consideration for confirmation is the charges which it can recover from the issuing bank. But by confirming a credit, the bank assumes an independent liability for the reimbursement of which it has to rely on the opening bank. Therefore, each bank assesses its other correspondent bank and places a limit up to which it would confirm the credits is issued by the other bank. When a request for confirming a specific letter of credit is received, it should assess the position taking into account the limit sanctioned for the credit issuing bank, the country risk (political and economic situation in the country issuing the credit), the trade environment, the beneficiary, etc. If the bank is not prepared to add its confirmation, it must so inform the issuing bank without delay [Article 9 (*c*) (*i*)].

The confirming bank will not be bound by any amendment not routed through it. If an amendment to a credit is advised to the confirming bank, it is upto the bank to accept or reject it. When a confirmed credit is amended, the confirming

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*Article 9 (*b*)

A confirmation of an irrevocable credit by another bank (the confirming bank upon the authorisation or request of the issuing bank, constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, provided that the stipulated documents are presented to the confirming bank or to any other nominated bank and that the terms and conditions of the credit are complied with:

(*i*) if the credit provides for sight payment—to pay at sight;

(*ii*) if the credit provides for deferred payment—to pay on maturity date(s) determinable in accordance with the stipulations of the credit;

(*iii*) if the credit provides for acceptance:

(*a*) by the confirming bank—to accept draft(s) drawn by the beneficiary on the confirming bank and pay them on maturity; or

(*b*) by another drawee bank—to accept and pay at maturity draft(s) drawn by the beneficiary on the confirming bank. In the event the drawee bank stipulated in the credit does not accept draft(s) drawn on it, or to pay draft(s) accepted but not paid by such drawee bank at maturity;

(*iv*) if the credit provides for negotiation—to negotiate without recourse to drawers and/or *bonafide* holders, draft(s) drawn by the beneficiary and/or document(s) presented under the credit. A credit should not be issued available by draft(s) on the applicant. If the credit nevertheless calls for draft(s) on the applicant, banks will consider such draft(s) as an additional document(s).

bank may extend its confirmation to the amendment and shall be irrevocably bound as at the time of its advice of the amendment. A confirming bank may, however, choose to advise an amendment to the beneficiary without extending its confirmation and if so, must inform the issuing bank and the beneficiary without delay [Article 9 (*d*) (*ii*)]. Forwarding the amendment by the confirming bank is taken to signify its acceptance of the amendment.

As per Article 2, branches of a bank in different countries are considered another bank. Hence a letter of credit opened by a bank can be confirmed by its branch in the exporter's country.

20.4. WITH RECOURSE AND WITHOUT RECOURSE CREDITS

The bill of exchange drawn under a letter of credit may indicate that it is drawn without recourse to the drawer. Unless the credit authorises drawing a 'without recourse' bill of exchange, it is not proper to present such a bill of exchange.

A bill of exchange is only one of the documents drawn under the letter of credit and cannot be discussed in isolation of the legal import of the credit. Therefore, to understand the utility of drawing a 'without recourse' bill of exchange, we should first know the recourse available to the parties involved, *viz.*, the negotiating bank, confirming bank and the issuing bank.

The exporter's intention in drawing a without recourse bill of exchange is to ensure that in case the documents are rejected by the issuing bank or payment is not made by the issuing bank for any reason, he should not be called upon to pay back the amount he received earlier on negotiation of documents.

As per Article 9, under an irrevocable letter of credit, both the issuing bank and confirming bank are required to negotiate documents without recourse to the drawers provided the documents tendered are in conformity with the terms of the letter of credit. Therefore, if the documents tendered by the beneficiary are in conformity with the credit terms, there is no need to draw the bill without recourse if the credit is confirmed. Normally the documents are not sent by the beneficiary directly to the issuing bank; he negotiates them with a bank in his country. In the case of confirmed credit, the confirming bank's undertaking is to honour bills without recourse and, therefore, the beneficiary is safe, irrespective of what transpires between the confirming bank and the issuing bank.

If the letter of credit is unconfirmed, the situation differs between a payment credit and negotiation credit. In a payment credit, the paying bank acts as an agent of the issuing bank. If the documents are accepted by it as conforming to the terms of credit, it has no recourse against the drawer. If it wants to have recourse, it should pay under reserve, *i.e.*, reserving the right to get back the money from the beneficiary if the documents are rejected by the issuing bank. Gutteridge and Megrah opine that the position should be the same in the case of a restricted letter of credit because the negotiating bank in that case is also acting as an agent of the issuing bank.*

The position is different in the case of a negotiation credit which contains an open invitation for any bank to negotiate. In such a case, the negotiating bank acts on its own and is, therefore, a principal *vis-a-vis* the beneficiary. The condition under Article 10 that the bank should negotiate without recourse does not apply to a negotiating bank. Therefore, if the negotiating bank is not reimbursed by the issuing bank, it can have recourse against the beneficiary for whom it has negotiated the bill. Similarly, "where the documents, apparently what they should be, are in fact not and the beneficiary (not fraudulent) is himself responsible for the discrepancy,

* Gutteridge and Maurice Megrah: *The Law of Bankers' Commercial Credits*, 1979, London.

the bank should be able to recover the money he has paid against them as paid in mistake of fact, unless he has expressly contracted not to have recourse".*

But there is a difference between the credit being a 'without recourse credit' and drawing the bill of exchange 'without recourse'. Where a bank is willing to waive its recourse it usually does so not by authorising the beneficiary to draw without recourse but by the intimation that the credit is 'without recourse' credit.

Gutteridge and Maurice Megrah state: "The beneficiary man...exclude liability by signing his draft 'without recourse', but this is a defence only on the draft. If the documents are in order the drawer will in such circumstances be free from recourse altogether. But irregularity in the documents tendered will vitiate the intermediary banker's promise or offer to negotiate and the drawing 'without recourse' will be of no avail.

"The advantage of restricting liability on the draft only arises where, being a 'time' draft, it becomes divorced from the documents and is in the hands of a transferee for value. There is no advantage to the drawer in a drawing withc : recourse where both draft and documents remain in the negotiating banker's possession until they are presented to the issuing banker, except where for some reason the documents are refused by the latter."** This is regarding drawing the bill of exchange without recourse.

As against this, regarding drawing the letter of credit without recourse, they state: "Whether or not a beneficiary is permitted do draw 'without recourse' depends upon whether the buyer is willing to make provision for it in the credit—a matter to which he may not be indifferent. Practice varies considerably, both in regard to relieving the beneficiary of responsibility and to the method of doing so. For instance, some of the Eastern banks head their credits 'Irrevocable Without Recourse Credit', the effect of which has not been judicially considered, in their desire to emphasise the irrevocable nature of their credits, though this is not the same as authorising the drawing of drafts 'without recourse' but amounts to an undertaking by the issuing bank not to have recourse. Sometimes also Eastern banks call for drafts on the buyers 'without recourse', and authorise bank to honour the bill on a sight basis against immediate reimbursement by the issuing bank."†

20.5. FIXED AND REVOLVING CREDITS

A *fixed* or *non-revolving* letter of credit is one in which the limit is reduced permanently to the extent of bills drawn under the credit. If the limit is for Rs. 10 lakhs only bills up to this value can be drawn under the credit.

Under a *revolving* letter of credit, the limit under the credit is renewed as and when bills drawn under it are paid, to the extent of such bills. For example, if the credit is for a limit of Rs. 10 lakhs and if already bills for Rs. 4 lakhs have been drawn under it, the limit available for further negotiation is Rs. 6 lakhs. If, among the bills already drawn, one for Rs. 2 lakhs is paid, the limit is reinstated to this extent and now the limit available for negotiation is Rs. 8 lakhs.

A credit, as in the above example, is termed non-automatic revolving letter of credit because the renewal of limit depends upon the receipt by the negotiating bank of payment advice from the issuing bank.

A credit is an automatic revolving letter of credit where the limits are renewed at fixed intervals irrespective of the fact whether the advice of payment has been received by the negotiating bank or not. For example, the credit may stipulate that the limit is Rs. 1 lakh, renewed by negotiation of bills for this amount every week. The total drawing in such cases is controlled by specifying an expiry period. The credit may be 'cumulative' or 'non-cumulative'. Under cumulative letter of credit,

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* Gutteridge and Megrah, *Op. cit.*, p. 74.

** *Op. cit.*, p. 74.

† *Op. cit.*, pp. 76-77.

the amount unutilised during one period (week) is carried forward to the subsequent period. Under non-cumulative letter of credit, the amount not utilised during one period gets expired and cannot be utilised along with subsequent period's quota.

As a variant of the above the letter of credit may not specify the period, but may stipulate that the total outstanding at any time should not exceed a specified limit.

A revolving letter of credit is useful where continuous transactions between the exporter and the importer are expected and the amount of each drawing is sought to be limited.

For an exporter with a large contract spreading over a period of years, a revolving credit offers the following *advantages:*

(*a*) He need not await receipt of letter of credit every time he exports; and

(*b*) Since the same credit covers all the transactions the terms and conditions do not change. It makes it easy for him to prepare documents as required by the credit.

Under exchange control regulations, opening of revolving letters of credit against import of goods into India is prohibited. However, occasionally, letters of credit may be opened providing for payment against drafts at any one time within a fixed limit which is renewed automatically on the draft being honoured ; but that aggregate drawings under the credit should be limited to the balance available on the import licence.

A revolving letter should be distinguished from a fixed credit available by instalments. Where the shipment is to be effected in parts, rather than in bulk, the credit may stipulate the periodicity and quantity of each shipment. For instance, the credit opened for £ 1,20,000 for one year covering 1,200 tonnes of the commodity, may stipulate that every month the shipment should be 100 tonnes at a total price of £ 1,000. If within this monthly quota, partial shipment can be made, it should be clearly indicated so in the credit. Article 41 provides: "If drawings and/or shipments by instalments within given periods are stipulated in the credit and any instalment is not drawn and/or shipped within the period allowed for that instatements, the credit ceases to be available for that and any subsequent instalments, unless otherwise stipulated in the credit."

20.6. TRANSFERABLE CREDITS

A transferable credit is one under which the exporter has the right to make the credit available to third parties. The exporter may be only an intermediary who procures goods from the suppliers and arranges them to be sent to the importer. For example, Exporters India Ltd. may enter into an agreement for supply of handicraft and get a transferable letter of credit opened in its favour. It may procure the articles from different manufacturers. To enable the manufacturers to get banking facilities for the export, Exporters India Ltd. may get the credit transferred to the manufacturers.

A credit is transferred in the following ways: The exporter, now called the first beneficiary, will apply to the negotiating bank (intermediary bank) to transfer and establish in favour of the manufacturer (the second beneficiary) a letter of credit with the same terms and conditions as that of the original with the exception to the following:

(*a*) The amount of the credit may be reduced. The difference would be the profit or commission on the transaction for the first beneficiary.

(*b*) The validity period and date of shipment may be curtailed. For example, if the original letter of credit has 12th May as the latest date of shipment and 18th May, respectively. The difference in time would be required by the first beneficiary to substitute his invoices of those submitted by the second beneficiary.

(c) Because the value of goods is reduced, the percentage for which insurance cover must be effected may be increased in such a way as to provide the amount of cover stipulated in the original credit.

The negotiating bank will obtain the original credit and endorse the fact of transfer on it. It will then issue a credit in favour of the second beneficiary complying with the terms of the first beneficiary. The credit would show the first beneficiary as the applicant. This is done so as not to reveal the name of the importer to the second beneficiary. But if the name of the applicant for the credit is specifically required by the original credit to appear in any document other than the invoice, such requirement must be fulfilled. When the second beneficiary ships and presents documents to the bank, the amount as per the credit in his favour is paid to him. The invoice of the first beneficiary is then substituted and the difference in the amount paid to him.

If the first beneficiary fails to supply his own invoice of first demand by the negotiating bank, he has the right to deliver to the issuing bank the documents, including the invoice, submitted by the second beneficiary.

As an alternative to the above arrangement, the first beneficiary may collect his commission directly from the second beneficiary and the transfer may be made for the full amount of the credit. In such cases normally no substitution of invoices by the first beneficiary is needed.

The first beneficiary may request that payment or negotiation be effected to the second beneficiary at the place to which the credit has been transferred up to and including the expiry date of the credit unless, the original credit expressly states that it may not be made available for payment or negotiation at place other than that stipulated in the credit. This is without prejudice to the first beneficiary's right to substitute subsequently his own invoices and drafts for those of the second beneficiaries and to claim any difference due to him.

Transfer of a credit is allowed only once. It may be transferred in full. For example, a letter of credit in favour of *A* for USD 20,000 may be transferred to *B* for USD 20,000. Or, it may be transferred in fractions up to the full limit of the credit provided partial shipments are not prohibited. In our example, the credit may be transferred to *B* for USD 5,000 and to *C* for USD 7,000 and balance of USD 8,000 may be retained by *A*. But no second transfer is allowed. Therefore, *C* cannot further transfer it to *D*.

A credit can be transferred only if it is expressly designated as transferable by the issuing bank. Terms such as 'divisible', 'fractionable,' 'assignable' and 'transmissible' do not render the credit transferable. If such terms are used they shall be disregarded [Article 48 (*b*)].

Who can effect the transfer? In the case of payment credit or acceptance credit, the paying bank or the accepting bank, as the case may be, is authorised to effect the transfer. In the case of a freely negotiable credit, transfer can be effected by the bank specifically authorised in the credit as a transferring bank.

The transferring bank shall be under no obligation to effect such transfer except to the extent and in the manner expressly consented to by such bank. However, the credit can be transferred only on the terms and conditions specified in the original credit except in respect of amount, period of validity, insurance, etc., as detailed above.

At the time of making a request for transfer and prior to transfer of credit, the first beneficiary must irrevocably instruct the transferring bank whether or not the right to refuse to allow the transferring bank to advise amendments to the second beneficiary(ies). If the transferring bank consents to the transfer under these conditions, it must, at the time of transfer, advise the second beneficiary(ies) of the first beneficiary's instructions regarding amendments.

If a credit is transferred to more than one, second beneficiary refusal of an amendment by one or more of them does to invalidate the acceptance by the other second beneficiary with respect to whom the credit will be amended accordingly. With respect to the second beneficiary who rejected the amendment, the credit will remain unamended.

Bank charges in respect of transfers are payable by the first beneficiary unless otherwise specified. The transferring bank shall be under no obligation to effect the transfer until such charges are paid.

Under UCP the transferable credit are governed by Article 48. The salient features of this lengthy Article are included in the above discussion.

20.7. BACK-TO-BACK CREDITS

Where the beneficiary under a letter of credit is an intermediary procuring goods from suppliers and likes the suppliers to get the benefit under the credit, it is done by transferring the credit in favour of the suppliers. But transfer of the credit is possible only if it is authorised by the credit itself. The problem is solved by the beneficiary requiring his bank (who may or may not be the intermediary bank for the credit) to open another letter of credit in favour of the supplier on the original credit. Such an ancillary letter of credit is known as the 'back-to-back credit' or 'countervailing credit' or 'credit and counter credit'.

A back-to-back letter of credit is often an inland letter of credit. It is different from the original credit except that the original credit forms the security based on which the bank undertakes the risk under the back-to-back credit. The supplier (beneficiary of the back-to-back credit) ships goods to the importer or supplies goods to the exporter and presents the documents to the bank as is specified in the credit. It is intended that the exporter would substitute his own documents and ship goods to the importer, if necessary, and present documents for negotiation under the original credit. His liability under the back-to-back credit would be adjusted out of these proceeds.

The following points may be kept in mind by the bank while opening a back-to-back credit:

1. The terms and conditions of the back-to-back credit should be exactly as that of original letter of credit except for curtailment in:
   (*a*) the amount of the credit. This would leave margin of profit for the exporter; and
   (*b*) the validity and shipment dates. This would leave sufficient time for the exporter to prepare and substitute his documents and arrange for shipment to importer if the goods are supplied by the supplier to him. Only then the bank can get reimbursement under the original credit.
2. Though it is not necessary that only an intermediary bank under the original credit should open a back-to-back credit, it would be better that such credits are opened only where the bank is also a negotiating bank. This would avoid the risk of the documents substituted by the exporter being rejected by the negotiating bank as not fulfilling the conditions of the credit.
3. The original credit should be an irrevocable credit.

   A back-to-back credit has certain features in common with a transferable credit. Under both, the benefit under the credit is transferred to a third party. The documents are substituted by the first beneficiary under both types of credits. The possibility of the importer knowing the real supplier or *vice-versa* is avoided in both cases.

But a back-to-back credit differs from a transferable credit in the following respects:

(*a*) There is an authority from the issuing bank for the transfer of benefit under the credit in the case of a transferable credit. No such authority is there under a back-to-back credit.

(*b*) In a transferable credit the second credit is only an extension of the first credit. A back-to-back credit has an existence independent of the original credit.

(*c*) Following from the above, under the transferable credit the negotiating bank can submit the documents submitted by the second beneficiary to the issuing bank in case the first beneficiary fails to submit his own documents (*i.e.*, invoice etc.) on first demand by the negotiating bank. Under a back-to-back credit submission of documents submitted by the second beneficiary is not possible.

20.8. RED CLAUSE AND GREEN CLAUSE CREDITS

Also known as 'packing' or 'anticipatory' credit a red clause letter of credit contains a clause printed in red, authorising the negotiating bank to grant advances to the exporter for the purchase and processing, packing and arranging for movement of goods up to the port for shipment. The advance, with interest and other charges, is recoverable from the bills that would be tendered under the letter of credit and only the balance would be paid to the exporter.

The amount of the advance should be less than the amount of the letter of credit so that it remains fully secured by the obligation of the opening of bank. The opening bank remains liable for the advance. If the exporter does not tender bills by the expiry date of credit, the bank should serve a notice on the exporter and also intimate the opening bank. If the advance fails the opening bank should reimburse the bank which has made the advance. The opening bank can recover the amount from the importer on whose request the credit has been established.

The negotiating bank is not required to supervise the utilisation of the advance. Mere declaration from the exporter that he would be utilising the funds for the exporters under the credit would be sufficient. But the bank should see that the stipulations, if any, in the credit regarding the advance are scrupulously followed.

At the time of advising the credit and advancing under the credit the bank should take the following precautions:

(*a*) The credit rating of the issuing bank should be verified. It should be kept in mind that in case the advance fails recourse has to be had to the issuing bank.

(*b*) If the credit requires certain documents to be taken or goods to be charged in favour of the bank or drafts to be obtained on the issuing bank, such formalities should be completed before the advance is made.

(*c*) If the beneficiary is not its customer, identification of the borrower is necessary before the advance is made. A report from the beneficiary's bank may be obtained.

(*d*) To cover exchange fluctuations the borrower may be advised to book a forward contract for the amount of the credit. This would help keep the advance granted fully covered by the amount of the credit. The amount of advance should be less than the amount of the credit.

(*e*) An undertaking that he would tender documents under the credit before the due date should be obtained from the beneficiary.

An extension of the red clause credit is the green clause credit which not only permits preshipment advances but also covers storage in the name of the bank.

Both red and green clause credits are used extensively in Australian wool trade.

20.9. STANDBY OR GUARANTEE CREDITS

Article 2 of UCP states that credit includes standby credits but does not define the term.

The US Comptroller of Currency define a standby letter of credit thus: "A standby letter of credit is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer:

(*i*) to repay money borrowed by or advanced to for the account of the party;

or

(*ii*) to make payment on account of any indebtedness undertaken by the account party;

or

(*iii*) to make payment on account of any default by the account party in performance of an obligation."

Under a standby credit, also known as guarantee credit, the issuing bank assures the beneficiary that in the event of non-performance or non-payment of an obligation by the applicant, the beneficiary may get the payment from the issuing bank. The claim should be a draft accompanied by the requisite documentary evidence of non-performance as stipulated in the credit.

Standby credit is a substitute for bank guarantee and is used in countries where issuing of bank guarantee is not allowed, *e.g.*, Japan and the USA.

21 Operation of a Letter of Credit

We have seen the general mechanism of a letter of credit and the various forms in which it is available in the previous chapters. A letter of credit involves fulfilment of various terms and conditions specifically mentioned in the credit or stipulated in the Uniform Customs and Practice, the fulfilment or non-fulfilment of which gives rise to corresponding responsibilities and/or liabilities on the parties connected with the transaction. These intricate points are brought out in this chapter in the form of discussion on the general features of a letter of credit and responsibilities and liabilities of parties to a credit.

21.1. SALIENT FEATURES OF A LETTER OF CREDIT

A specimen of a letter of credit is given as Fig. 21.1 (page 232 and 233). The important features of a letter of credit are discussed below in the light of the provisions in UCP.

☐ Operative Instrument

A letter of credit may be issued by: (*a*) airmail, or (*b*) telecommunication (telex/cable).

When established by airmail, the standard format of the bank (on security paper) is filled in with the relevant details, signed by the authorised signatories of the bank and mailed to the advising bank.

Where the letter-of credit is to be issued by telecommunication, full details of the credit are cabled/telexed to the advising bank. The communication is authenticated by the Test Code relevant between the issuing bank and the advising bank. Opening of a letter of credit by telecommunication is of course costly. It is resorted to only when the applicant requires it and on his account.

Article 11 (*a*) (*i*) of UCP states: "When an issuing bank instructs an advising bank by an authenticated teletransmission to advise a credit, the teletransmission will be deemed to be the operative credit instrument, and no mail confirmation should be sent. Should a mail confirmation nevertheless be sent, it will have no effect and the advising bank will have no obligation to check mail confirmation against the operative credit instrument received by teletransmission.

The bank may also first intimate the information of opening of the credit by telecommunication and send the letter of credit by mail. The purpose is to inform the beneficiary that letter has been opened, but not to authorise the negotiating bank to negotiate. In such a case a short message is sent by telecommunication with indication that the regular letter of credit is being airmailed. A specimen of such message by telecommunication is given below:

"Airmailing our irrevocable credit number ....
favouring ....
covering ....
applicant ....
expiry for shipment.......................for negotiation ...."

Article 11 (*a*) (*ii*) provides: "If the teletransmission states 'full details to follow' (or words of similar effect) or states that mail confirmation is to be the operative credit instrument, then the teletransmission will not be deemed to be the operative credit instrument. The issuing bank must forward the operative credit instrument to such advising bank without delay."

Article 11 (c) stipulates: "A preliminary advice of the issuance of an irrevocable credit (pre-advice) shall only be given by an issuing bank if such bank is prepared

to issue the operative credit instrument. Unless otherwise stated in such preliminary advice by the issuing bank, an issuing bank having given such pre-advice shall be irrevocably committed to issue the credit, in terms not inconsistent with the pre-advice, without delay.

❑ Instructions relating to Credit

Instruments for the issuance of the credit, the credit itself, instructions for an amendment thereto, and the amendment itself, must be complete and precise. In order to guard against confusion and misunderstanding, banks should discourage any attempt:

(*i*) to include excessive detail in the credit or in any amendment thereto;
(*ii*) to give instructions to issue, advise or confirm a credit by reference to a credit previously issued where such credit has been subject to accepted/unaccepted amendments [Article 5 (*a*)].

If incomplete or unclear instructions are received to advise, confirm or amend a credit, the bank requested to act on such instructions may give a preliminary notification to the beneficiary for information only and without responsibility. This preliminary notification should state clearly that the notification is provided for information only and without responsibility of the advising bank. In any event, the advising bank must inform the issuing bank of the action taken and request it to provide the necessary information. The issuing bank must provide the necessary information without delay. The credit will be advised, confirmed or amended, only when complete and clear instructions have been received and if the advising bank is then prepared to act on the instructions (Article 12).

❑ Expiry Dates

Each credit will indicate two dates, the last date of shipment and last date for negotiation. The latest date of shipment indicates the date on or before which beneficiary should despatch the goods to the importer's country. Normally a further period is allowed to enable the beneficiary to prepare other documents (like invoice) and submit them for negotiation with a bank. The date on or before which the negotiation should be effected is the latest date for negotiation, also known as the expiry date of the letter of credit.

Article 42 (*a*) provides that all credits must stipulate an expiry date for presentation of documents for payment, acceptance or negotiation. Documents must be presented on or before such expiry date. In addition, the credit should stipulate a specified period of time after the date of issuance of the transport document during which presentation must be made in compliance with the terms and conditions of the credit. If no such period of time is stipulated, banks will not accept documents presented to them later than 21 days after the date of shipment. In every case, however, documents be presented not later than the expiry date of the credit [Article 43 (*a*)].

If the expiry date of the credit falls on a day on which the bank to which the presentation has to be made is closed for reasons other than by acts of God, riots, civil commotions, insurrections, wars or any other causes beyond their control, or by any strikes or lockouts, the stipulated expiry date shall be extended to the first following day on which such bank is open [Article 44 (*a*)].

The above provision is applicable also for the last date for presentation of documents after the date of shipment.

The latest date for shipment will not be extended by reason of the extension of the expiry date. If no such latest date of shipment is stipulated in the credit, banks will reject transport documents indicating a date of issuance later than the expiry date stipulated in the credit [Article 44 (*b*)].

MODEL BANK

Telex No.:
Cable:

ORIGINAL
REGISTERED AIRMAIL
Place & Date of issue
....
....
....
....

Instructions marked × to be complied.
☐ Confirmation of our short cable/telex of ....

IRREVOCABLE DOCUMENTARY CREDIT	Issuing Bank's Credit No.
Applicant	Beneficiary
Advising Bank	Amount not exceeding
	EXPIRY DATE In Country of Beneficiary For Shipment For Negotiation
OUR IRREVOCABLE CREDIT NO.	

Dear Sirs,

We hereby issue our irrevocable Documentary Credit in your favour available upto the aggregate sum not exceeding.................................. by negotiation/acceptance/payment of your sight/......................... days usance drafts to be drawn on..
....
and bearing the clause "Drawn under Documentary Credit No. .... of MODEL BANK .... covering full/.................................. % invoice value, covering shipment/despatches purporting to be ....
....
....
Drafts are to be accompanied by the following documents × marked in English in duplicate unless otherwise specified:

- ☐ Signed commercial Invoices in.................................... for value not exceeding the draft amo. nt, quoting Import Licence No. .... and certifying goods are per order/indent.............................. .... The gross FOB/CIF/CFR value of the goods before deduction of Agent's Commission, if any, must not exceed the Credit amount.
- ☐ Certificate of .... origin issued by a Chamber of Commerce.
- ☐ Full set, signed, CLEAN, ON BOARD, Ocean Bills of Lading of a Conference Line Vessel/Airway bill, made out to order of MODEL BANK and marked Freight prepaid/Freight payable at destination and notify .... L/C No. .... Dated ....
- ☐ Llyods Certificate that carrying steamer is seaworthy and not more than 15 years old.
- ☐ Marine/Air Risk Insurance Policies/Certificates dated not later than the date of Bill of Lading/Airway bill unto order and blank endorsed in negotiable form in duplicate for full CIF value of the goods plus 10% covering Institute Cargo Clauses (A), Institute War Clauses (Cargo) and Institute Strikes Clauses (Cargo). Warehouse to Warehouse Clauses with claims payable in India irrespective of percentage. Transhipment risks must be covered if goods are subject to transhipment.
- ☐ Insurance covered by openers. The shippers must give notice of shipment by cable to M/s .... quoting their Open Policy No. .... and a copy of the same to accompany the documents.
- ☐ Packing List with the same details as mentioned in Test Certificate/Inspection Certificate.

Shipment/despatch should be effected from .... to ....

Bill of Lading must be dated not later than ....

Bills of exchange must be dated and negotiated not later than .... days after the date of shipment/despatch, in any case not later than the expiry date of the Credit

Part shipment is permitted/prohibited.

Transhipment is permitted/prohibited.

The advising Bank is requested to handover this credit to beneficiary without adding their confirmation unless otherwise requested by us. busementfrom .... Except so far as otherwise stated, this credit is subject to the Uniform Customs and Practice for Documentary Credits (1993 Revision) ICC Publication No. 500	We hereby engage with drawers and/or *bonafide* holders that drafts drawn and negotiated in conformity with the terms of this credit will Negotiating Bank to claim reimbursement from be duly honoured on presentation, and that drafts accepted within the terms of this credit will be duly honoured at maturity. Yours faithfully, For MODEL BANK Authorised Signatory.

Fig. 21.1. Specimen of a Letter of cred.t

The bank to which presentation is made on such first following business day must add to the documents its certificate that the documents were presented within the time limits extended in accordance with Article 44 (*a*) of the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500.

There are further provisions regarding date terms.

If an issuing bank states that the credit is to be available "for one month", "for six months" or the like, but does not specify the date from which the time is to run, the date of issuance of the credit by the issuing bank will be deemed to be the first date from which such time is to run. Banks should discourage indication of the expiry date of the credit in this manner [Article 42 (*c*)].

The words "to", "until", "till", "from", and words of similar import applying to any date or period in the credit referring to shipment will be understood to include the date mentioned [Article 47 (*a*)].

The word "after" will be understood to exclude the date mentioned [Article 47(*b*)].

The terms "first half", "second half" of a month shall be construed respectively as from the 1st to the 15th, and the 16th to the last day of each month, all dates inclusive [Article 47 (*c*)].

The terms "beginning", "middle", or "end" of a month shall be construed respectively as from the 1st to the 10th, the 11th to the 20th, and the 21st to the last day of each month, all days inclusive [Article 47 (*d*)].

Expressions such as "prompt", "immediately", "as soon as possible", and the like should not be used. If they are used banks will disregard them [Article 46 (*b*)].

If the expression "on or about" or similar expressions are used, banks will interpret them as a stipulation that shipment is to be made during the period from five days before to five days after the stipulated date, both end days included [Article 46 (*c*)].

❑ Value and Quantity of Goods

The credit will indicate the amount up to which drafts can be drawn under credit, the total quantity of goods to be exported. The unit price may also be indicated. The limits mentioned in the credit in respect of amount and quantity should not be exceeded. UCP has, however, allowed certain tolerance limits.

Article 39. (*a*) The words "about", "approximately", "circa" or similar expressions used in connection with the amount of the credit or the quantity, or the unit price stated in the credit are to be construed as allowing a difference not to exceed 10% more or 10% less than the amount or the quantity or the unit price to which they refer.

(*b*) Unless the credit stipulates that the quantity of the goods specified must not be exceeded or reduced, a tolerance of 5% more or 5% less will be permissible, always provided that the amount of the drawings does not exceed the amount of the credit. Thus tolerance does not apply when the credit stipulates the quantity in terms of a stated number of packing units or individual items.

(*c*) Unless a credit which prohibits partial shipment stipulates otherwise, or unless Article (*b*) above is applicable, a tolerance of 5% less in the amount of the credit is permissible, provided that if the credit stipulates the quantity of the goods, such quantity of goods is shipped in full, and if the credit stipulates a unit price, such price is not reduced. This provision does not apply when expression referred to in sub-Article (*a*) above are used in the credit.

❑ Documents to be Tendered

The credit specifies clearly (*i*) the various documents to be tendered, and (*ii*) the number of copies of each document required.

Article 5 (*b*). All instructions for the issuance of the credit and the credit itself and, where applicable, all instructions for an amendment thereto and the

amendment itself, must state precisely the document(s) against which payment, acceptance or negotiation is to be made.

Article 20 (*a*) provides that terms such as "first class", "well-known", "qualified", "independent", "official", "competent", "local" and the like shall not be used to describe the issuers of any documents to be presented under a credit. If such terms are incorporated in the credit, banks will accept the relative documents as presented, provided that they appear on their face to be in accordance with the other terms and conditions of the credit and to have been issued by the beneficiary.

Further as per Article 21 when documents other than transport documents, insurance documents and commercial invoices are called for, the credit should stipulate by whom such documents are to be issued and their wording or data content. If the credit does not so stipulate, banks will accept such documents as presented, provided that their data content is not inconsistent with any other stipulated document presented.

Article 20 (*b*) provides that unless otherwise stipulated in the credit, banks will also accept as original document, a document produced or appearing to have been produced:

(*i*) by reprographic, automated or computerised systems;
(*ii*) as carbon copy;

provided that it is marked as original and, where necessary, appears to have been signed.

A document may be signed by handwriting, by facsimile signature, by perforated signature, by stamp, by symbol, or by any other mechanical or electronic method of authentication.

Article 20 (*c*) dealing with copies of documents states that unless otherwise stipulated in the credit, banks will accept as a copy, a document either labelled copy or not marked as an original. A copy need not be signed.

Credits that require multiple documents such as 'duplicate', 'two fold', 'two copies' and the like, will be satisfied by the presentation of one original and the remaining number in copies except where the document itself indicates otherwise.

Regarding authentication of a document Article 20 (*d*) provides that unless otherwise stipulated in the credit, a condition under a credit calling for a document to be authenticated, validated, legalised, visaed, certified or indicating a similar requirement, will be satisfied by any signature, mark or stamp or label on such document that on its face appears to satisfy the above condition.

❑ Shipments

The credit will indicate if partial shipment and transhipment are allowed. Partial shipment refers to despatch of goods in more than one instalment. Transhipment refers to use of more than one vessel or mode of transport in transporting the goods. In the absence of specific indication in the credit, both partial shipment and transhipment are allowed.

Article 40 (*b*). Transport documents which appear on their face to indicate that shipment has been made on the same means of conveyance and for the same journey, provided they indicate the same destination, will not be regarded as covering partial shipments, even if the transport documents indicate different dates of shipment and/or different ports of loading, places of taking charge or despatch.

Article 40 (*c*). Shipments made by post or by courier will not be regarded as partial shipments if the post receipts or certificates of posting or courier's receipts or despatch notes appear to have been stamped, signed, or otherwise authenticated in the place from which the credit stipulates the goods are to be despatched, and on the same day.

Instructions to the Nominated Bank

It indicates if the advising bank should add its confirmation or forward it without adding the confirmation. It also indicates the reimbursing bank, if any, under the credit. Finally, it is signed by two authorised officials of the bank, specimens of whose signatures are available with the advising bank.

21.2. RESPONSIBILITIES AND LIABILITIES OF PARTIES

The parties involved in a credit operation are:

(*a*) Applicant (importer),
(*b*) Beneficiary (exporter),
(*c*) Issuing bank (opening bank),
(*d*) Nominated bank (intermediary bank) which may be:
 (*i*) Advising bank
 (*ii*) Confirming bank
 (*iii*) Negotiating bank
 (*iv*) Accepting bank
 (*v*) Paying bank
 (*vi*) Reimbursing bank.

The responsibilities and obligations of the above parties are outlined below bearing in mind the provisions of the UCP.

Banks' Clients

1. Applicant

(*i*) Since the credit is based on the sale contract between the exporter and the importer, the latter has a duty to the exporter to see that the credit opened is as per the terms of the sale contract. However, once a credit is issued, it stands by itself whether or not it is in accordance with the sale contract.

(*ii*) A letter of credit is not regarded as absolute payment unless the exporter stipulates expressly or impliedly that it should be so. Therefore, if the exporter has fulfilled his obligation under the contract, but the issuing bank fails before payment is made to him, the importer remains liable to the exporter for the amount.

(*iii*) The obligations between the importer and the issuing bank are governed by the application-cum-agreement submitted by the importer to the bank. Such instructions for the issuance of credits as well as his instructions for any amendments thereto must be complete and precise (Article 5).

(*iv*) The issuing bank utilising the services of another bank or banks for the purpose of giving effect to the instructions of the applicant does so for the account and at the risk of the applicant. The issuing bank is not liable if the instructions it transmits are not carried out, even if the issuing bank itself took the initiative in the choice of such other bank(s) [Article 21(*a*) and (*b*)].

(*v*) He is liable to pay charges, including commissions, fees, costs and expenses incurred by the issuing bank in connection with the letter of credit. Where a credit stipulates that such charges are for the account of the beneficiary, and charges cannot be collected, he remains ultimately liable for the payment thereof [Article 18 (*c*)].

(*vi*) The applicant is liable to indemnify the banks against all obligations and responsibilities imposed by foreign laws and usages [Article 18 (*d*)].

(*vii*) Under the application-cum-agreement for opening the credit, the applicant agrees that till he reimburses the issuing bank the goods that are covered by the documents shall stand charged to the bank.

2. Beneficiary

(i) The beneficiary has the obligation to make export as per the contract and produce the documents as required by the credit. He cannot avail himself of the contractual relationship existing between the banks or between the applicant for the credit and the issuing bank [Article 3 (b)].

(ii) If the documents tendered are accepted by the negotiating bank, but later found to be defective due to some latent defects or falsification, he should reimburse the negotiating bank unless the negotiation was made without recourse.

(iii) In a transferable credit, if he requires it to be transferred, he should pay the charges of the transferring bank.

❑ Bank

1. Advising Bank

(i) A credit may be advised to a beneficiary through another bank (the advising bank) without engagement on the part of the advising bank, but that bank shall take reasonable care to check the apparent authenticity of the credit which it advises. If the advising bank cannot establish such apparent authenticity, it must inform, without delay, the bank from which the instructions appear to have been received that it has been unable to establish the authenticity of the credit and if it elects nonetheless to advise the credit it must inform the beneficiary that it has not been able to establish the authenticity of the credit (Article 7).

(ii) If the bank elects not to advise the credit, it must inform the issuing bank without delay (Article 7).

Thus the responsibility of the advising bank is to vouchsafe the authenticity of the credit. It may negotiate documents under the credit, if it so desires, in which case it becomes the negotiating bank. The beneficiary cannot compel the advising bank to negotiate documents.

2. Confirming Bank

(i) When a bank in the exporter's country adds its confirmation to the credit, it gives an additional undertaking to the beneficiary, in addition to that of the issuing bank, to negotiate documents under the credit. Therefore, the relationship of the confirming bank with the beneficiary is similar to that of the issuing bank. If the documents tendered are in conformity with the letter of credit terms and within the expiry time of the credit, it has to make payment against them. The responsibilities and liabilities of the issuing bank discussed below apply *mutatis mutandis*, to confirming bank also, which please see.

(ii) As to the relation of the confirming bank with the issuing bank, the position is same as that of the negotiating bank.

3. Paying Bank

Paying bank is a bank in the beneficiary's country nominated in the letter of credit to make payment against documents to be tendered under the credit. As already discussed, when the paying bank accepts its nomination in the credit, it is liable to pay against documents tendered provided they satisfy the requirements of the credit. The payment is without recourse to the drawers, unless the payment is made under reserve. As regards the responsibilities for scrutiny of documents, etc., its position is similar to that of the negotiating bank.

4. Accepting Bank

Accepting bank is the bank nominated in the letter of credit to accept usance bills drawn under the credit. If the bank so nominated accepts the nomination, its responsibility to the beneficiary is not only to accept the drafts drawn, but also to make payment on their due dates. See under Negotiating Bank for the relation with issuing bank.

5. Negotiating Bank

(*i*) Unless the negotiating bank is nominated in the credit and it accepts the nomination or it is the confirming or paying bank, no bank can be compelled by the beneficiary to negotiate documents under the credit. A bank, under an open credit, may accept on its own to negotiate documents.

(*ii*) Article 13 provides: "Banks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit. Compliance of the stipulated documents on their face with the terms and conditions of credit, shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit." Therefore, the negotiating bank should accept documents tendered only if they conform to the terms and conditions of the credit. In documentary credits all parties concerned deal in documents and not in goods. Therefore, he cannot ensure correctness of the goods shipped but can only see that the documents on their face appear to be as required by the credit.

(*iii*) If the negotiating bank finds any discrepancies in the documents tendered, but still negotiates, it may require the beneficiary to execute an indemnity in favour of the bank. But such indemnity cannot be transferred to the issuing bank without the consent of the beneficiary.

6. Issuing Bank

(*i*) The issuing bank is primarily responsible for payment under the credit to the beneficiary. This is already dealt with in detail in the previous chapter under 'Revocable and Irrevocable Credits'.

(*ii*) Credits and any amendments thereto issued by the bank must be complete and clear. In order to guard against confusion and misunderstanding, the issuing bank should discourage any attempt to include excessive details in the credit or in any amendment thereto.

(*iii*) The issuing bank should nominate the bank which is authorised to pay or to accept drafts or to negotiate, unless the credit allows negotiation by any bank. "By nominating a bank, or by allowing for negotiation by any bank, or by authorising or requesting a bank to add its confirmation, the issuing bank authorises such bank to pay, accept drafts or negotiate, as the case may be, against documents which appear on their face to be in accordance with the terms and conditions of the credit, and undertakes to reimburse such bank" [Article 10 (*d*)].

(*iv*) If a bank uses the services of an advising bank to have the credit advised to the beneficiary, it must also use the services of the same bank for advising any amendments [Article 11 (*b*)].

(*v*) Upon receipt of the documents, the issuing bank must determine, on the basis of the documents alone, whether or not they appear on their face not to be in accordance with terms and conditions of the credit. If the documents appear on their face not to be in compliance with the terms and conditions of the credit, the issuing bank may refuse to take up the documents [Article

14 (*b*)]. The issuing bank shall have a reasonable time not exceeding seven banking days following the day of receipt of the documents to examine the documents and to determine whether to take up or to refuse documents and to inform the party from which it received the documents accordingly [Article 13 (*b*)].

(*vi*) If the issuing bank determines that the documents appear on their face not to be in compliance with the terms and conditions of the credit, it may, in its sole judgment, approach the applicant for a waiver of the discrepancies. This does not, however, extend the period of seven days available for scrutiny and communicating the decision [Article 14 (*c*)].

(*vii*) If the issuing bank decides to refuse the documents, it must give notice to that effect without delay by telecommunication or, if that is not possible, by other expeditious means, without delay but not later than the close of the seventh banking day following the day of receipt of documents. Such notice shall be given to the bank from which it received the documents, or to the beneficiary, if it received the documents directly from him. Such notice must state the discrepancies in respect of which the issuing bank refuses the documents and must also state whether it is holding the documents at the disposal of, or is returning them to, the presenter. The issuing bank shall then be entitled to claim from the remitting bank refund of any reimbursement which may have been made to that bank [Article 14 (*d*)].

(*viii*) If the issuing bank fails to act in accordance with the above provisions and/ or fails to hold the documents at the disposal of, to return them to the presenter, the issuing bank shall be precluded from claiming that the documents are not in compliance with the terms and conditions of the credit [Article 14 (*e*)].

(*ix*) If the remitting bank draws the attention of the issuing bank to any discrepancies in the documents or advises the issuing bank that it has paid, incurred a deferred payment undertaking, accepted or negotiated under reserve or against an indemnity in respect of such discrepancies, the issuing bank shall not be thereby relieved from any of its obligations. Such reserve or indemnity concerns only the relations between the remitting bank and the party towards whom the reserve was made, or from whom, or on whose behalf, the indemnity was obtained [Article 14 (*f*)].

7. Reimbursing Bank

The issuing bank may indicate in the credit the name of a bank, from whom the paying/negotiating bank can obtain reimbursement. The documents are sent to the bank; the negotiating/paying bank simultaneously makes a claim with the reimbursing bank for the negotiation/payment effected. Normally the reimbursing bank would be the bank with whom the issuing bank maintains an account.

Article 19 governs the relationship between the reimbursing bank and the issuing bank which is reproduced below:

"(*a*) If an issuing bank intends that the reimbursement to which a paying, accepting or negotiating bank is entitled shall be obtained by such bank (the 'claiming bank'), claiming on another party (the 'reimbursing bank'), it shall provide such reimbursing bank in good time with the proper instructions or authorisation to honour such reimbursement claims.

(*b*) Issuing bank shall not require a claiming bank to supply a certificate of compliance with the terms and conditions of the credit to the reimbursing bank.

(*c*) An issuing bank shall not be relieved from any of its obligations to provide reimbursement if and when reimbursement is not received by the claiming bank from the reimbursing bank.

(*d*) The issuing bank shall not be responsible to the claiming bank for any loss of interest if reimbursement is not provided on first demand, or as otherwise specified in the credit, or mutually agreed, as the case may be.

(*e*) The reimbursing bank's charges should be for the account of the issuing bank. However in cases where the charges are for the account of another party, it is the responsibility of the issuing bank to so indicate in the original credit and in the reimbursement authorisation. In cases where the reimbursing bank's charges are for the account of another party they shall be collected from the claiming bank when the credit is drawn under. In cases where the credit is not drawn under, the reimbursing bank's charges remain the obligation of the issuing bank."

21.3. UNIFORM RULES FOR BANK-TO-BANK REIMBURSEMENTS

The letter of credit may provide for reimbursement to the negotiating bank with a bank other than the issuing bank. This may happen when the letter of credit is issued in a currency other than the national currency of the issuing ba.... The reimbursement in such case is arranged to be made by a bank in the country of currency of the letter of credit. The reimbursement arrangement may also be made to expedite payment to the negotiating bank by designating a bank near to the negotiating bank. The provision relating to reimbursing arrangement in a letter of credit is contained in Article 19 of the UCP. However, it was observed that practices around bank-to-bank reimbursements had outgrown what is contained in the UCP and had developed into more sophisticated procedures. They also remained large subject to local accepted practice in major financial centres, where banks formulated their own operating rules. In order to bring uniformity and international standards in the reimbursement process, the International Chamber of Commerce brought out its publication 'Uniform Rules for Bank-to-Bank Reimbursements', ICC Publication No. 525 (URR 525, in short). These rules came into effect 1st July 1996.

URR applies to all bank-to-bank reimbursements where they are incorporated into the text of the reimbursement authorisation. The bank issuing the letter of credit is responsible for indicating in the credit that the reimbursement claims are subject to URR.

☐ Reimbursement Arrangement

The procedure involved in arranging for reimbursement under a letter of credit may be stated as follows:

1. The issuing bank indicates in the credit that the *reimbursement claims* under the credit are subject to URR. It also issues the *reimbursement authorisation* to the reimbursing bank authorising the latter to reimburse a claiming bank, or to accept and pay drafts drawn on the reimbursing bank.
2. If the reimbursing bank is not prepared to act for any reason whatsoever under the reimbursement authorisation, it must so inform the issuing bank without delay. [Article 6 (9)]
3. The issuing bank may request the reimbursing bank to issue a *reimbursement undertaking* to the claiming bank. Except as provided by the terms of its reimbursement undertaking, a reimbursing bank is not obligated to honour a reimbursement claim. [Article 4]
4. The claiming bank which pays, incurs a deferred payment undertaking, accepts a draft or negotiates under a credit presents a reimbursement claim to the reimbursing bank.
5. The reimbursing bank will have a reasonable time, not exceeding three business days to process the claim. Where the claim conforms to the

reimbursement undertaking. It will reimburse the claiming bank. Generally, the charges of the reimbursing bank are on account of the issuing bank.

❑ Reimbursement Authorisation

Reimbursement authorisation is the instruction/authorisation issued by the issuing bank to the reimbursing bank to reimburse a claiming bank. The authorisation may also be to accept and pay a time draft drawn on the reimbursing bank. Important provisions in URR regarding reimbursement authorisation are as follows:

1. A reimbursement authorisation is separate from the credit to which it refers. A reimbursing bank is not concerned with or bound by the terms and conditions of the credit, even if any reference to them is included in the reimbursement authorisation. [Article 3]
2. The reimbursement authorisation must be issued in the form of an authenticated telecommunication or a signed letter. Where it is sent by telecommunication, no mail confirmation need be sent; if sent, it will not be checked by the reimbursing bank. [Article 6 (*a*)]
3. The authorisation must be complete and precise. Copies of letter of credit should not be sent to the reimbursing bank. Multiple authorisations should not be carried in one telecommunication or letter, unless agreed to by the reimbursing bank. [Article 6 (*b*)]
4. Issuing bank shall not require a certificate of compliace with the terms and conditions of the credit in the reimbursement authorisation. [Article 6 (*c*)]
5. The authorisation must state: (*i*) credit number, (*ii*) currency and amount, (*iii*) additional amounts payable and tolerance, if any, (*iv*) claiming bank, and (*v*) parties responsible for charges. In case of freely negotiable credits, as also where no claiming bank is mentioned, reimbursement will be to any claiming bank. If the reimbursing bank is to accept and pay a time draft, information about (*i*) tenor of the draft, (*ii*) drawer, and (*iii*) party responsible for acceptance and discount charges should additionally be indicated. [Article 6 (*d*) and (*e*)]
6. If the claiming bank has to give pre-notification of the claim to the issuing bank, or if the reimbursing bank is to issue pre-debit notification to the issuing bank, such conditions should be incorporated in the letter of credit, and not in the reimbursement authorisation. [Article 6 (*f*)]
7. The issuing bank may issue a reimbursement amendment or cancel a reimbursement authorisation at any time by sending a notice to the reimbursement bank, provided reimbursement undertaking has not been issued. It must send a notice of amendment to the nominated bank/advising bank. If the credit is still valid, alternative reimbursement arrangement should be made. The issuing bank must reimburse the reimbursing bank for reimbursements made prior to the receipt of notice of amendment or cancellation. [Article 8]. Where reimbursement undertaking has already been issued, the authorisation cannot be amended or cancelled without the agreement of the reimbursing bank. [Article 9 (*g*)]

❑ Reimbursement Undertaking

Reimbursement undertaking is the separate irrevocable undertaking of the reimbursing bank, issued upon the authorisation or request of the issuing bank, to the claiming bank named in the reimbursement authorisation, to honour that bank's reimbursement claim provided the terms and conditions of the reimbursement undertaking have been complied with. [Article 2 (*g*)]. The important provisions relating to reimbursing undertaking are :

1. If the reimbursement authorisation authorises the issue of reimbursement undertaking by the reimbursing bank, in addition to the details mentioned under reimbursement authorisation, it must also specify the latest date for presentation of a claim, including any usance period. [Article 9 (*b*)]. The reimbursement undertaking should indicate all the details mentioned already under reimbursement authorisation.
2. If the latest date for presentation of a claim falls on a day on which the reimbursing bank is closed, the latest date for presentation of claim shall be extended to the first following day on which the reimbursing bank is open. [Article 9 (*f*)]
3. When the issuing bank amends its authorisation, the reimbursing bank may amend its undertaking to reflect such amendment. If it chooses not to issue its reimbursement undertaking amendment, it must so inform the issuing bank without delay. While the issuing bank will be bound by the amendment to authorisation as from the time of its issue, the terms of the original authorisation will remain in force for the reimbursing bank until it communicates its acceptance of the amendment to the issuing bank. The reimbursing bank is not required to accept or reject the amendment to the authorisation until it receives acceptance or rejection from the claiming bank to its amendment to the reimbursement undertaking. [Article 9 (*g*)]
4. An amendment to the reimbursement undertaking is not valid unless accepted by the claiming bank. [Article 9 (*h*)]

❑ Reimbursement Claim

Reimbursement claim is the request for reimbursement from the claiming bank to the reimbursing bank. Important provisions in this regard are:

1. The reimbursement claim must be in the form of a teletransmission, unless specifically prohibited by the issuing bank, or an original letter. If a claim is made by teletransmission, no mail confirmation is to be sent. If sent, the claiming bank will be responsible for any consequence that may arise from a duplicate reimbursement. [Article 10 (*a*)]
2. The claim must clearly indicate the credit number, issuing bank, principal amount claimed, additional amount, if any, and charges. It should not be a copy of the claiming bank's advice of payment etc., to the issuing bank. Multiple claims should not be included under one teletransmission or letter. The claim must comply with the terms and conditions of the reimbursing undertaking, if one issued. [Article 10 (*a*)]
3. Claiming banks must not indicate in a claim that a payment, acceptance or negotiation was made under reserve or against an indemnity. [Article 10 (*c*)]
4. The reimbursing bank will have a reasonable time, not exceeding three business days, to process the claim. If a pre-debit notification is required by the issuing bank, such period will be additionally available. If the reimbursing bank decides not to reimburse, it must give notice to that effect by telecommunication, or if that is not possible, by other expeditious means, without delay, but not later than the period mentioned above, to the claiming bank and the issuing bank. [Article 11 (*a*)]
5. Where a reimbursing bank has not issued a reimbursement undertaking, and a reimbursement is due on a future date, the reimbursement claim must specify the predetermined future date. The claim should not be presented more than ten days prior to such due date. If the claim is made earlier, the reimbursing bank may disregard such claim and inform the claiming bank. If the due date is more than three banking days following the day of receipt of the claim, the reimbursing bank has no obligation to

provide notice of non-reimbursement until such due date, or the close of the third banking day following the receipt of the claim and pre-debit notification period, whichever is later. [Article 11 (*c*)]

6. Unless otherwise agreed to by the reimbursing bank and the claiming bank, the reimbursing bank will effect reimbursement only to the claiming bank. [Article 11 (*d*)]
7. Reimbursing bank's charges are for account of the issuing bank. Where the charges are for the account of another party, the issuing bank should indicate so in the original credit and in the reimbursement authorisation. In such cases, they will be deducted when the reimbursement claim is honoured. [Article 16]

21.4. DISCLAIMER OF RESPONSIBILITY BY BANKS

There are certain provisions in the UCP absolving the bank involved in the transaction from responsibility on certain contingencies:

1. *Article 3.* Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the credit.

2. *Article 4.* In credit operations all parties concerned deal in documents, and not in goods, services and/or other performance to which the documents may relate.

3. *Article 15.* Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any documents, or for the good faith or acts and/or omissions, solvency, performance or standing of the consignor, the carriers, or the insurers of the goods, or any other person whomsoever.

It is evident from the above article that though the banks are under obligation to examine the documents, they do not guarantee their genuineness. If on the face of it the document appears to be forged, the bank would refuse payment against it. But if the forgery is not apparent, the negotiating bank and the issuing bank have paid against them without negligence on their part, they stand absolved of responsibilities.

However, it may happen that the forgery of the documents is found by the issuing bank before the reimbursement is made to the negotiating bank. In such cases, the negotiating bank cannot insist on reimbursement by the issuing bank but can have recourse against the person who has tendered forged documents.

4. *Article 18 (b).* Banks assume no liability or responsibility should the instructions they transmit not be carried out, even if they have themselves taken the initiative in the choice of such other bank(s).

5. *Article 16.* Banks assume no liability or responsibility for the consequences arising out of delay and/or loss in transit or any messages, letters or documents, or for delay, mutilation or other errors arising in the transmission of any telecommunication. Banks assume no liability or responsibility for errors in translation or interpretation of technical terms, and reserve the right to transmit credit terms without translating them.

6. *Article 17.* Banks assume no liability or responsibility for consequences arising out of the interruption of their business by acts of God, riots, civil commotions, insurrections, wars or any other causes beyond their control, or by any strikes or lockouts. Unless specifically authorised, banks will not, upon resumption of their business, pay, incur a deferred payment undertaking, accept drafts or negotiate under credits which expired during the interruption of their business.

7. *Article 13* (c). If a credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them.

8. *Article 45*. Banks are under no obligation to accept presentation of documents outside their banking hours.

21.5. PRACTICAL PROBLEMS

Problem 21.1. How will you deal with the following requests?

(*i*) You have been asked to add your confirmation to an irrevocable letter of credit by the issuing bank.

(*ii*) The beneficiary of a revocable letter of credit has asked you to add your confirmation to the credit.

Your answer should bear in mind the provisions of Uniform Customs and Practice for Documentary Credits (1993 Revision) ICC Publication No. 500.

Solution.

(*i*) *Confirmation of an irrevocable letter of credit.* By confirming a letter of credit, the confirming bank indicates to accept and/or pay bills drawn under the credit provided the terms and conditions of the credit are satisfied (Article 9 of UCP). Before confirming a letter of credit, the bank would weigh its risk by evaluating the credit standing of the issuing bank and the country risk involved. If these are satisfied the request from the issuing bank of an irrevocable letter of credit to confirm the LC can be accepted. Under an irrevocable letter of credit, there is the commitment by the issuing bank not to alter or cancel the credit unilaterally and, therefore, generally, the interest of the confirming bank is protected.

(*ii*) *Confirmation of revocable letter of credit.* The request may not be accepted for the following two reasons:

(*a*) As per the provisions of UCP, the request for confirmation should emanate from the issuing bank and not the beneficiary.

(*b*) The credit in question is a revocable credit. The credit may be amended or even cancelled before the due date and, therefore, the confirming bank is not definite of getting the reimbursement from the issuing bank for payments made by it under the credit.

Problem 21.2. You had transferred a transferable letter of credit in full to an export house at the request of the beneficiary. The transferee presented the shipping documents through his banker and you have observed certain discrepancies in terms of the original letter of credit but you have been advised that certain amendments had been received by the transferee through his banker. How will you handle these documents bearing in mind that the letter of credit is governed by Uniform Customs and Practice for Documentary Credits (1993 Revision) ICC Publication No. 500?

Solution. The position of the bank is that of an advising bank. The relationship is not changed by the mere fact that it has effected the transfer of the credit as required by the beneficiary. According to Article 7 of UCP, a credit may be advised to beneficiary through another bank (the advising bank), without engagement on the part of the advising bank, but that bank shall take reasonable care to check the apparent authenticity of the credit which it advises. Thus the responsibility of the advising bank is to vouchsafe the authenticity of the credit. It may negotiate documents under the credit if it so desires, but the beneficiary cannot compel the bank to do so.

In order that any amendment of a letter of credit already established reaches the beneficiary through the same channel through which the original credit was advised, so that all the concerned parties may know of the amendment, Article 11 (*b*) says that if a bank uses the services of another bank or banks (the advising bank) to have the credit advised to the beneficiary, it must also use the services of the

same bank for advising any amendment. In the present case, the issuing bank routed the amendment through a bank other than the advising bank. Therefore, the advising bank is not bound by such amendment. The situation reinforces the right of the advising bank to refuse to negotiate documents under the credit.

In case the bank desires to accommodate the beneficiary, it may agree to take the documents on collection basis provided they are otherwise in order. This handling of documents will be purely at the discretion of the advising bank and the transaction will not be governed by the provisions of Uniform Customs and Practice for Documentary Credits.

PROBLEM 21.3. As a negotiating bank you have negotiated an export bill for a valued customer under reserve and against an indemnity from the customer or certain discrepancies as noticed in the documents in terms of the relative letter of credit and have forwarded the documents to the issuing bank with suitable advice.

The issuing bank informs you after passage of about 3 months that the documents are not acceptable to the openers and that to protect the goods and avoid demurrage they (issuing banks) have cleared and stored the goods to your (the negotiating bank) order and seek further instructions.

Discuss the action of the opening bank with reference to the liabilities and responsibilities detailed in the Uniform Customs and Practice Documentary Credits.

What stand would you take as a negotiating bank in the matter?

SOLUTION. While negotiating a bill under a letter of credit the negotiating bank would see if the documents strictly satisfy the terms and conditions of the credit. In case any discrepancy in the documents is noticed it may refuse to negotiate the bill. But if the beneficiary is a valued customer of the bank and is willing to execute an indemnity in favour of the bank, it may negotiate the documents and make payment under reserve. It means the bank retains the right of recourse against the beneficiary and the beneficiary agrees to pay back the amount received by him together with other expenses that may be incurred, if the documents are rejected by the issuing bank.

Obtaining an indemnity is only between the negotiating bank and the beneficiary. It does not affect the relation between the negotiating bank and the issuing bank which is governed by Articles 13 and 14 of the UCP.

The negotiating bank can get reimbursement from the issuing bank only when the documents tendered are in order and are in strict compliance with the terms and conditions of the credit. Presentation of documents with discrepancy is not a valid tender. However, Articles 13 and 14 provide that the issuing bank shall have a reasonable time not exceeding seven banking days following the day of receipt of the documents to examine the documents and if it considers that the documents are not in accordance with the terms and conditions of the credit, it should, without delay, notify the negotiating bank of its claim and also either hold the documents at the disposal of the negotiating bank or return them. If there is delay in taking these actions by the issuing bank, it forfeits its right to reject the documents. Therefore, in the present case, after an inordinate delay of the three months the issuing bank cannot make any claim. If the bank had not accepted the documents, it was unwarranted on its part to clear the goods and store them, though it was done to protect the interests of the negotiating bank.

The issuing bank cannot also defend that the negotiating bank knew the discrepancies before it forwarded the documents to the issuing bank. Article 14 provides that the negotiating bank intimating the issuing bank of the discrepancies found by it in the documents while forwarding the documents does not absolve the issuing bank of its responsibilities under this Article.

The claim of the issuing bank cannot be accepted.

Problem 21.4. An export bill negotiated by you under an irrevocable letter of credit has been dishonoured by the drawee on presentation on the ground of a discrepancy which was not observed by you at the time of negotiation. What steps will you take as a negotiating banker to protect your interest keeping in view the provisions of the Uniform Customs and Practice for Documentary Credits?

Solution. It is opined that "where the documents, though apparently what they should be, are, in fact, not and the beneficiary (not fraudulent) is himself responsible for the discrepancy, the banker should be able to recover the money he has paid against them as paid under mistake of fact, unless he has expressly contracted not to have recourse" (*Law of Bankers' Commercial Credits*, by Gutteridge and Maurice Megrah). But the immediate security available to the bank is the goods covered by the documents and efforts should be made by the bank to safeguard them. If the goods are of perishable nature, the issuing bank may be instructed to dispose of the goods immediately. If the goods are of durable nature, the issuing bank may be instructed to get the goods released and arrange for their storage and sell them to an alterative buyer. In the meanwhile, the issuing bank should be required to keep alive the insurance on the goods.

Problem 21.5. You negotiated a bill under an irrevocable letter of credit covering export of iron ore to Japan and claimed reimbursement for the value of the bill from the opening bank. It was reported that the relative steamer carrying the cargo sank in the midstream. The opening bank refused payment on the ground that the cargo has been lost.

Is the opening bank within its right to refuse payment, if:

(*a*) the bill and documents negotiated by you comply with the terms of the letter of credit;

or

(*b*) there were certain discrepancies in the documents tendered by the beneficiary?

Discuss the obligations of the opening bank bearing in mind the provisions of the Uniform Customs and Practice for Documentary Credits (1993 Revision).

Solution. Article 4 of the UCP provides: "(*a*) In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate."

Article 14 provides further: "(*a*) If a bank so authorised effects payment, or incurs a deferred payment undertaking, or accepts, or negotiates against documents, which appear on their face to be in accordance with the terms and conditions of a credit, the party giving such authority shall be bound to reimburse the bank which has effected payment, or incurred a deferred payment undertaking, or has accepted, or negotiated, and to take up the documents.

"(*b*) If upon receipt of the documents, the issuing bank considers that they appear on their face not to be in accordance with the terms and conditions of the credit, it must determine, on the basis of the documents alone, whether to take up such documents, or to refuse them and claim that they appear on their face not to be in accordance with the terms and conditions of the credit."

Therefore, the issuing bank's decision should be based only on the documents and not on any other factor like non-receipt of goods. If the bill and documents negotiated comply with the terms of the credit, the issuing bank is bound to reimburse the negotiating bank. If, on the other hand, the documents carry certain discrepancies, it is then the right of the issuing bank to refuse to reimburse the negotiating bank.

Problem 21.6. Your bank had opened an irrevocable letter of credit in US dollars in favour of an overseas exporter covering import of edible oil from Malaysia.

(*a*) You had requested your Malaysian correspondent bank to add its confirmation to the letter of credit.

(*b*) Letter of credit was also made available for negotiation by a bank other than the confirming bank.
(*c*) Letter of credit called for 120 days D/A bill with the provision that reimbursements should be obtained on the date by the negotiating bank from your US correspondent bank.
(*d*) The documents which were in compliance with the letter of credit were presented by the negotiating bank to the confirming bank and the bill was accepted by the confirming bank.
(*e*) It transpired that the shipment has been diverted to another country and that opener had brought a court order restraining the opening bank from making payment on the due date.

Discuss the responsibilities of the opening bank, confirming bank and the negotiating bank under the Uniform Customs and Practice for Documentary Credits, ICC Publication No. 500.

Solution. In the case cited, the issuing bank cannot repudiate claim on the ground that the shipment has been diverted to another country and that the opener has brought a court order restraining the opening bank from making payment on the due date. It has to reimburse the confirming bank which would be making payment after 120 days when the bill falls due. The issuing bank should obtain vacation of the court order and arrange for payment to the confirming bank which has accepted the bill.

The confirming bank is bound to reimburse negotiating bank provided the documents tendered are in accordance with the terms of the credit. The letter of credit is not restricted and, therefore, any bank can negotiate the documents and obtain payment from the confirming bank on the due date.

The negotiating bank is well within its rights to get the documents accepted by the confirming bank, provided they are as per the terms of the credit, and get payment on the due date of the bill.

Problem 21.7. You had opened an irrevocable letter of credit covering shipment of 500 tonnes of edible oil from Malaysia which included the following stipulations:
(*i*) Edible oil as per Indent dated 29th July, 1996, and
(*ii*) Partial shipments prohibited.

In September, the letter of credit was amended as follows:
(*i*) Shipment and expiry dates extended to 31st October and 15th November, 1996.
(*ii*) Partial shipments permitted.

However, on receipt of documents the customer observed the following discrepancies:

"Goods not in accordance with the indent and shipped in one lot contrary to the terms specified in the indent."

and refused to accept the documents.

Examine your responsibilities as an opening bank under the provisions of the Uniform Customs and Practice for Documentary Credits, ICC Publication No. 500.

Solution. Articles 3 and 4 of UCP are relevant in this case and are reproduced below.

Article 3. Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s) even if any reference whatsoever to such contract(s) is included in the credit.

Article 4. In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate.

It is clear that the customer is not justified in refusing the documents tendered. *First*, the banks are not bound by the terms specified in the indent, even though a reference to it has been made in the letter of credit.

Secondly, the bank has no obligation to verify that the goods conform to the specifications in the indent.

Thirdly, although this point has not been raised, the amendment to the credit permitting partial shipment carries no obligation to ship in instalments only.

The opening bank is bound to reimburse the negotiating bank.

PROBLEM 21.8. Your correspondent bank opened an 'operative letter of credit' through your bank by telex which was relayed to the beneficiary. When the documents which were drawn in conformity with the terms of the credit as received by you were presented, the issuing bank rejected the documents on the ground that consular invoice had not been submitted. It was then observed that there has been a transmission error and the telex message did not contain this stipulation.

Examine the responsibility of the opening bank and negotiating bank and whether the opening bank can reject the documents in the context of the provisions of the Uniform Customs and Practice for Documentary Credits (1993 Revision), ICC Publication No. 500.

SOLUTION. Article 16 of UCP states: "Banks assume no liability or responsibility for the consequences arising out of delay and/or loss in transit of any messages, letters or documents, or for delay, mutilation or other errors arising in the transmission of any telecommunication."

The negotiating bank has fulfilled the requirements of the letter of credit as it was received and is, therefore, entitled to be reimbursed by the opening bank.

If the opening bank had sent mail confirmation for the telex message sent, the negotiating bank (as the advising bank) could have verified that the telex message received was in order. In that case the opening bank has a reason to claim that the negotiating bank was negligent. But even such claim is unlikely to succeed because the responsibility of an advising bank is to authenticate the genuineness of the credit and does not extend beyond that.

PROBLEM 21.9. As a negotiating banker, will you accept the following bills of lading submitted by your customer under an irrevocable letter of credit?

(*a*) Bill of lading is dated 19th April, 1996 whereas the letter of credit calls for shipment towards the end of April, 1996; and

(*b*) Description on the bill of lading of goods as 100 bags 'as per shipper's load and count' Soda Ash, whereas the letter of credit calls for 100 bags light Soda Ash.

SOLUTION.

(*a*) Article 53 provides: "The terms 'beginning' or 'end' of a month shall be construed respectively as from the 1st to the 10th, the 11th to the 20th and the 21st to the last day of each month, both dates inclusive." In the present case the letter of credit requires a bill of lading evidencing shipment towards the end of April, 1996. Therefore, the bill of lading should be dated a day between 21st and 30th April, 1996. The bill of lading tendered, which is dated 19th April, 1996, cannot be accepted.

(*b*) Article 41 (c) provides: "The description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents the goods may be described in general terms not inconsistent with the description of the goods in the credit." In the present case the letter of credit calls for 100 bags light soda ash. The description of goods in the bill of lading—soda ash—conforms to the requirement of the above Article. Further, the notation 'as per shipper's load and count' does not render the bill of lading claused. The bill of lading can, therefore, be accepted.

22 Documents Used in Foreign Trade

A long list can be drawn of the documents used in international trade. Some of the documents owe their use to commercial expediency. The buyer and the seller rarely meet: the conditions of sale are included in the contract of sale which incorporates in detail the terms of the contract. When the seller ships the goods, he is required to furnish evidence to show that the various conditions of the contract have been fulfilled. Thus, there is need for evidence that goods have been shipped; the goods shipped are of specific quality; the required quantity has been shipped, etc. These evidences are furnished in the form of different documents. While in transit, the goods are exposed to risks and need to be insured. Besides these commercial factors, the exchange control regulations in certain countries also require certain other documents to be furnished. Thus, we have certificate of origin, consular invoice, etc. Important among the documents used in foreign trade may be enumerated as under:

1. *Bill of exchange* It is a direction from the exporter to the importer to pay the value of the goods exported to the bank through whom he sends the documents.

2. *Transport documents* Where the goods are sent by sea transport the document evidencing shipment is the bill of lading; if the goods are airlifted, an airway bill is obtained. Recent additions are combined transport documents involving more than one mode of transport.

3. *Marine insurance policy* It provides cover against perils of the sea and other connected risks which the goods are exposed to.

4. *Invoices* Commercial invoice is an evidence of the sale made, containing the detailed description of the goods sold. Consular invoice and certified invoice serve specific purposes.

5. *Other documents* Certificate of origin indicates the country in which the goods exported were manufactured or produced. Weight certificate certifies the weight of goods exported. Packing list details the goods that each particular packing contains. Quality certificate may be required to ensure the quality of goods exported.

It is not necessary that each set of documents should contain all the above documents. Depending upon the agreement between the parties, a few or more of the documents may be needed for a transaction.

The documents may be drawn under a letter of credit or they may be without a letter of credit. Where the documents are drawn under a letter of credit, the provisions of Uniform Customs and Practice for Documentary Credits should be kept in view. If the documents are drawn without a letter of credit, they become a Collection item and are governed by the Uniform Rules for Collections—another publication of the International Chamber of Commerce.

In this chapter the important documents, other than transport documents, are discussed in the light of legal provisions governing the documents and the UCP. Transport documents are reserved for the next chapter.

22.1. BILL OF EXCHANGE

❑ Definition

A bill of exchange is an instruction by the exporter (drawer) to the importer or the importer's bank to make payment of the amount mentioned in it. A bill of exchange is a negotiable instrument and is governed by the Negotiable Instruments Act in India and by similar enactments in other countries. The Negotiable Instruments Act defines a bill of exchange as "an instrument in writing containing an unconditional order, signed by the maker directing a certain person to pay a

certain sum of money only to, or to the order of, a certain person or to the bearer of instrument."

The bill, under a letter of credit, may be drawn on the issuing bank or another drawee bank but not on the importer. If the credit nevertheless calls for a bill on the applicant, banks will consider such bills as additional documents [Article 9 (a) (iv) and (b) (iv)].

❑ Types of Bills

1. *Sight and usance bills* A bill of exchange is a sight bill (or demand bill) if the drawee is to make payment immediately on presentation of the bill to him. A bill is a usance bill if the drawee is to make payment after a period specified (say, 30 days or 60 days) in the bill has expired. A usance bill may be 'after date' bill or 'after sight' bill. For an 'after date' bill, the due date is calculated from the date appearing on the face of the bill. This may also be drawn 'after so many days from date of bill of lading or airway bill' in which case the due date will be calculated from the date appearing on the relevant bill of lading or airway bill. For an 'after sight' bill, the date is calculated from the date it is sighted, *i.e.*, it is accepted by the drawee.

2. *D/A and D/P bills* A usance bill may be on D/A or D/P terms. If it is on D/A terms (documents against acceptance), the collecting bank is to deliver the documents to the drawee on the acceptance of the bill by him. The payment will be made by the drawee on the due date of the bill. For the period from the date of acceptance to the date of payment, the bank remains unsecured. If it is a D/P bill (documents against payment), the documents will be delivered to the drawee only on payment till which time they are retained by the bank. So the bank retains control over goods till payment is received.

It may be noted that whether the bill is D/A bill or D/P bill may or may not appear on the bill. The indication to this effect will be found in the instructions of the drawer to the bank.

3. *Inland and foreign bills* According to Negotiable Instruments Act, a bill which is drawn in India and made payable in or drawn upon any person resident in India is an inland bill. Thus an inland bill must fulfil both the conditions that (*i*) it is drawn in India, and (*ii*) it is payable in India or drawn on a person resident in India (even though payable abroad). Any bill which does not fulfil either of the conditions is a foreign bill. Thus, a bill drawn in India, payable at a place outside India by a person resident outside India and a bill drawn at a place outside India, but payable in India are foreign bills.

Foreign bills are normally drawn in sets. Section 132 of the Negotiable Instruments Act provides: "Bills of Exchange may be drawn in parts, each part being numbered and containing a provision that it shall continue payable only so long as the others remain unpaid. All the parts together make a set; but the whole set constitutes only one bill, is extinguished when one of the parts, if a separate bill, would be extinguished." The exception to this section states that "when a person

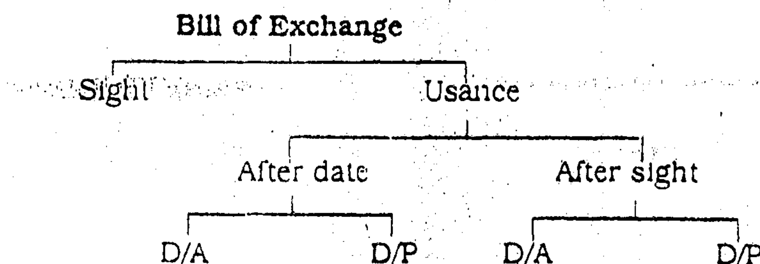


Fig. 22.1. Types of Bills of Exchange.

accepts or endorses different parts of the bill in favour of different persons, he and the subsequent endorsers of each part are liable on such part as if it were a separate bill."

Normally bills are drawn in sets of two copies. Either of the copies can be presented to the drawee for payment or acceptance. Once payment or acceptance is made on one copy, the other becomes null and void.

In international dealings, not only bills of exchange, but other documents are also prepared in multiple copies. The documents are sent in two sets, by separate mail for each set. The first set is sent on one day and the second set may be sent on the subsequent day. The procedure is to avoid risk of delay/loss of documents in transit.

❑ Noting and Protest

When a bill is dishonoured, steps should be taken to get it noted and protested. Noting and protesting by the Notary Public serves as an authentic proof of the fact of dishonour of the bill.

Noting should be done within a reasonable time of dishonour. For noting, the dishonoured bill is again presented formally by the notary himself or by his clerk or, where authorised by an agreement or usage, by a registered letter. When acceptance or payment is refused he makes a note on the instrument. The note should contain the particulars of the fact of dishonour, or, if the instrument has not been expressly dishonoured, the reason why the holder treats it as dishonoured, and the notary's charges.

Protest is a step ahead of noting. It contains in the form of a legal document, the facts of dishonour and all other related facts. Under Negotiable Instruments Act, when a bill is required to be protested within a specified time or before some further proceeding is taken, it is sufficient that the bill has been noted for protest before the expiration of the specified time or the taking of the proceedings and the formal protest may be extended at any time thereafter as of the date of noting.

Foreign bills of exchange must be protested for dishonour, when such protest is required by the law of the place where they are drawn.

❑ Stamp Duty

A bill of exchange issued in India will bear stamp duty according to the rates prescribed in the Indian Stamp Act. Sight bills and bills with usance up to 90 days are exempt from stamp duty. Usance bills for periods beyond 90 days are to be stamped at the rate of Rs. 1.25 per Rs. 1,000 per quarter. Whether the bills drawn in India will attract stamp duty at the place of payment will depend upon the local law prevalent there.

When a usance foreign bill is received into India, it has to be affixed with the stamp duty as per the Indian Stamp Act, irrespective of the duty paid abroad. It should be stamped even though it was originally stamped in India. The amount of the bill, if expressed in foreign currency, should be converted into Indian rupees by applying the rate of exchange prevalent on the date of the bill. The rate of exchange for different currencies for this purpose announced by the government is circulated periodically to banks by FEDAI. For this rupee value, the bill should be appropriately stamped, before it is presented to the drawee for acceptance. The stamp to be affixed is the special adhesive stamp with the words 'Foreign Bill' printed on it.

22.2. MARINE INSURANCE POLICY

❑ Meaning and Need

The safe conduct of the goods from the time it leaves the exporter's godown and till it reaches the warehouse of the importer is what all parties in the transaction

Allianz Versicherungs-Aktiengesellschaft **Allianz**

Certificate (Policy) of Marine Insurance

Certificate No.
900 0145

Sum Insured	Place and Date of Issue	Copies	Open Cover No.
DM 5,160,00			
+10% 516,00		two	117.850
DM 5,676,00	September 27th, 2000		

This is to certify that insurance has been granted under the above open cover to:

Bakelite AG, Gennaer Str. 2-4 D-58642 Iserlohn-Letmathe
Federal Republic of Germany

for account of whom it may concern, on the following goods:
40 bags = 1.000 kg net

Bakelite Moulding Compound
PF 31-9005-S 1 500 kg
MP 6605-9005-S 2 500 kg

Marks : MINI Portal LTD.
Port of unloading : Chennai (Madras)
Order No. IMP/2041008/2000-2001/Made in Germany

Invoice no. 11003845 + 11003846 dated 27.09.2000

for the following voyage (conveyance, route):

from Frielendorf via Rotterdam
by truck and ship APL Almandine
to Chennai (Madras)

from warehouse to warehouse, in accordance with Clause 5 of the German General Rules of Marine Insurance, Special Conditions for Cargo (ADS Cargo 1973-Edition 1984), as printed overleaf.
Claims payable to the holder of this certificate. Settlement under one copy shall render all others null and void.

Conditions :

1. German General Rules of Marine Insurance (ADS), Special Conditions for Cargo (ADS Cargo 1973-Edition 1984).
2. Terms and conditions of the above open cover.
3. Form of cover (see overleaf).
4. Clauses (see overleaf).

See overleaf for instructions to be followed in case of loss or damage.
claim setling agent

Claims Surveyor:

T.A. Taylor & Co. (Madras)
Private Ltd.
18, Shri Ram Nagar South Street
P.O. Box 51
Madras 600 018 (Tamil Nadu)
Phone (044) 450088
451709

Premium Paid

For and on behalf of all insurance companies participating
Allianz Versicherungs-Aktiengesellschaft
Zweigniederlassung fur Norddeutschland
Groller Burslah 3, 20457 Hamburg.
Postfach, 20448 Hamburg
Telephone (040) 36170. Cables Allianzfrank
Telex 211392 azhh d.
Facsimile (040) 36173322
Sd- Sd-

pray for. It depends upon the safety of the goods during the voyage as well as the safety of the vessel that carries the goods. The loss of or damage to goods during the voyage would affect any one or more parties involved in the transaction, *viz.*, the importer, the exporter, the shipping company and the bank which has paid against the documents covering the goods. Marine insurance offers the desired cover against loss of or damage to the goods during the transit. It allows a free flow of international trade by absorbing an important uncertainty connected with it.

In India marine insurance is governed by the Marine Insurance Act, 1963. Section 3 of the Act defines a contract of marine insurance as "an agreement whereby the insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against marine losses, that is to say, the losses incidental to marine adventure."

Marine insurance may cover the ship (hull insurance) or the goods (cargo insurance). Our interest is to study in some detail the marine cargo insurance. The consideration for which a marine insurance contract is undertaken is the 'premium'.

❑ Nature of Marine Cargo Insurance

1. Parties The 'proposer' under the policy may be the shipper or the importer. The proposer may approach the insurance company directly or through an 'agent' or a 'broker' because they know well the intricacies of marine insurance business. The insurers in marine insurance are generally called 'underwriters'. The person who is to receive payment in case of loss or damage is the 'assured'.

2. Insurable interest A person is having an insurable interest if he is interested in the safe arrival of the cargo. Section 8 (1) of the Marine Insurance Act provides that the assured must be interested in the subject-matter insured at the time of the loss, though he need not be interested when the insurance is effected. The shipper/exporter has the insurable interest since he is the owner of the goods. The buyer acquires an insurable interest at a later date, *i.e.*, when the goods are boarded on the ship. Thus either the seller or the buyer may effect the insurance. If the sale contract is on CIF (Cost, Insurance and Freight) basis, the seller has to arrange for insurance. If the contract is on CFR (Cost and Freight) or FOB (Free on Board) basis, it is for the buyer to arrange for insurance.

3. Utmost good faith A contract of insurance is a contract of *uberrimae fidei*, *i.e.*, one of utmost good faith. If either party to the contract has concealed any material fact, the contract can be avoided by the other party.

4. Indemnity The contract of marine insurance is a contract of indemnity. The assured under the policy is not allowed to make a profit out of a claim under the insurance. But the marine insurance does not represent a pure indemnity. At the time the policy is taken, the value of the cargo is agreed between the parties. In the valuation for the insurance, in addition to the cost, the transportation expenses and a certain percentage of profit is also included. Normally the insurance is affected for CIF value plus 10%.

5. Assignment A marine policy can be transferred by assignment unless it contains terms expressly prohibiting assignment. Since a marine cargo insurance does not normally prohibit assignment, it can be assigned. The assignment can be made either before or after a loss. The general practice is to get the policy assigned to bank's name by an endorsement thereon.

❑ Marine Insurance Policy

1. Contents of policy The Marine Insurance Act provides that a contract of marine insurance shall not be admitted in evidence unless it is embodied in a marine policy in accordance with the Act. Marine insurance policy may be issued in the form given in the schedule to the Act, which follows the standard format of the Lloyds of London. The policy must specify the following:

(*i*) the name of the assured or of some person who affects the insurance on his behalf;
(*ii*) the subject-matter insured and risk insured against;
(*iii*) the voyage or period of time or both, as the case may be, covered by the insurance;
(*iv*) the sum or sums insured; and
(*v*) the name or names of the insurer or insurers. The marine policy may be signed by or on behalf of two or more insurers.

2. *Voyage and time policies* A voyage policy covers the goods from the commencement and till the completion of a particular voyage. A time policy covers the risk for a specified period mentioned in the policy. A contract for both voyage and time may be included in the same policy. A time policy can be issued for a maximum period of 12 months.

3. *Valued and unvalued policies* A policy may be either valued or unvalued. In a valued policy the value of goods insured is agreed between the assured and the insurer. An unvalued policy is a policy which does not specify the value of the goods, but subject to the limit of the sum insured, leaves the insurable value to be subsequently ascertained.

4. *Specific and open policies* A policy issued against specific shipment of goods is known as specific policy. This has to be on a stamped document. The policy should be issued in the standard format.

Exporters having continuous shipment may opt for an open policy. Under this arrangement a policy covering the expected shipments for a period of, say, one year, is taken. As and when shipment is made, they are declared to the insurer and covered under the insurance. The insurance policy issued for the overall limit will be a stamped document. For the declaration of shipment made under the insurance separate certificates of insurance are issued. The certificates of insurance are unstamped as the original policy is stamped. A variant of the practice is the 'open cover'. An open cover is similar to an open policy, but is not a legal document and not executed on stamped paper. Specific policies or certificates of insurance issued under the open cover are stamped.

❑ Marine Losses

Basic Risks

The basic risks covered by any marine insurance policy are:

(*i*) Perils of Sea which include damage to the vessel or cargo by forces of waves, storms, stranding of the vessel, sinking of the vessel and collision with other vessel, etc.
(*ii*) Fire which includes damage directly due to fire or efforts to extinguish the fire.
(*iii*) Jettison which means voluntary throwing overboard of some cargo to save the ship and the rest of the cargo.
(*iv*) Barratry which means loss due to fraudulent or wrongful acts of the captain of the vessel or its crew.

Types of Losses

The loss of goods insured may be a total loss or partial loss.

Total loss A total loss may be either an actual total loss or a constructive total loss. When the goods insured are destroyed or so damaged as to cease to be a thing of the kind insured, or where the assured is irretrievably deprived thereof, there is an actual total loss. The loss is a constructive total loss appearing to be unavoidable or because it could not be preserved from actual total loss without an expenditure which would exceed their value when the expenditure had been incurred.

Partial loss Partial loss is defined as a loss other than total loss. Partial loss may include particular average loss or general average loss.

General average loss In time of general peril an extraordinary sacrifice or expenditure may be made or incurred for the purpose of preserving the properties in common. Examples of such acts are:

(*a*) Cargo jettisoned in an effort to refloat the vessel.
(*b*) Goods damaged by water used to extinguish a fire, provided the goods themselves have not been on fire.
(*c*) Expenses of entering and leaving a port of refuge.
(*d*) Expenses of discharging, storing and reloading of the cargo if that be necessary for the common safety.

An act as is indicated above is known as general average act and the loss the general average loss. Where there is general average loss, the party on whom it falls is entitled to a rateable contribution from the other parties interested. Such contribution is called the general average contribution. Where the assured has incurred a general average of expenditure, he may recover from the insurer in respect of the proportion of the loss which falls upon him. In respect of a general average sacrifice he may recover from the insurer in respect of the whole loss without having enforced his right of contribution from the other parties liable to contribute. Where the assured has paid, or is liable to pay, a general average contribution in respect of the interest insured, he may recover therefor from the insured.

Particular average loss A particular average loss is a partial loss of the goods insured, caused by a peril insured against, and which is not a general average loss. While the general average loss is voluntarily undertaken for the common safety of all the parties insured, a particular average loss is fortuitous or accidental. It cannot be partially shifted to others but has to be borne by the person directly affected.

We may summarise the different types of losses as in fig. 22.2.

❑ Risks Covered

The exporter can get cover for different risks according to his choice. The risks covered are indicated by attaching the relevant cargo clause to the policy. The standard cargo clauses used in many countries, including India, are known as the Institute Cargo Clauses as they have been evolved by the Institute of London Underwriters. The principal cargo clauses are Clause C, Clause B and Clause A, affording greater protection in the same order.

❑ Risks not Covered

There are certain risks which are not covered by a marine insurance policy under any of the cargo clauses mentioned above. They are:

(*a*) loss, damage or expense caused by delay and inherent vice or nature of the subject-matter;
(*b*) loss, damage or expense attributable to wilful misconduct of the insured;
(*c*) ordinary leakage, ordinary loss in weight or volume, or ordinary wear and tear of the subject-matter insured;

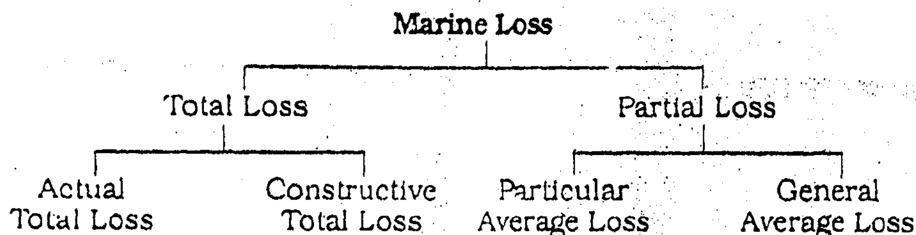


Fig. 22.2. Types of Marine Losses.

(*d*) insufficiency or unsuitability of packing;
(*e*) deliberate damage to or deliberate destruction of the goods;
(*f*) loss, damage or expense arising from insolvency or financial default of the owners, managers, charterers or operators of the vessel; and
(*g*) loss, damage or expense arising from the use of atomic weapons or nuclear fission and/or other like reaction or radioactive force.

Institute Cargo Clauses

1. Institute cargo clause (C) The policy under Cargo Clause (*C*) covers loss or damage to goods covered by:

(*i*) fire or explosion;
(*ii*) standing, grounding, sinking or capsizing of the vessel;
(*iii*) overturning or derailment of land conveyance;
(*iv*) collision or contact of vessel, craft or conveyance with any external object other than water;
(*v*) discharge of cargo at a port of distress;
(*vi*) general average sacrifice; and
(*vii*) jettison.

2. Institute cargo clause (B) In addition to the risks covered by Institute Cargo Clause (C), the following risks are covered by a policy with Cargo Clause (*B*):

(*i*) loss or damage to the goods attributable to earthquake, volcanic eruption or lightning;
(*ii*) washing overboard;
(*iii*) loss or damage to the goods caused by entry of sea, lake or river water into vessel, craft, hold, conveyance, container, lift van or place of storage; and
(*iv*) total loss of any package lost overboard or dropped whilst loading on to, or unloading from, vessel or craft.

By paying extra premium the following additional risks can be covered under policy under Institute Cargo Clause (*B*). They will appear as endorsements to the policy:

(*i*) Theft, pilferage and non-delivery,
(*ii*) Fresh and/or rain and/or river water damage,
(*iii*) Hook, oil, mud, acid and damage by other cargo,
(*iv*) Heating and sweating,
(*v*) Breakage, denting, chipping, scratching and blending,
(*vi*) Leakage, and
(*vii*) Bursting and tearing.

3. Institute cargo clause (A) The policy with Cargo (A) offers the widest cover. It provides cover against all risks except war and strike, riot and civil commotion.

4. War and SRCC cover The exporter can obtain war, strike, riot and civil commotion cover along with any of the three types of policies by payment of an additional premium. The above cover is granted by attaching Institute War Clauses (Cargo) to the policy of insurance.

Warehouse-to-Warehouse Clause

Marine policies usually provide for a warehouse-to-warehouse clause which states that the goods are insured from the time they leave the warehouse of the exporter and remains in force till the goods reach the destination and are stored in a warehouse there. But on the ship reaching the destination, if the goods cannot be taken delivery of due to reason beyond the control of the consignee, the insurance will be valid for 60 days from the date of arrival of the ship after which it expires. Thus, the insurance will expire on the goods being placed in a godown in the importer's country or on expiry of 60 days from the date of arrival of the ship whichever is earlier. But the period of 60 days is allowed only in cases where the delay is beyond the control of the importer.

☐ Marine Policy under Letter of Credit

1. ***The document*** Insurance documents must appear on their face to be issued and signed by insurance companies or underwriters or their agents [Article 34 (*a*)] Insurance may be arranged through insurance brokers. If the proposal is acceptable to him he would issue a cover note which would later on be replaced by an insurance policy. The insurance is effective from the date of cover note. Cover notes issued by brokers will not be accepted unless specifically authorised in the credit [Article 34 (*c*)].

Unless otherwise stipulated in the credit, banks will accept an insurance certificate or a declaration under an open cover pre-signed by insurance companies or underwriters or their agents. If a credit specifically calls for an insurance certificate or a declaration under an open cover, banks will accept, in lieu thereof, an insurance policy.

2. ***Number of copies*** If the insurance document indicates that it has been issued in more than one original, all the originals must be presented unless otherwise authorised in the credit [Article 34 (B)].

3. ***Type of insurance*** Credits should stipulate the type of insurance required and, if any, the additional risks which are to be covered. Imprecise terms such as "usual risks" or "customary risks" should not be used; if they are used, banks will accept insurance documents as presented without responsibility for any risks not being covered [Article 35 (*a*)].

Failing specific stipulations in the credit, banks will accept insurance documents as presented without responsibility for any risk not being covered [Article 35 (*b*)].

When a credit stipulates "insurance against all risks", banks will accept an insurance document which contains any "all risks" notation or clause, whether or not bearing the heading "all risks", even if the insurance document indicates that certain risks are excluded, without responsibility for any risk(s) not being covered (Article 36). It may be noted that the present Institute Cargo Clause (A) corresponds to former Institute Cargo Clause (All Risks).

4. ***Franchise clause*** Unless otherwise stipulated in the credit, banks will accept an insurance document which indicates that the cover is subject to a franchise or an excess (deductible) [Article 35 (*c*)]. Franchise is a stipulated percentage which must be reached before a loss can be recovered under the policy. If the percentage is exceeded, the entire loss is paid. Excess is a percentage which is deducted from all claims on the policy. If the amount of loss does not reach the specified percentage, it is not payable at all; if it exceeds the percentage, only the excess is payable and not the entire loss.

5. ***Amount of insurance*** Unless otherwise stipulated in the credit, the minimum amount for which the insurance document must indicate the insurance cover to have been effected is the CIF (Cost, insurance and freight ... "named port of destination") or CIP (Freight/carriage and insurance paid to ... "named point of destination") value of the goods, as the case may be, plus 10%. However, if banks cannot determine the CIF or CIP value, as the case may be, from the documents on their face, they will accept as such minimum amount 110% of the amount for which payment, acceptance or negotiation is requested under the credit, or 110% of the gross amount of the invoice, whichever is greater [Article 34 (*f*) (*ii*)].

6. ***Currency of insurance*** Unless otherwise stipulated in the credit, the insurance document must be expressed in the same currency as the credit [Article 34 (*f*) (*i*)].

7. ***Date of policy*** Unless otherwise stipulated in the credit, or unless it appears from the insurance document(s) that the cover is effective at the latest from the date of loading on board or despatch or taking in charge of the goods, banks will not accept an insurance document which bears a date of issuance later than the

date of loading on board or despatch or taking in charge as indicated by the transport document(s) [Article 34 (*e*)].

*8. **Coverage of voyage*** The insurance should cover the entire voyage. If transhipment is permitted in credit, the insurance cover should be available for transhipment risks also.

❑ Claim Procedure

In the event of loss or damage to the goods giving risks to a claim under the policy the assured should do the following:

(*i*) Give a notice of loss to the insurance company immediately;
(*ii*) Take all steps to minimise the loss, preserve all rights against third parties;
(*iii*) Arrange for survey by ship surveyors if the packages show any outward sign of damage of loss;
(*iv*) Arrange for insurance survey by the insurance company in other cases;
(*v*) Prefer claims with shipping company and other parties where required.

The time limit for filing suit against the shipping companies is one year from the date of discharge.

The time following documents should be submitted to the insurance company while preferring a claim:

(*i*) Original insurance policy,
(*ii*) Original invoice and packing list,
(*iii*) Copy of bill of lading,
(*iv*) Survey report/short land/non-delivery/landed but missing certificates,
(*v*) Copies of correspondence exchange with carriers or bailees, and
(*vi*) Claim bill.

22.3. INVOICES

1. Commercial Invoice

A commercial invoice is a statement containing full details of the goods shipped. The general contents of a commercial invoice used in foreign trade are:

(*a*) names and addresses of the seller and the buyer;
(*b*) details of goods shipped—quantity, quality, description and value;
(*c*) packing details and packing marks;
(*d*) price and amount payable by the buyer;
(*e*) terms of trade—FOB, CFR or CIF, etc.;
(*f*) details of freight charges, insurance premia and other charges;
(*g*) reference to the sale contract in fulfilment of which the shipment is made;
(*h*) name of the vessel in which the goods are shipped; and
(*i*) reference to the licence number under which the import is made.

An invoice is not a document of title to goods but is only a description of goods. It serves the purpose of verifying that the goods shipped and the price charged are as per the contract. Though there is no specific proforma in which an invoice is to be prepared certain countries may prescribe the format in which invoices for imports into their countries have to be prepared. Such requirements have to be kept in view while preparing the invoice.

Provisions of UCP Article 37 contains provisions regarding commercial invoice. Unless otherwise stipulated in the credit, commercial invoices must appear on their face to be issued by the beneficiary named in the credit and must be made out in the name of the applicant for the credit.

Unless otherwise stipulated in the credit, banks may refuse commercial invoices issued for amounts in excess of the amount permitted by the credit. Nevertheless, if a bank authorised to pay, incur deferred payment undertaking, accept drafts or

negotiate under a credit, accepts such invoices, its decision will be binding upon all parties, provided such bank has not paid, incurred a deferred payment undertaking, accepted drafts or negotiated for an amount in excess of that permitted by the credit.

The description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit.

2. Consular Invoice

It is a special type of invoice, usually in a prescribed form, describing the details of the goods shipped and sworn as being correct in all respects by the exporter before the Consul of the importing country stationed in the exporting country. The Consul of the importing country then certifies the invoice. A consular invoice may also contain a declaration about the place of origin of goods. It would serve the importer in getting the duties assessed and goods released by the customs without much delay. Any false declaration in the consular invoice involves heavy penalty.

3. Legalised/Visaed Invoice

The purpose of a legalised or visaed invoice is similar to that of a consular invoice. The difference is that instead of a specific format of invoice, the ordinary commercial invoice is presented to the Embassy or Consulate for certification. Certain countries in Middle East require legalised invoice.

4. Certified Invoice

A commercial invoice becomes a certified invoice when it contains certain certification by the exporter. The certification may state that (*i*) the goods are of particular country of origin; or (*ii*) the goods are in conformity with a specific contract or proforma; or (*iii*) any other stipulation of the importer has been fulfilled.

5. Proforma Invoice

It is essential to make a distinction between a commercial invoice and a proforma invoice. A proforma invoice contains all the particulars in a commercial invoice. It is distinguished from the latter by the words 'proforma invoice' appearing on it.

A proforma invoice does not evidence a sale. The proforma invoice may be required in the following cases:

(*i*) It may be the basis on which the contract of sale is concluded later.

(*ii*) When goods are sent on consignment basis, a proforma invoice may be used since the goods are sent only to an agent of the seller; it serves as a guide as to the price at which the agent should sell the goods.

(*iii*) It may be used to support a tender for sale contract.

Details of the goods in the commercial invoice should agree with that in the proforma invoice.

6. Other Invoices

Countries like USA and Canada require customs invoices in the prescribed form for the purpose of their customs valuation. Combined Certificates of Value and Origin are used between members of the Commonwealth. Special forms of invoice are also used for trade between members of other free trade areas such as the EEC and LAFTA.

22.4. CERTIFICATES AND OTHER DOCUMENTS

1. Certificate of Origin

A certificate of origin declares the place of actual manufacture or growth of the goods. A country may place restrictions on imports from certain countries. Or, preferential treatment may be accorded in tariff for imports from certain countries.

For both these purposes, certificate of origin becomes necessary. Usually such certificates are issued by the Chambers of Commerce or Trade Associations in the exporting country.

2. Packing List

The list would contain the details of goods contained in individual packages. This helps in identifying the contents of specified packages and thus may facilitate assessment by the customs.

3. Weight Note or Certificate

This gives the weight of individual items shipped. If the goods are shipped in bulk, like foodgrains, the list may cover the entire shipment. It is generally issued by a public agency. Since the weight certificates are issued by an independent agency, the importer is assured that goods of proper weight have been shipped.

4. Quality or Inspection Certificate

This may be issued by the supplier or by an independent inspection agency that the goods were examined and found to be as required under the contract of sale.

5. Analysis Certificate

This may be issued in the case of chemicals, drugs, etc., showing the results of analysis made of their ingredients.

6. Health Certificates, etc.

Where live animals are exported, they may certify that the animals are of good health; if foodgrains are exported, they are fit for human consumption; the packing materials are not a health hazard.

7. Blacklist Certificate

A country at war with or having a strained political relationship with another country may require a certificate that: (*i*) the goods are not of the origin of the particular country, or (*ii*) the parties involved in the transaction are not blacklisted, or (*iii*) the transport vessel will not touch the other country.

Provision of UCP

1. When documents other than transport documents, insurance documents and commercial invoices are called for, the credit should stipulate by whom such documents are to be issued and their wording or data content. If the credit does not so stipulate, banks will accept such documents as presented, provided that their data content is not inconsistent with any other stipulated document presented (Article 21).
2. Unless otherwise stipulated in the credit, banks will accept a document bearing a date of issuance prior to that of the credit subject to such document being presented within time limits set out in the credit and in the UCP (Article 22).

23 Transport Documents

The carriage of goods in international trade involves more than one mode of transport. Goods are carried up to seaport or airport by land and from there they are transported to the buyer's country. The goods may again be transported by land/rail to reach the buyer's place. Carriage by each mode of transport is covered by a separate contract of carriage. But the modern trend is the move towards multimodal transport, providing for the continuous obligation of the carrier for more than one mode of transport. In fact, the major reason for the last two revisions of UCP has been the advances in transport technology.

23.1. BILL OF LADING

In international trade shipping occupies an important place as a mode of transport. The document evidencing the carriage of goods by sea is the 'bill of lading'. *A bill of lading is a document issued by the shipping company or its agent, acknowledging the receipt of goods for carriage which are deliverable to the consignee or his assignee in the same condition as they were received.*

❑ Nature of Bill of Lading

A bill of lading has been defined as "a document which evidences a contract of carriage by sea and the taking over of loading of the goods by the carrier, by which the carrier undertakes to deliver the goods against surrender of the document." A bill of lading renders the following three functions:

(*i*) It is an evidence of contract of carriage;
(*ii*) It is a receipt for the goods received by the carrier; and
(*iii*) It is a document of title to goods.

1. Receipt for goods received by carrier The primary function of a bill of lading is to serve as a receipt by the shipping company acknowledging that the goods have been received for transportation. After receiving the goods into its charge the shipping company should, on demand by the shipper, issue to him a bill of lading showing among other things (*a*) the leading marks necessary for identification of the goods, (*b*) either the number of packages or pieces, or the quantity, or weight as the case may be, and (*c*) the apparent order and condition of the goods. Such a bill of lading shall be *prima facie* evidence of the receipt by the carrier of the goods as therein described (Article IV, Rules 3 and 4 of The Hague Rules). Further, the Indian Bill of Lading Act provides that every bill of lading shall be conclusive evidence of such shipment notwithstanding that such goods or some part thereof may not have been so shipped, unless the holder of the bill of lading shall have had actual notice at the time of receiving the same that the goods had not in fact been taken on board.

2. Evidence of contract of carriage The contract of carriage by sea is known as the contract of affreightment. The contract of affreightment is concluded long before the bill of lading is issued. This is because the practice is to book the shipping space in advance. The bill of lading thus serves as an evidence of the terms and conditions under which the contract is concluded. Normally, every bill of lading contains the terms and conditions of the contract in fine print, on the back of the instrument. It is also possible for the bill of lading to refer some other source for the terms and conditions.

3. Document of title to goods A bill of lading is a document of title to goods and recognised as such by the Indian Sale of Goods Act. The effect is that possession of a bill of lading confers the right to the goods covered by it. The person who is in possession of the bill of lading in his name can, therefore, claim the delivery of

goods to him. During transit, the holder can deliver the goods by merely transferring the bill of lading.

A bill of lading is not a negotiable instrument though it has some features of negotiability. Thus, it can be transferred by endorsement and delivery and the transferee for value and in good faith can sue in his own name. But it lacks one important feature of a negotiable instrument. In a negotiable instrument the transferee gets a better title than what the person from whom he receives it had. But a transferee in a bill of lading gets his rights subject to defects in the title of the transferor. In this connection Section 1 of the Indian Bills of Lading Act, 1356 provides: "Every consignee of goods named in a bill of lading and every endorsee of a bill of lading to whom the property in the goods therein mentioned shall pass, upon or by reason of such consignment or endorsement shall have transferred to and vested in him all rights of suit, and be subject to the same liabilities in respect of such goods as if the contract contained in the bill of lading had been made with himself." Thus, in the strict sense of the term a bill of lading is not a negotiable instrument. It is commonly termed a quasi-negotiable instrument.

❑ Mate's Receipt and Bill of Lading

Bill of lading should be distinguished from the mate's receipt. When the goods are delivered to the shipping company for transportation, at first a temporary receipt is issued which is known as the mate's receipt. On the basis of the mate's receipt, the shipper has to pay the port dues and other charges. After these formalities are over the mate's receipt is exchanged for a regular bill of lading.

A mate's receipt is not a substitute for bill of lading. It is not a document of title to goods. The transfer of a mate's receipt does not pass the title in the goods, nor is its possession equivalent to possession of the goods. Its statement does not bind the shipping company. It is, however, *prima facie* evidence of the quantity and condition of the goods received. The possessor of the mate's receipt is generally the person entitled to have the bill of lading issued to him.

Where the letter of credit calls for a bill of lading, mate's receipt cannot be accepted.

❑ Non-negotiable Sea Waybills

In recent years, as a move towards simplification of documentary practices, bills of lading are frequently replaced by non-negotiable documents similar to those which are used for other modes of transport than carriage by sea. These documents are called 'sea waybills', 'liner waybills', 'freight receipts', or variants of such expressions. These non-negotiable documents are quite satisfactory to use except where the buyer wishes to sell the goods in transit by surrendering a paper document to the new buyer.

The advantage of a waybill is that it reduces the incidence of fraud. A copy of the waybill is received by the purchaser immediately by fax, and the delivery of the goods is not dependent on the production of the original document as in the case of bill of lading. The problems of goods arrived ahead of documents and the inconvenience of delivery against letters of guarantee are also avoided.

A waybill is non-negotiable instrument; it is not a recognised document of title. Therefore FEDAI has advised that if a bank accepts a waybill, it has to ensure that its security is well protected, either by naming the bank as consignee or by marking a lien on the waybill.

Under a letter of credit, where a bill of lading is called for, these non-negotiable documents will not be accepted. The newly added Article 24 of UCP provides the conditions to be fulfilled where a credit calls for a non-negotiable sea waybill. These are similar to the provisions for bill of lading as discussed below.

❑ Description of Goods

The bill of lading gives a brief description of the goods accepted for transportation. The description given in the bill of lading should not be different from the requirement of the credit. Where the description differs, the bank is right in refusing to accept the documents. Where the credit called for documents covering a shipment of Coromandel groundnuts, the bill of lading evidenced shipment of machine shelled groundnut kernels, the bank refused to pay. It was argued against the bank that both the descriptions refer to the same thing. The Court upheld the decision of the bank asserting that a banker cannot be expected to have knowledge of the customs and terminology of each trade.

However, the description in a bill of lading need not be a complete description of the goods. It is sufficient if the description in the bill of lading does not contradict the description in the letter of credit. Article 37 (c) of the UCP provides: "The description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents the goods may be described in general terms not inconsistent with the description of the goods in the credit." It is, therefore, clear that full description of the goods is not necessary in the bill of lading, since it would not be feasible to include the description, sometimes running into a few pages, in the bill of lading. If the description generally agrees with the wordings of the letter of credit, it would be accepted.

❑ Bill of Lading Under a Letter of Credit

The letter of credit normally calls for a "Full Set Clean on Board Freight paid Ocean bill of lading made to Order and blank endorsed."

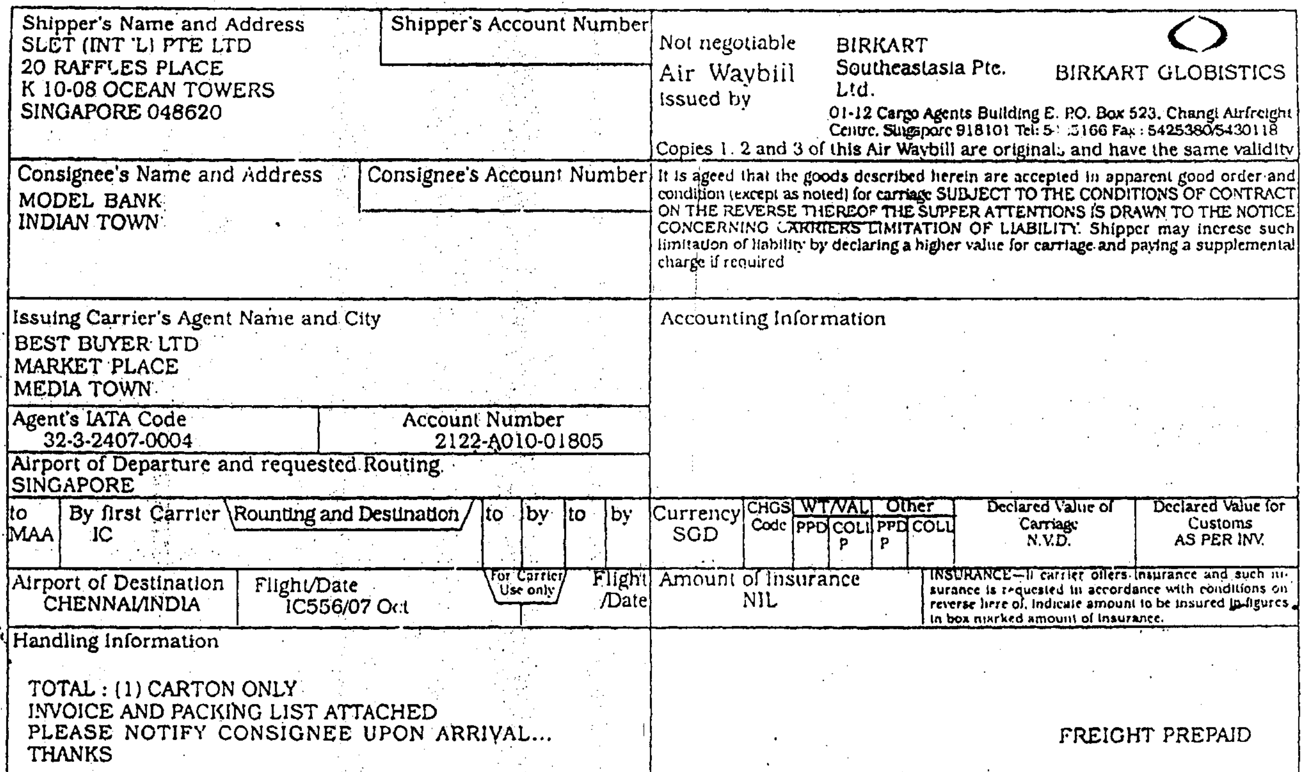
Each of the above requirement is discussed below.

1. Full set of bill of lading The bill of lading is usually drawn in sets of more than two negotiable copies, goods deliverable against any one of the copies surrendered to the shipping company duly discharged. Each negotiable copy is called an original of the bill of lading. The number of negotiable copies prepared would be mentioned in the bill of lading which would also provide that "one of the copies being accomplished, the others shall stand void."

If more than one copy of the bill of lading is negotiated by the consignee to third parties, the first negotiation will be valid as against the subsequent ones. However, the shipping company is discharged from its liability if it delivers against whichever copy is presented to it first. In a letter of credit transaction, the bank would like to retain control over the goods till it is reimbursed by the importer. It is, therefore, essential that the bank obtains all the copies of the bill of lading. The UCP provides that unless otherwise stipulated in the credit, banks will accept a bill of lading which consists of a sole original bill of lading or, if issued in more than one original, the full set as so issued [Article 23 (*a*) (*iv*)].

2. Clean and claused bill of lading Article 32 (*a*) of UCP states: "A clean transport document is one which bears no clause or notation which expressly declares a defective condition of the goods and/or the packaging." Therefore, a clean bill of lading is one which either states that the goods are received in good condition or does not make any remark about the defective condition of the goods or packing. "The formal acknowledgement by the carrier that the goods have been 'received on board in apparent good order and condition' is regarded both in practice and in law as a representatio in to the consignee of the goods or his successor in title that the carrier has made a reasonable inspection of the goods and found no defect in them. If the contract of carriage is subject to The Hague Rules, the carrier will be liable to the consignee for damage found on delivery at the port of destination unless the circumstances fall within any of the defined exceptions.

As against a clean bill of lading a 'claused' or 'dirty' or 'foul' bill of lading contains an adverse remark about the goods or packing, such as "packages torn", or "drums



Shipper's Name and Address
SLET (INT 'L) PTE LTD
20 RAFFLES PLACE
K 10-08 OCEAN TOWERS
SINGAPORE 048620

Shipper's Account Number

Not negotiable
Air Waybill
issued by

BIRKART
Southeastasia Pte.
Ltd.

BIRKART GLOBISTICS

01-12 Cargo Agents Building E. P.O. Box 523, Changi Airfreight Centre, Singapore 918101 Tel: 5[illegible]3166 Fax : 5425380/5430118

Copies 1, 2 and 3 of this Air Waybill are originals and have the same validity

Consignee's Name and Address
MODEL BANK
INDIAN TOWN

Consignee's Account Number

It is ageed that the goods described herein are accepted in apparent good order and condition (except as noted) for carriage SUBJECT TO THE CONDITIONS OF CONTRACT ON THE REVERSE THEREOF THE SUPPER ATTENTIONS IS DRAWN TO THE NOTICE CONCERNING CARRIERS LIMITATION OF LIABILITY. Shipper may increse such limitation of liability by declaring a higher value for carriage and paying a supplemental charge if required

Issuing Carrier's Agent Name and City
BEST BUYER LTD
MARKET PLACE
MEDIA TOWN

Accounting Information

Agent's IATA Code	Account Number
32-3-2407-0004	2122-A010-01805

Airport of Departure and requested Routing
SINGAPORE

to	By first Carrier	Rounting and Destination	to	by	to	by	Currency	CHGS Code	WT/VAL PPD	WT/VAL COLL	Other PPD	Other COLL	Declared Value of Carriage	Declared Value for Customs
MAA	IC						SGD			P	P		N.V.D.	AS PER INV.

Airport of Destination	Flight/Date	For Carrier Use only	Flight /Date	Amount of Insurance	INSURANCE—If carrier offers insurance and such insurance is requested in accordance with conditions on reverse here of, indicate amount to be insured in figures in box marked amount of insurance.
CHENNAI/INDIA	IC556/07 Oct			NIL	

Handling Information

TOTAL : (1) CARTON ONLY
INVOICE AND PACKING LIST ATTACHED
PLEASE NOTIFY CONSIGNEE UPON ARRIVAL...
THANKS

FREIGHT PREPAID

No. of Pieces RPCP	Gross Weight	Kg lb	Rate Class Commodity item No.	Chargeable Weight	Rate / Charge	Total	Nature and Quantity of Goods (Incl. Dimensions or Volume)
1	94.0			94.0	AS ARRANGE		BEARINGS.AS COVERED BY OUR INVOICE NO. 3080/ 12903 1/110×96×45 cm = 475200cc. = V79.5 kg

CASE MARKS:

LRT
KS/IMP/II/2050/2000
TO: CHENNAI
FROM: SINGAPORE
C/NO: 1290/1
HAWB: SGD 24517

Prepaid	Weight Charge	Collect	Other Charges
AS ARRANGE		PREPAID	
	Valuation Charge		
	Tax		
	Total other Charges Due Agent		Shipper certifies that the particulars on the face hereof are correct and that insofar as part any of the consignment contains dangerous goods, such part is properly described by name and is in proper condition for carriage by air according to the applicable Dangerous Goods Regulations.
	Total other Charges Due Carrier		BIRKART SOUTHEASTASIA PTE. LTD Signature of Shipper or his Agent
Total prepaid	Total collect		
Currency Conversion Rates	Co charges in Dest. Currency		07/Oct./2000 SINGAPORE Sd- Executed on (Date) at (Place) Signature of issuing Carrier or its Agent
For Carrier's Use only at Destination	Charges at Destination		Total collect Charges
			3-ORIGINAL (FOR SHIPPER)

leaking", etc. The carrier is always entitled after inspection to stamp, write or type clauses on the bill of lading to indicate that the packing is unsuitable or insufficient or that the condition of the goods is below the normal standard or the damage exists or evidence of possible damage is apparent. Clauses of that kind indicate that the carrier modifies, to the extent, his statement that the goods are in apparent good order and condition, and consequently reduces his liability under. The Hague Rules to the extent that damage on delivery can be identified with or directly attributed to the defects and condition recorded by such clauses. A claused bill of lading would not be accepted by the bank unless the specific remark is acceptable as per the terms of the letter of credit. Article 32 (*b*) provides: "Banks will not accept transport documents bearing such clauses or notations unless the credit expressly states the clauses or notations which may be accepted."

Article 31 (*ii*) of UCP provides: "Unless otherwise stipulated in the credit, banks will accept transport documents which bear a clause on the face thereof such as 'shippers load and count' or 'said by shipper to contain' or words to similar effect." The provision of UCP is to facilitate containerised transport where the contents of the containers cannot be verified by the shipping company.

3. Port of loading and port of discharge The bill of lading should indicate the same port of loading and the port of discharge as stipulated in the letter of credit. However, a bill of lading which indicates a place of taking in charge different from the port of loading, and/or a place of final destination different from the port of discharge, and/or contains the indication 'intended' or similar qualification in relation to the port of loading and/or port of discharge, as long as the document also states the ports of loading and/or discharge stipulated in the credit [Article 23 (*a*) (*iii*)]. The terms 'place of taking in charge' (which occurs earlier in the movement of goods than the port of loading) and 'final destination' (which occurs subsequent to port of discharge) are applicable in container and multimodal transport extending the responsibility of the carrier beyond sea voyage. Their presence, in addition to the requirement of the credit regarding the port of loading and port of discharge does not vitiate its requirements.

4. On board and received for shipment bill of lading An 'on board' bill of lading is one which states that goods to be carried have actually been loaded into the ship. Sometimes the goods may be delivered to the shipping company but they may not be put into the ship because of non-availability of space or non-arrival of the vessel. In such cases the shipping company will issue a 'received for shipment' bill of lading whereby it acknowledges that goods have been received by it for carriage and will be carried by the next available vessel or a specified vessel. Article 23 (*a*) (*ii*) states that banks will, unless otherwise stipulated in the credit, accept a document which indicates that the goods have been loaded on board or shipped on a named vessel. Therefore, when a marine bill of lading is required and the letter of credit is silent, a received for shipment bill of lading is not acceptable.

Loading on board or shipment on a named vessel may be indicated by pre-printed wording on the bill of lading that the goods have been loaded on board a named vessel or shipped on a named vessel, in which case the date of issuance of the bill of lading will be deemed to be the date of loading on board and the date of shipment.

When the goods are subsequently put on the board of the ship, a received for shipment bill of lading will be stamped with the notation 'on board', the name of the vessel indicated if not already there, signed or initialled and dated by the carrier or his agent. A received for shipment bill of lading thus noted is as good as any 'on board' bill of lading. In this case the date of the on board notation will be deemed to be the date of shipment.

If the bill of lading contains the indication 'intended vessel', or similar qualification in relation to the vessel, loading on board a named vessel must be evidenced by an on board notation which includes the name of the vessel on which

the goods have been loaded, even if they have been loaded on the vessel named as the 'intended vessel'.

If the bill of lading indicates a place of receipt or taking in charge different from the port of loading, the on board notation must also include the port of loading stipulated in the credit and the name of the vessel on which the goods have been loaded, even if they have been loaded on the vessel named in the bill of lading. This provision also applies whenever loading on board the vessel is indicated by pre-printed wording on the bill of lading.

5. Shipped on deck bill of lading Goods carried on the deck of the ship are subject to the risk of damage and, therefore, if the bill of lading mentions that the goods are carried on deck it is not accepted under a letter of credit unless the credit authorises it. Nevertheless, banks will accept a transport document which contains a provision that the goods may be carried on deck, provided it does not specifically state that they are or will be loaded on deck [Article 31 (*i*)]. Thus mere reservation of the right to carry the goods on the deck will not be a ground for refusal of the document unless it states that the goods are or will be loaded on deck.

6. Freight paid and freight collect bill of lading If the contract between the seller and the buyer is on FOB basis, the freight is payable by the importer. In such a case the bill of lading will be a 'freight to pay' or 'freight collect' bill of lading, on which freight is payable at the destination by the cosignee. If the sale contract is on CIF and CFR terms, the price quoted includes freight and, therefore, the exporter has to pay the freight in advance. In such cases the bill of lading will be a 'freight paid' bill of lading. Article 33 of UCP is quite clear on this subject:

"(*a*) Unless otherwise stipulated in the credit, or inconsistent with any of the documents presented under the credit, banks will accept transport documents stating the freight or transportation charges (hereinafter referred to as 'freight') have still to be paid.

(*b*) If a credit stipulates that the transport document has to indicate that freight has been paid or prepaid, banks will accept a transport document on which words clearly indicating payment or prepayment of freight appear by stamp or otherwise, or on which payment of freight is indicated by other means.

(*c*) The words 'freight prepayable' or 'freight to be prepaid' or words of similar effect, if appearing on transport documents, will not be accepted as constituting evidence of the payment of freight.

(*d*) Banks will accept transport documents bearing reference by stamp or otherwise to costs additional to the freight charges such as costs of, or disbursements incurred in connection with, loading, unloading or similar operations, unless the conditions of the credit specifically prohibit such reference."

7. Ocean bill of lading The stipulation that the bill of lading should cover transportation by an ocean-going vessel, as against smaller vessels used in inland transport, may be made to ensure safe voyage. This is a method of ensuring seaworthiness of the ship. UCP provides that banks will reject a transport document which indicates that the carrying vessel is propelled by sail only.

8. Straight or order bill of lading A bill of lading the goods covered by which are deliverable to a named consignee is known as a straight bill of lading as against an order bill of lading which provides that the goods are deliverable to a named person or his order. A straight bill of lading is not a negotiable instrument and is normally taken in the name of the consignee (importer). Presentation of bill of lading may not be necessary for delivery of goods under a straight bill of lading if the consignee is known to the shipping company. Goods will be delivered to him against his receipt. The exporter or the bank cannot have any right over the goods once it is shipped, since the bill of lading is taken in the name of the consignee to whom the title passes. Therefore, a straight bill of lading may not be accepted by banks under a letter of credit.

An order bill of lading is normally taken in the name of the shipper or his order. The bill of lading will indicate the buyer as the 'notify party'. That is, on arrival at the port of destination a notice should be sent to the importer intimating the fact of arrival of cargo. But this does not entitle the importer to take delivery of the goods. Under an order bill of lading the title over the goods covered by it is transferred by endorsement and delivery of the bill of lading. The goods are deliverable to the last endorsee. Normally the letter of credit would require an order bill of lading with shipper's name as consignee and endorsed to the order of the bank or blank endorsed.

An order bill of lading is also known as 'negotiable' bill of lading.

❑ Other Types of Bill of Lading

1. Through or port-to-port bill of lading Where the goods are to be carried by two or more ships or partly by ship and partly by rail, the bill of lading providing for the continuous responsibility of all the shipping companies or the shipping company and the railway company is called a through bill of lading. Where issued by a railway company, it serves as a railway receipt for transport up to the port and as a bill of lading for the sea voyage. Since it does not specify that the goods are on board the ship, it is similar to a received for shipment bill of lading. Unless otherwise specified in the credit, a through bill of lading issued by shipping companies or their agents will be accepted even though they cover several modes of transport.

In a through bill of lading issued by the shipping company, the shipping company is liable for damages if it occurs during the sea voyage. For any damage to the goods during land transport the shipping company is not liable. Though the shipping company undertakes to arrange for land transport, the rail or road transport company entrusted with the job is supposed to work as agents of the consignor. Thus, under a through bill of lading, for the loss of goods, if any, during the land transport, the consignor cannot have recourse to the shipping company. To remedy this situation, the combined transport documents have been evolved which are discussed in the next section.

2. Stale bill of lading In order to avoid undue delay in presentation of documents for negotiation after effecting shipment, the letter of credit provides for a period from the date of the transport document within which they should be tendered for negotiation. A bill of lading presented for negotiation after the period allowed in the credit is considered a stale bill of lading. Article 43 (*a*) states that every credit should stipulate a specified period of time after the date of shipment during which presentation must be made in compliance with the terms and conditions of the credit. If no such period of time is stipulated, banks will not accept documents presented to them later than 21 days after the date of shipment. In any event, documents must be presented not later than the expiry date of the credit.

3. Charter party bill of lading A complete ship may be made available to a shipper for a particular voyage or for a particular period of time. The document containing the terms and conditions of this contract is known as the charter party. The shipper who has chartered the ship may agree to carry the goods of others in the ship and issue bill of lading for this purpose. The bill of lading thus issued is subject to the terms and conditions of the charter party. Unless specifically authorised in the credit, bills of lading which are issued subject to a charter party will be rejected [Article 23 (*a*) (*v*)]. Where the credit calls for or permits charter party bill of lading, a bill of lading subject to charter party will be accepted provided it fulfils the stipulations of the credit. But, even if the credit requires the presentation of the charter party contract in connection with a charter party bill of lading, banks will not examine such charter party contract, but will pass it on without responsibility on their part.

4. House bill of lading A few freight forwarders indulge in collection of cargo from different shippers and arrange for a consolidated shipment under their name, normally in containers. They issue their own bills of lading in favour of the shippers who have entrusted them with shipment. The bill of lading issued by such freight forwarders is known as 'house bill of lading'. A house bill of lading does not afford the protection to the shipper as is normally available under a regular bill of lading. The UCP provides that unless authorised by the credit the banks will reject a transport document issued by a freight forwarder unless it indicates that it is issued by such forwarder acting as a carrier or the agent of a named carrier.

5. Liner bill of lading A liner vessel is a ship operating on a fixed route between two ports or series of ports. It operates a regular scheduled service and the freight charges can be quoted from a fixed schedule. A conference is an arrangement between liners operating on the same route to avoid unhealthy competition among themselves. A liner bill of lading or a conference liner bill of lading ensures regular service and is welcomed by shippers. As against liner vessel is a tramp which is a chartered ship prepared to carry anything anywhere ; there are no regular trips. The freight charges vary and depend upon demand and supply.

6. Short form bill of lading Normally the bill of lading contains the full terms and conditions under which it is issued. A bill of lading, which indicates some or all of the conditions of carriage by reference to a source or document other than the bill of lading itself, is called a short form or blank back bill of lading. Unless the credit stipulates otherwise a short form bill of lading is acceptable; banks will not examine the contents of such terms and conditions (Article 23).

7. Third-party bill of lading It is a bill of lading in which the consignor is a party other than the seller. Unless otherwise stipulated in the credit banks will accept transport documents indicating as the consignor of the goods a party other than the beneficiary of the credit (Article 13).

23.2. MULTIMODAL TRANSPORT DOCUMENTS

The customary method of handling cargo for sea transport is known as 'break bulk cargo' under which each piece of cargo is handled separately. For instance, if the consignment consists of 40 packages, the consignor has first to arrange for its carriage to the port by land transport. The 40 packages are to be loaded individually at the factory and similarly unloaded at the port. They have again to be loaded individually into ship. Similar operations are required even if the consignment is carried by rail from the factory site to the port. The container system was developed to do away with the individual handling of packages. Containers are large and strong boxes (40′ × 8′ × 8′ or 20′ × 8′ × 8′) which can be easily placed on and locked into specially built trucks or railway wagons. All the packages are now put into a container which is lifted from the factory and carried to the port by a truck or by rail. At the port the entire container is lifted and loaded into the ship as a single piece. Thus developed the 'containerised cargo' or the 'unitized cargo'.

It was stated earlier that one disadvantage with through bill of lading is that the shipping company does not undertake the risk of damage of goods during the land journey. A need, therefore, arose for development of a document which would ensure continued responsibility of the transport company during the entire voyage. An effort in this direction was made by the International Chamber of Commerce (ICC) and the result was their Uniform Rules for a Combined Transport Document. These Rules* have no statutory force ; they operate by the contract made by the consignor and the shipping company.

In India, the era of containerised transportation began with the establishment of Inland Container Depot (ICD) at Bangalore, by the Government. The FEDAI in

* (1975 Revision) ICC Publication No. 298.

consultation with RBI and the Government brought out two brochures entitled FEDAI Rules for a Combined Transport Document (Brochure Nos. 081 and 082). Both the brochures are based on and incorporate to a great extent the Uniform Rules for Combined Transport Documents of ICC. Brochure 081 and brochure 082 differ slightly in providing for the liability of the transport operator. The combined transport is known as multimodal transport.

The Government passed the Multimodal Transportation of Goods Act, 1993 which now provides for the regulation of the multimodal transportation of goods, from any place in India to a place outside India on the basis of a multimodal transport contract.

Multimodal transportation means carriage of goods by two or more modes of transport from the place of acceptance of goods in India to a place of delivery of goods outside India.

A *multimodal transport document* may be negotiable or non-negotiable.

A *negotiable multimodal transport document* means a multimodal transport document which is—

(i) made out to order or to bearer; or
(ii) made out to order and is transferable by endorsement; or
(iii) made out to bearer and is transferable without endorsement.

A *non-negotiable multimodal transport document* means a multimodal transport document which indicates only one named consignee.

A multimodal transport document is to be regarded as document of title. Every consignee named in the negotiable or non-negotiable multimodal transport document and every endorsee of such document, as the case may be, to whom the property in the goods mentioned therein shall pass, upon or by reason of such consignment or endorsement, shall have all the rights and liabilities of the consignor (Section 8).

❑ Provisions of UCP

In a marine bill of lading, the ports of shipment and delivery are indicated. A multimodal transport document has to talk of something else. It indicates the place of taking charge and place of final destination (both inland) which may be different from the port of loading and port of destination. Further, in such documents the multimodal transport operator may not be in a position to foretell the name of the vessel, etc., in which the goods will be carried. Therefore, the UCP provides that a transport document which indicates a place of taking in charge different from the port of loading and/or a place of final destination different from the port of discharge, will not be rejected as long as the document also states the port of loading and/or port of discharge stipulated in the credit (Article 23). Similar is the position of a document which contains the indication 'Intended' or similar qualification, in relation to the vessel or other means of transport, and/or the port of loading and/or the port of discharge.

UCP provides a separate Article 26 for multimodal transport document whose provisions are similar to Article 23 on marine bill of lading with the difference that the former talks of despatch, taking in charge of goods in place of port of loading and port of discharge.

❑ Transport Documents Issued by Freight Forwarders

Unless otherwise authorised in the credit, banks will only accept a transport document issued by a freight forwarder if it appears on its face to indicate:

(i) the name of the freight forwarder as a carrier or multimodal transport operator and to have been signed or otherwise authenticated by the freight forwarder as carrier or multimodal transport operator, or

(*ii*) the name of the carrier or multimodal transport operator and to have been signed or otherwise authenticated by the freight forwarder as a named agent for or on behalf of the carrier or multimodal transport operator (Article 30).

Transhipment

Transhipment has been defined as a unloading and reloading from one vessel to another during the course of carriage from the port of loading or place of dispatch or taking in charge to the port of discharge or place of destination either from one conveyance or vessel to another conveyance or vessel within the same mode of transport or from one mode of transport to another mode of transport.

Transhipment is inevitable where a multimodal document is involved. Unless transhipment is prohibited by the terms of the credit, banks will accept transport documents which indicate that the goods will be transhipped, provided the entire carriage is covered by one and the same transport document.

Even if transhipment is prohibited by the terms of the credit, UCP provides that banks will accept transport documents which:

(*i*) indicates that transhipment will take place as long as the relevant cargo is shipped in containers, trailers or LASH barges* as evidenced by the transport document, provided that the entire carriage is covered by one and the same transport document, and/or

(*ii*) incorporates clauses stating that the carrier reserves the right to tranship.

23.3. AIR WAYBILL

Carriage by air is suitable where quick delivery is essential. It is frequently employed in carriage of life-saving drugs, costly and sophisticated items, etc., where the parties require the goods to be carried expeditiously and safely.

Every carrier of goods by air has the right to require the consignor to make out and hand over to him a document called the 'air waybill'. However, in practice, they are prepared by the carrier or his agent in which case they are acting on behalf of the consignor. Every consignor has the right to require the carrier to accept the air waybill submitted by him. The absence, irregularity or loss of the air waybill does not affect the existence or the validity of the contract of carriage.

The air waybill is made out in three originals and handed over to the carrier along with the cargo. The consignor must also furnish such information and attach to the air waybill such documents as are necessary to meet the formalities of customs, octroi or police before the goods can be delivered to the consignee. The first of the originals is intended for the carrier and is signed by the carrier The second intended for the consignee is signed both by the consignor and the carrier. It is sent along with the cargo. The third original is a receipt for the consignor: it is signed by the carrier.

An air waybill serves several purposes as follows:

(*i*) It is a *prima facie* evidence of the conclusion of the contract, of the receipt of cargo and of the condition of cargo.

(*ii*) It serves as an instruction sheet giving all the instructions needed for moving the goods and handling them at all stages of their journey from departure to destination.

(*iii*) It is customer's declaration and a bill for the freight.

(*iv*) If the amount and extent of insurance are included in it, it becomes a certificate of insurance.

It may, however, be noted that unlike a bill of lading, an air waybill is not a document of title to goods. The consignor has the right to call back the goods before

* LASH refers to Lighter Aboard Ship. The barges are themselves loaded into and carried by the ship during ocean voyage; they are discharged at ports where the barges carry on the inland water journey.

PARTICULARS FURNISHED BY SHIPPER

CONTAINER NO.	MARKS & NO.	NO. OF PKG.	DESCRIPTION OF PACKAGES AND GOODS said to contain	GROSS WEIGHT KGS	MEASUREMENT
NOSU 426	335.2	1 x 20 CONT	12 PACKAGES 12 NoS GRINDING AND POLISHING EQUIPMENT	14560 Ka	
SUPERIOR JEWELLERY MADURAI					
SHIPPER'S LOAD. STOWAGE AND COUNT					
TOTAL NO. OF CONTAINERS OR PACKAGES (IN WORDS)	THREE				

FREIGHT AND CHARGES	REVENUE TONS	RATE	PER	PREPAID	COLLECT
TOTAL					

EX RATE	PREPAID AT	PAYABLE AT	PLACE AND DATE OF ISSUE
		BREMEN	BREMEN
	TOTAL PREPAID IN LOCAL CURRENCY	NO. OF ORIGINALS 3/THREE	*APPLICABLE ONLY WHEN USED AS A MORE THROUGH BILL OF LADING

The present contract aquired upon a subject to the terms and conditions appearing on the lace and ask relief and to the terms of the Cancers Apprucome Tarms.

LADEN ON BOARD ORIENTAL BAY ROTTERDAM

DATE: 29.11.1997

BY ______________________

SHIPPER/EXPORTER (COMPLETE NAME AND ADDRESS)

SHIPPER/EXPORTER (COMPLETE NAME AND ADDRESS)	
TRUETZSCHLER GMBH AND CO., POSTRFACH 41 01 64, D-41241, MOENCHENGLADBACH, GERMANY	
CONSIGNEE (OR ORDER) BANK IN INDIA MADURAI	
NOTIFY PARTY (COMPLETE NAME AND ADDRESS) SUPERIOR JEWELLERY MADURAI	
LOCAL VESSEL (WHEN TRANSHIPMENT IS INVOLVED)	PLACE OF RECEIPT BY PRE-CARRIER** MONCHENGLADBACH
OCEAN VESSEL VOY. NO ORIENTAL BAY 10	PORT OF LOADING ROTTERDAM
PORT OF DISCHARGE TUTICORIN, INDIA	PLACE OF DELIVERY BY ON-CARRIER TUTICORIN Cy

Bill of Lading

B/L No.
BRM 0129216

NOL

NEPTUNE ORIENT LINES LIMITED

(Incorporated in the Republic of Singapore)

Received by the Carrier from the Shipper in apparent good order and condition ((unless otherwise noted herein) the total number of Containers or other packages or others enumerated below and said by the Shipper to contain the Goods specified below (weight, quantity, contents, condition quality and value unknown) for Carriage, subject to all the terms hereof INCLUDING THE TERMS ON THE REVERSE HEREOF AND THE TERMS OF THE CARRIER'S APPLICABLE TARIFF) from the Place of Receipt or the Port of Loading, whichever is applicable, to the Place of Delivery or Port of Discharge, whichever is applicable. The Merchant in accepting this Bill of Lading or in presenting it to the Carrier expressly accepts and agrees to all the terms, conditions and exceptions whether printed, stamped, or written or otherwise incorporated, notwithstanding the non-signing of the Bill of Lading by the Merchant.
IN WITNESS WHEREOF the Master or Agent of the said vessel has affirmed to the number of Bills of Lading stated below all of this tenor and data. One of which being accomplished the other shall stand void.

FINAL DESTINATION (FOR MERCHANT'S REFERENCE ONLY)

it is delivered to the consignee. He can also direct that goods should be delivered at another place and/or to another person.

When the goods reach the destination, the carrier should give a notice of arrival of cargo to the consignee. The consignee is entitled to require the carrier to hand over to him and to deliver the cargo to him. He must pay the charges due.

Article 27 of UCP provides the basis of reckoning the date of shipment in an air waybill for the purposes of letters of credit. It provides that where the credit calls for an actual date of dispatch, the air waybill should indicate a specific notation of such date. The date of dispatch so indicated on the air waybill will be deemed to be the date of shipment. The information appearing in the box on the air waybill (marked 'For carrier use only' or similar expression) relative to the flight number and date will not be considered as a specific notation of such dispatch. In all other cases, the date of issuance of the air waybill will be deemed to be the date of shipment.

❑ House Air Waybill

Certain cargo agents have been approved by the International Air Transport Association and given a separate IATA Code Number. The approved IATA agents consolidate air cargoes for individual consignors. Under this arrangement, individual consignors sending goods abroad by air have an advantage in air freight to be paid by them.

A consignor who wants to avail of this facility should go through the customs formalities for the cargo and have the relevant shipping bill duly passed and authenticated by the customs authorities. Such cargoes from different consignors are collected by the consolidator who is an approved IATA agent. The agent prepares a Master Airway Bill in which description of goods appear as 'consolidation cargo as per list attached'. The list attached contains in respect of each consignment the name of the exporter, the description of goods and their quantity and weight, shipping bill number and House Airway Bill Number. The house air waybill ~~is~~ the air waybill issued by the IATA agent to each of the consignors in respect of their goods. The house air waybill contains all the particulars of the consignment of an individual consignor concerned as is given in any normal air waybill. The cargoes are carried by air on the basis of the master air waybill. The date of despatch in such cases is taken as the date of the master air waybill as mentioned by the airlines in the relevant house air waybill. A house air waybill is acceptable under a letter of credit.

23.4. OTHER TRANSPORT DOCUMENTS

(a) Road, Rail or Inland Waterway Transport Documents

If the credit calls for a road, rail, or inland waterway transport document, banks will, unless otherwise stipulated in the credit, accept a document of the type called for, which indicates that the goods have been received for shipment, despatch or carriage or wording to this effect. The date of issuance will be deemed to be the date of shipment unless the transport document contains a reception stamp, in which case the date of the reception stamp will be deemed to be the date of shipment.

In the absence of any indication on the transport document as to the numbers issued, banks will accept the transport document(s) presented as constituting a full set. Banks will accept as original(s) the transport document(s) whether marked as original(s) or not (Article 28).

(b) Post Receipts

If a credit calls for a post receipt or certificate of posting, banks will, unless otherwise stipulated in the credit, accept a post receipt or certificate of posting

which appears on its face to have been stamped or otherwise authenticated and dated in the place from which the credit stipulates the goods are to be shipped or despatched and such date wil be deemed to be the date of shipment or despatch (Article 29).

(c) Courier Receipts

If a credit for a document issued by a courier or expedited delivery service evidencing receipt of the goods for delivery, banks will, unless otherwise stipulated in the credit, accept a document, however named, which appears on its face to indicate the name of the courier/service, and to have been stamped, signed or otherwise authenticated by such named courier/service. Unless the credit specifically calls for a document issued by a named courier/service, banks will accept a document issued by any courier/service. The document should indicate a date of pick-up or of receipt or wording to this effect, such date being deemed to be the date of shipment or despatch (Article 29).

24 Financing Exports

The statutory basis for regulation of exports from India is the Foreign Trade (Development and Regulation) Act, 1992 which has replaced the Imports and Exports (Control) Act, 1947. The Government is empowered to ban the export of certain goods from India and/or restrict export in quantity, value, etc., by subjecting them to licensing procedures.

In exercise of the powers conferred under Section 30 of the Act, the Central Government has notified the Export and Import Policy valid for a period of five years, 1st April 2002 to 31st March 2007. During the currency of the policy, the Central Government may make any amendments to it. Such amendments will be published by means of Public Notices issued by the Director General of Foreign Trade.

Exports from the country are generally free. Item-wise information on the exportability of the product should be verified from the book titled "ITC (HS) Classification of Export and Import Items" published by the Director General of Foreign Trade. The goods may be classified under any of the following categories:

(a) *Free*—items which can be exported without any restriction;
(b) *Restricted*—items which can be exported only under a licence or permission;
(c) *State trading*—items export of which can be done only through the specified State Trading Enterprise;
(d) *Prohibited*—items which cannot be exported.

Most items fall under the category of free goods.

❑ Role of Commercial Banks

All the financial requirements of an exporter, from the time he enters into a sale contract and starts working on it and till he receives final payment from the importer, are met by commercial banks. The facilities available from banks are generally divided into two broad heads : (*i*) Pre-shipment Finance, and (*ii*) Post-shipment Finance.

(*i*) *Pre-shipment Finance or packing credit* is the advance granted to the exporter to procure, process, manufacture, pack and prepare the goods for export. In other words, it is the facility extended to the exporter before and till the goods are shipped for export.

(*ii*) *Post-shipment Finance* refers to the credit facilities extended to the exporter from the time goods are shipped and till the export proceeds are realised. Post-shipment finance may take any of the following forms:
- (a) Negotiation of a bill drawn under a letter of credit;
- (b) Purchase of a bill not drawn under a letter of credit;
- (c) Advance against bill sent for collection; and
- (d) Advance against duty drawback.

Advances at the pre-shipment stage are discussed in this chapter and those at post-shipment stage in the next chapter.

24.1. PACKING CREDIT ADVANCES

❑ Definition

A pre-shipment credit or packing credit is any loan or advance granted to an exporter for financing the purchase, processing, manufacturing or packing of goods meant for export.

❑ Eligibility

The pre-shipment credit can be granted to *bona fide* exporters generally on the strength of letter of credit established by banks of standing abroad in favour of the exporter. If no letter of credit has been established, the credit can be granted on the strength of a firm order. The bank should ensure that the letter of credit or the firm order is lodged with it. In case the exporter is not able to lodge the letter of credit or firm order immediately, the packing credit may be granted on the strength of cables, letters, etc., exchanged between the exporter and the importer. In such cases, it should be ensured that the exporter lodges the letter of credit or firm order within a reasonable period of time.

❑ Type of Account

Normally, packing credit will be extended in the form of a loan account, a separate account being maintained for each export order. The request from the party should be supported by lodgement of letter of credit or firm order as mentioned under 'Eligibility' above. However, depending upon the merits of the case, banks may extend packing credit as a running account (*i.e.*, single cash credit account for all export orders) and also waive the condition of prior lodgement of letter of credit/firm order, provided the following conditions are fulfilled:

(*i*) The need for 'running account' facility has been established by the exporter to the satisfaction of the bank;
(*ii*) The exporter's track record continues to be good;
(*iii*) The letter of credit/firm order should be produced within a reasonable time;
(*iv*) The packing credit account should be maintained separately and not mixed with normal current account or cash credit account of the customer.

❑ Period of Loan and Interest

The period for which a packing credit may be granted depends upon the circumstances of the individual case, such as the time required for procuring, manufacturing or processing and shipping the related goods. Banks have the discretion to decide the period for which the packing credit is granted subject to the following conditions:

(*a*) Reserve Bank of India will provide refinance only for a period up to 180 days;
(*b*) Concessional rate of interest will be withdrawn *ab initio* if the packing credit is not adjusted within 360 days from date of advance.

Currently, interest is chargeable at PLR minus 2.5% for period up to 180 days and at PLR plus 0.5% for period beyond 180 days and up to 270 days. Banks have discretion to charge their own rates of interest for period beyond 270 days under the category of ECNOS – Export Credit Not Otherwise Specified (pre shipment stage).

If the packing credit is adjusted from export proceeds within 360 days, but beyond the sanctioned date, for the period beyond the due date, interest at ECNOS is applicable.

If the packing credit is not adjusted within 360 days, interest at ECNOS is applicable from the first day of the advance.

If exports do not materialise, domestic rate of interest plus penalty as decided by the Board of the Bank is applicable.

Where the export house and the supplier/manufacturer avail the packing credit for the same order, the period for which the concessional rate of interest is available may be apportioned between the two. For example, pre-shipment finance at PLR minus 2.5% p.a. may be made available to the supplier for 90 days and to the export house for the balance of 90 days.

The revision in interest rates made from time to time is applicable to fresh advances as also to existing advances for the remaining period of credit.

❑ Quantum of Advance

Normally the amount advanced as pre-shipment finance should not exceed the FOB price or the domestic cost of production whichever is lesser. Margin may also be stipulated depending upon the party's worth and the commodity to be exported. If the letter of credit or firm order is on CIF/CFR basis, the value should be reduced to FOB value and finance eligible should be calculated on that value.

Advance exceeding the FOB value, but up to the domestic cost of production, can be made in the following cases:

(*a*) The commodity is eligible for duty drawback. As soon as the shipment is made, the bill amount should be adjusted towards the packing credit account and any balance in the account should be treated as a post-shipment finance to be adjusted out of duty drawback to be received later.

(*b*) Export of HPS groundnuts and deoiled/defatted cakes. The excess is to be adjusted within 30 days from the date of export.

(*c*) Export of agro-based products like tobacco, pepper, cardamom, cashew nuts where the exporter buys larger quantity of raw agricultural produce and grade it for exports. For packing credit portion adjusted out of domestic sales, interest applicable for domestic advance should be charged from date of advance.

(*d*) Wastage is involved in the processing of agro products like cashew nuts and the excess packing credit is adjusted by export of by-products.

If the exporter has an intention of transferring funds to his EEFC account out of exports under a letter of credit or firm order, packing credit can be granted only for the balance amount.

❑ Sources of Repayment

The packing credit account should be repaid out of the proceeds of foreign bills of exchange drawn under the export contract. It may also be repaid out of export incentives like duty drawback.

Substitution of contract. In case the exporter is not able to export against the original contract due to reasons beyond his control, the packing credit may be adjusted by negotiating export bills relating to another contract, provided the goods financed against are exported under the substituted contract within a reasonable time.

Substitution of commodity/fresh export. In respect of exporters with good track record, banks may:

(*i*) permit liquidation of packing credit by exporting some other commodity where it becomes commercially necessary and unavoidable; and

(*ii*) mark off the existing packing credit with export proceeds of documents against which no packing credit has been drawn by the exporter.

The relaxation is not to be extended to transactions of sister/associate/group concerns. Banks should ensure that the exporter has not availed of packing credit from another bank against the documents submitted. Banks should also satisfy themselves about the valid reasons as to why the packing credit extended for shipment of a particular commodity cannot be liquidated by the normal method.

Rupee payment. If the export cannot take place at all, the account may be adjusted out of local funds. But interest at domestic rate plus penalty as per a transparent policy approved by the board of the bank should be charged on the account from the date of advance.

❑ Appraisal

Packing credit is to be adjusted out of the export bills tendered by the borrower on shipment of goods. Therefore, the packing credit limit should be considered along with limit for purchase of foreign bills.

The normal credit appraisal norms used by the bank are applied in the case of grant of packing credit also. The bank has to decide on the basis of the borrower's character, capital, etc., besides his experience in export. In addition, the bank should judge if export would take place. This entails enquiring into if exchange control regulations have been or will be fulfilled.

(*a*) The applicant has an importer-exporter code number allotted by the Regional Trade Control authorities.
(*b*) The exporter's name is not in the exporter's caution list of Reserve Bank.
(*c*) The goods to be exported are not banned for export.
(*d*) The letter of credit/firm order provides all essential details like the type and quality of goods to be exported, price, quantity, shipment date, etc. They do not violate any of our exchange control regulations relating to terms and method of payment.
(*e*) There is sufficient time allowed in the letter of credit/firm order to enable the exporter to manufacture the goods and export them.
(*f*) The country to which exports are to be made is not under political or economic stress, which may delay remittance of foreign exchange by the country. ECGC may help in getting information in this regard.
(*g*) If the letter of credit is restricted to some other bank, the exporter gives an undertaking to route the bills through the bank making the advance.

❑ Certain Special Cases

Manufacturer suppliers Packing credit can be granted to manufacturer suppliers who do not have letters of credit or export orders in their own name and are routing their exports through the State Trading Corporation/Minerals and Metals Trading Corporation or other export houses, agencies, etc., adopting the following procedure:

(*i*) The export house should issue a letter setting out the details of the export order and the portion thereof to be executed by the manufacturer and also certifying that the export house has not obtained and will not ask for packing credit facility in respect of such portion of the order as is to be executed by the manufacturer.
(*ii*) The export house should open inland letter of credit in favour of the supplier giving relevant particulars of the export letter of credit/order and the outstanding in the packing credit account should be extinguished by negotiation of bills under such an inland letter of credit. If it is inconvenient for the export house to open such an inland letter of credit in favour of the manufacturer, the latter should draw bills on the export house in respect of the goods supplied for export and adjust packing credit advance from the proceeds of such bills. In case the bills drawn under such arrangement are not accompanied by bills of lading or other export documents, the bank should obtain through the manufacturer/supplier a certificate from the export house at the end of each quarter that the goods supplied under this arrangement have in fact been exported.
(*iii*) The manufacturer should give an undertaking that the advance payment, if any, received from the export house against the export order would be credited to the packing credit account.

Sub-suppliers Packing credit can be granted to sub-suppliers of raw materials, components of exported goods, on the basis of the inland letter of credit opened in favour of the supplier by the exporter concerned. On supply made by the supplier to the exporter, the exporter's bank will pay the supplier and absorb the amount in the packing credit account of the exporter. The scheme covers only the first stage of production cycle, *i.e.*, a manufacturer exporter will be allowed to open inland

letter of credit only in favour of his immediate supplier of raw material, component, etc. It will not be extended to suppliers of materials to such immediate suppliers. Running account facility is not extended to sub-suppliers.

Export processing units/export processing zone units supplying goods to another EOU/EPZ unit for export purposes are also eligible for packing credit.

Deemed exports Packing credit can be extended to parties against orders for supplies to projects financed by multilateral or bilateral agencies/funds (such as IBRD, ADB, OPEC) which is recognised as deemed export under the Export Import Policy provided:

(*i*) The advance will be adjusted from free foreign exchange representing payments for the supplies of goods made under the order of the agency/fund. However, in certain cases free foreign exchange may be placed at the disposal of a Central Agency of the Government of India like the Central Water and Power Commission. The supplier of goods is not directly concerned with the receipt of foreign exchange. Packing credit may be granted on the basis of an authenticated copy of the contract between the project authorities and the supplier, together with a certificate issued by the concerned Central Agency to the party to the effect that he has won a particular tender under international competitive bidding for supplies to such aided project in India.

(*ii*) The supplies made by the Indian suppliers are used by the agency/fund only for its aided projects/programmes in India and are eligible for the grant of normal export benefits by the Government of India.

Construction Contractors

The packing credit advances to the construction contractors to meet their initial working capital requirements for execution of contracts abroad may be made on the basis of a firm contract secured from abroad, in a separate account. The advances should be adjusted within 180 days of the date of advance by negotiation of bills relating to the contract or by remittances received from abroad in respect of the contract executed abroad. To the extent the outstandings in the account are not adjusted in the stipulated manner, banks will charge normal rate of interest on such advance.

Export of consultancy Pre-shipment credit facilities may be granted to consultancy firms for meeting the expenses of the technical and other staff employed for the project and purchase of any materials required for the purpose as well as for export of computer software, both standard and custom built software programs, subject to the usual conditions of packing credit scheme. While deciding the pre-shipment facilities, advance payments received against the contract must be taken into account.

Floriculture, grapes and other agro-based products In the case of floriculture, pre-shipment credit is allowed to be extended by banks for purchase of cut-flowers, etc. and all post-harvest expenses incurred for making shipment.

Packing credit at concessional interest can be extended also for working capital purposes in respect of export-related activities of all agro-based products including purchase of fertilisers, pesticides and other inputs for growing of flowers, grapes, etc., provided such activities as export-related and they are not covered by direct/indirect finance schemes of NABARD or any other agency.

Export credit should not be extended for investments, such as, import of foreign technology, equipment, land development, etc. or any other item which cannot be regarded as working capital.

Processors/Exporters-agri-export zones The producer has to enter into contract farming with the farmers around the unit and has to ensure supply of quality seeds, pesticides, micro-nutrients and other material to the group of farmers from whom the exporter would be purchasing their products as raw-material for

production of the final products for export. Such export processing units may be provided packing credit for the purpose of procuring and supplying inputs to the farmers so that quality inputs are available to them which in turn will ensure that only good quality crops are raised. The exporters will be able to purchase/import such inputs in bulk which will have the advantages of economies of scale.

Advance payment for exports Where exporters receive direct remittances from abroad by means of cheques, drafts, etc. in payment for exports, export credit at concessive interest rate may be granted to exporters of good track record till their realisation. It should be ensured that the remittance is against an export order, is as per trade practices in respect of the goods in question and is an approved method of realisation of export proceeds as per extant rules.

If, pending compliance with the above conditions, an exporter has been granted accommodation at normal commercial interest rate, effect to concessive export credit rate may be given retrospectively once the aforesaid conditions have been complied with.

Large value exports For large value exports of select products, which are internationally competitive and have high value addition, viz., pharmaceuticals, agro-chemicals, transport equipment, cement, iron and steel, electrical machinery, leather and leather goods, textiles, products of aluminium, petroleum products, sugar and food grains credit is extended at concessional rate of interest for an extended period up to 365 days at pre-shipment stages as against the maximum periods of 270 applicable for normal export credits. The rate of interest of export credit for period beyond 270 days and up to 365 days will be the same as for normal pre-shipment credit for period beyond 180 days and up to 270 days. Exporters of above products with export contracts of Rs. 100 crore and above in value terms in one year-are eligible for the special financial package. This scheme is valid for the period up to September 30, 2003.

❑ Conduct of Account

Separate loan account should be maintained for each export contract unless it is decided to grant the running account facility. The loan should be disbursed in stages depending upon the requirements of the exporter. Lump sum disbursement disregarding the actual requirement for the purpose of the loan should be discouraged.

All the goods that are purchased out of the loan are either hypothecated or pledged to the bank. Thus packing credit may be secured by hypothecation or pledge of goods. But sometimes the credit may remain a clean advance also. This may be the case where payment is to be made in advance for procurement of required materials or where payment is made for services.

The normal precautions and procedures followed in advances against goods should be followed in the case of packing credits also. This includes periodical inspection of godowns and stock verifications. Margin may also be stipulated taking into account the worth of the party and the nature of goods to be exported.

Where the packing credit is in the form of cash credit account, the bank should see that the operations in the account are confined only to export transactions. All export proceeds should be credited to this account. Earliest debit in the account would be adjusted first out of the credits made into the account, irrespective of the contract to which such debits and credits relate.

❑ Documentation

All documents taken for advance against goods, *viz.*, Demand Promissory Note, hypothecation or pledge agreement, etc., should be taken for packing credit also. In addition some banks have a separate packing credit agreement.

24.2. PRE-SHIPMENT CREDIT IN FOREIGN CURRENCY

Under the Pre-shipment Credit in Foreign Currency (PCFC) exporters are allowed to avail pre-shipment credit in a convertible currency at interest rates not exceeding 0.75% over 6 months Libor* plus withholding tax. The credit will be self-liquidating in nature and will be adjusted by discounting the relative export bill designated in foreign currency.

The banks which lend under the scheme may use the balance available in EEFC, Resident Foreign Currency Accounts, FCNR (B) Accounts, and foreign currency balances available in Escrow accounts**. Or, it may raise lines of credit abroad at a cost not exceeding 6 months Libor plus 0.75%.

The credit under the scheme is available for a maximum period of 180 days. If extended beyond this period, 2% penal interest is charged. If the PCFC is not adjusted within 360 days, it will be adjusted at the TT selling rate for the currency concerned and will be treated as a rupee advance.

PCFC can be extended in one convertible currency in respect of an export order invoiced in another convertible currency. For instance, an exporter can avail of PCFC in US dollar against an export order invoiced in Deutsche mark. The risk and cost of cross currency transaction will be that of the exporter.

In case of HPS groundnuts and oil extracts packing credit can be granted higher than the FOB value, the excess to be adjusted within 30 days of export. For these commodities packing credit can be granted both in rupees and in foreign currency, restricting the PCFC only to the portion to be exported.

Apart from the lower interest rate, the major advantages under PCFC are cover from exchange risk (due to fluctuation in exchange rates) and cost of buying and selling the same foreign currency from the bank, provided the facility is used for imports and the imports are invoiced in the same currency as export under the order. For instance, if the export order is for USD 1,00,000 and import component is 60%, assuming the exporter avails PCFC of USD 60,000, the liability will be adjusted by his submission of a bill in US dollars. If he avails rupee packing credit, on imports bank will apply the bill selling rate and for the export bill submitted bill buying rate. Under PCFC on USD 60,000 no conversion is involved. The exporter saves the difference between the buying and selling rates for dollar. Further he is insulated from fluctuations in the exchange rate between dollar and rupee.

PCFC may also be availed in rupees towards local payments for materials, labour, etc. In that case the liability of the exporter will be designated in the foreign exchange by applying the ruling TT selling rate.

If PCFC has been availed by the exporter against an export order, the export bill drawn under that will have to be discounted with the bank under the Export Bills Discounting Scheme. PCFC will be adjusted by discounting the bill. Interest at Libor plus 0.75% is charged on the bill thus discounted. The bank will realise the bill in foreign currency and adjust the foreign currency liability under Export Bills Discounted account. The balance, if any, will be converted at the ruling TT buying rate and paid to the exporter.

Other conditions and eligibility are similar to that of packing credit in rupees.

❑ Forward Cover for PCFC

No exchange risk is involved if the PCFC is availed in the same foreign currency as the invoice. If the invoice is in Indian rupee and the PCFC is availed in Indian

* The reference rate can be Libor or Euro Libor or Euribor, referred to generally as Libor here. For meaning of these terms please refer to Chapter 31 on International Financial Markets.

** Escrow account is the foreign currency account opened under a 'Countertrade' arrangement. Countertrade is the modern version of barter trade. A countertrade agreement is voluntarily entered into between an Indian party and an overseas party, whereby the value of goods imported from the overseas party is adjusted against the value of exports made to him.

rupee, yet the liability of the exporter under PCFC will be designated in foreign currency, say, US dollar. In such case, the exporter may book forward cover as under:

(i) From the date of order/letter of credit to the date of drawal of PCFC covering the amount of PCFC sanctioned; and

(ii) From the date of order/letter of credit to the date of discounting converting the invoice less PCFC sanctioned/drawn.

If the exporter avails PCFC in a currency other than the currency of invoice forward cover may be booked as follows:

(i) Forward cover in the currency in which PCFC is availed of and the rupee, from the date of order/letter of credit to the date of drawal of PCFC, covering the amount of PCFC sanctioned.

(ii) Cross currency forward cover in the currency in which PCFC is availed against invoiced currency from the date of order/letter of credit to the date of discounting.

(iii) Forward cover from the date of order to the date of discounting between rupee and the currency in which PCFC is taken, to the extent of amount available after discounting of bills and repayment of outstanding PCFC.

On availing of PCFC, the contract should be cancelled at prevailing market rates to the extent of the PCFC drawal used for payment towards imported inputs in foreign currency.

❑ PCFC—When Advantageous

Apparently PCFC is advantageous as compared to the rupee packing credit due to interest differential and avoidance of conversion cost. But this advantage will accrue to the exporter only so long as the gain thus made is not offset by the premium he loses on dollar for the bill under the export contract.

Where PCFC is availed, the export bill tendered will be discounted under the export bill discounting scheme and no conversion into rupee is involved. In case the exporter had availed rupee packing credit, for the export bill tendered, the bank will apply the bill buying rate. The bill buying rate applied will have a built-in premium for the transit and usance period which is not available to the exporter when he avails PCFC.

The actual financial cost to the exporter under PCFC remains the same as the interest paid by him on PCFC. If he avails rupee packing credit, the total financial cost would be the interest paid, plus conversion cost (difference between buying and selling rates), less the premium on forward dollar. If the premium gained is more than offset by the conversion cost and interest difference between rupee credit and PCFC, rupee credit would be preferable to PCFC. Let us illustrate it with an example.

The following are the merchant rates for dollar:

TT selling	Rs. 49.00
TT buying	Rs. 48.80
Bill buying	Rs. 48.75
30 days bill buying	Rs. 49.45
60 days bill buying	Rs. 49.95
90 days bill buying	Rs. 50.50

Interest on PCFC and on Export Bill discounting is 4% p.a.

Interest on rupees packing credit and rupee post-shipment credit is 9% p.a.

For simplicity sake, we assume the dollar-rupee rates to remain the same throughout the transaction.

PCFC. If the exporter avails PCFC of USD 10,000 for 3 months and adjusts it by export bill for equivalent amount, drawn payable 3 months from bill of lading, his cost would be as under:

On PCFC interest at 4% for 3 months	=	USD 100
On export bill discounted at 4% for 3 months	=	USD 100
	=	USD 200

Converted at the TT selling rate of Rs. 49.00, the rupee cost is Rs. 9,800.

Rupee PC If the exporter avails equivalent amount in rupees (Rs. 4,90,000), interest at 9% for 3 months would be Rs. 11,025.

For the export bill, the bank will quote him a rate of Rs. 50.50 and pay him Rs. 5,05,000. Interest for 3 months on Rs. 5,05,000 at 9% is Rs. 11,363. His cost of funds would be:

PC	Rs.	4,90,000
Interest on PC	Rs.	11,025
Interest on bill	Rs.	11,363
	Rs.	5,12,388
Less: Export bill	Rs.	5,05,000
Cost of funds	Rs.	7,388

Availing of rupee packing credit turns out to be cheaper in this case.

24.3. ADVANCE AGAINST DUTY DRAWBACK

The import duty paid on raw materials or components for export products or the excise duty paid on items indigenously produced for export are repaid to the exporter on completion of the export. The items on which duty drawback is available is determined by Government policies.

The need for advance against duty drawback arises because of the delay involved in verifying the claims of the exporter by the authorities concerned and payment of the drawback by them. The exporter's funds are locked up during this interval and he seeks financial assistance from the bank to tide over the situation.

Normally, the exporter can claim the drawback amount from the customs authorities only after export of goods by producing the necessary documents to them. But bank finance against incentives may be made available either at the pre-shipment stage or at the post-shipment stage.

Advance at the pre-shipment stage may take the form of packing credit being granted at a level higher than the FOB value of the contract. As already discussed under 'pre-shipment finance', bank can grant packing credit advances up to certain percentages above the FOB value, but not exceeding the domestic cost of production in respect of goods which are entitled for duty drawback from the government. In such cases, the excess over the FOB value advanced by the bank amounts to advance against duty drawback. Advance against drawback at the pre-shipment stage is granted only to exporters of good standing on their furnishing satisfactory evidence to the bank as to the amount of their entitlements. The exporter should also undertake to authorise the bank to receive the entitlement when he makes claim with the concerned authorities.

Advance may also be made at the post-shipment stage as a separate limit. The advance will be disbursed when the exporter makes a claim with the concerned authorities and produces copies of the claims to the bank.

As per the Reserve Bank of India directive, advance against incentives can be granted for a maximum period of 90 days at an interest rate of 13% per annum. The advance is to be adjusted out of the incentives to be received by the bank on behalf of the exporter. All claims are now payable directly to the bank. A declaration by the exporter authorising payment to the bank should be registered with the concerned authorities.

The bank may prescribe a margin after considering the merits of each case. If the sanction is made as a part of packing credit, the documents taken for packing credit would be sufficient for this facility also. If the facility is granted as a separate limit, an agreement for hypothecation of book debts may be taken. The advance

can be covered under Export Production Finance Guarantee or Export Finance Guarantee of ECGC. It is to be adjusted out of the incentives received from the government. If the advance is not adjusted within 90 days, it is treated as overdue. If the account is adjusted out of local funds, *i.e.*, not the export incentive, domestic rate of interest is charged from the date of advance.

24.4. OTHER SERVICES TO EXPORTERS

1. Advising Letters of Credit

The letter of credit issued in favour of exporters in India is normally advised through a bank in India. A bank in India may receive a request to advise the letter of credit from its correspondent bank abroad.

The letter of credit may be received through cable or by airmail. Where the credit is received by cable, the bank should verify the authenticity by means of the test code incorporated in the message. It should also be noted if there is a mention about airmail confirmation. In the absence of any such notation, the cable message will be the operative instrument. The bank should incorporate the cable message in its own format and send it to the beneficiary. The standard formats used for this purpose are designed to convey to the beneficiary the fact that the bank is only an advising bank and does not undertake any liability under the credit that is being advised.

Where the letter of credit is received by airmail, the bank should verify the authenticity of the letter of credit by comparing the signature on the credit with the specimen signatures supplied by the issuing bank, the letter of credit may be advised in either of the two ways:

(*a*) The credit received is incorporated in the format of the advising bank and forwarded to the beneficiary.

(*b*) More commonly, the credit received is forwarded in original to the beneficiary. The advising bank may certify that the signatures on the credit have been verified, by way of a rubber stamp affixed on the letter of credit. Or, a covering letter from the bank may accompany the credit. Such letters of credit are called 'hand-on' credits.

Whether it is a cable credit or airmail credit, the bank should ensure the following:

(*a*) The letter of credit conforms to the exchange control requirements in India.

(*b*) Proper record is maintained of the letters of credit advised.

(*c*) Commission for advising the credit is recovered from the beneficiary. If the beneficiary fails to pay, the bank can recover it from the opening bank.

(*d*) A notation is made in the credit that stamps worth Rs. 2 should be affixed on the instrument before documents are negotiated under the credit.

(*e*) A statement, in form Stat 9, is sent to the Reserve Bank every month for all letters of credit advised, including those confirmed by it.

Advising Amendments. If the credit is amended, the bank should follow the same procedure for advising the amendment as is followed for advising the letter of credit. Record of the amendment advised should be kept along with the record of advising of the letter of credit.

2. Confirming Letters of Credit

A letter of credit may be confirmed by the bank in India when a request to this effect is received from the opening bank of the credit. The branch which receives the request to confirm should consult the Head Office to verify that the limit fixed for the opening bank for confirming letters of credit on its behalf is not exceeded.

The letter of credit is confirmed by making an appropriate note in the letter of credit under the signature of the officials of the confirming bank. The confirmed credit is then advised to the beneficiary.

For the risk involved in confirming letters of credit, the bank can avail of the transfer guarantee of the ECGC.

3. Transfer of Letters of Credit

A request may be received from the beneficiary of the credit to transfer a part or whole of the credit to other exporter(s). The bank should verify that (*i*) the credit is transferable; and (*ii*) the second beneficiary is an exporter having an exporter's code number.

If the entire credit is transferred to another exporter and the first beneficiary does not mind the importer and the second beneficiary knowing each other, the transfer can be effected by simply making an endorsement to this effect and forwarding it to the second beneficiary. In other cases, the bank may get the original credit lodged with it and issue another credit, in favour of the second beneficiary. The credit thus issued will conform to the requirements of UCP for transferring credits.

If partial shipment is allowed, the first beneficiary may require the credit to be transferred to more than one second beneficiary for part of the amount each. If no secrecy need be maintained, photostat copies of the original credit may be taken and forwarded to the second beneficiaries along with a letter of the bank apportioning the credit to each, to the extent stipulated by the first beneficiary. In other cases, bank will issue fresh credits. In all cases, the original credit is lodged with the bank.

The commission for transferring the credit should be recovered from the first beneficiary.

2. Insurance is expressed in a currency other than the one in which the credit is drawn.
3. Risk covered does not agree with the requirements of the credit.
4. Insurance does not cover the entire voyage.
5. Description of goods and shipping marks do not agree with the invoice.
6. The name of the vessel indicated differs from that in the bill of lading.
7. Insurance policy is not endorsed in blank.
8. Insurance certificate is not countersigned by the shipper.
9. Insurance policy is dated later than the date of bill of lading.
10. The place of settlement of claims differs from that in the letter of credit.
11. Insurance policy is not in negotiable form.
12. It is signed by a person other than the agent or underwriter of the insurance company.
13. It is not properly stamped.
14. Where more than one negotiable copy is issued, all copies are not submitted.
15. Transhipment risk is not covered, while credit allows transhipment.
16. Cover note is submitted when credit insists on policy.

5. Other Documents

1. The document tendered is not issued by the authority specified in the letter of credit.
2. The title of document differs from that required.
3. The description of goods differs from that in the invoice/credit.
4. Certification/Declaration, if any, required by the credit is not made.

25.2. DEALING WITH DISCREPANCIES IN DOCUMENTS

When the bank is satisfied that the documents tendered under a letter of credit satisfy the requirement of the credit, they may be negotiated and amount paid to the customer. Where the documents tendered under a letter of credit show some discrepancies, the bank would point out such discrepancies to the exporter and ask him to get them rectified. This would be possible if the discrepancies are in the documents prepared by the exporter himself. For example, if the description of goods in the invoice differs from that in the letter of credit, the exporter can suitably alter the invoice and resubmit to the bank.

The discrepancy in the documents may be such that they cannot be rectified by the exporter. For instance, the bill of lading is claused or shipment is later than that allowed in the credit. Where the discrepancy cannot be rectified the bank may elect to negotiate or not to negotiate depending upon (*i*) the nature of the discrepancy, (*ii*) the worth of the party, (*iii*) the experience of the bank in handling documents relating to transactions between the exporter and the particular importer in the past. Depending upon these factors, the alternatives available to the bank are:

(*a*) *Confirmation of Opening Bank*. It may intimate the credit opening bank of the discrepancies and seek their confirmation. The opening bank will, in turn, consult the importer whether the documents with the discrepancies can be accepted and intimate the negotiating bank its permission to negotiate the bill. When such a permission is received, it amounts to amendment of the credit to the effect, but only in respect of the particular transaction and, therefore, the bank can negotiate the documents. If the exporter wants the money urgently, the list of discrepancies may be sent and the reply sought by cable. The cost should be borne by the exporter. While seeking confirmation by cable or letter, the bank should take care to include all the discrepancies found precisely and completely.

(*b*) *Negotiation under Reserve*. Even where the confirmation of the opening bank is sought by cable, it takes some time to get it. If the party is in urgent

need of funds and cannot wait and the bank's rating of the customer is high, the documents may be negotiated under reserve. That is, the documents are negotiated by the bank on the understanding that if the documents are not accepted by the opening bank and the negotiating bank is not reimbursed, the negotiating bank shall have the right to receive back the amount paid to the exporter along with interest and other charges. As already noted, negotiating under reserve is done only for customers of good standing.

(c) *Negotiation against Indemnity*. Where the bank is not satisfied with the informal arrangement of negotiation under reserve, it may adopt a more legalistic method of obtaining an indemnity from the exporter. Under this method, the exporter executes an indemnity bond in favour of the bank under which he promises to reimburse the bank for any loss that the bank may be put to on account of negotiating the document with discrepancy. The indemnity bond should include all discrepancies found in the documents. Normally it also provides immunity to the bank against any other discrepancy that may be found later.

(d) *Take under Collection*. If the bank does not want to take risk, it may not make immediate payment against the documents and take the documents only for collection.

Where the documents are presented by a person other than the customer of the bank, the negotiating bank may request that the documents be presented through the exporter's bank. Here, too, if discrepancies are found in the documents, the bank may:

(a) pay after getting confirmation from the opening bank ; or
(b) pay against indemnity of the exporter's bank ; or
(c) refuse to accept the documents.

25.3. PURCHASE/NEGOTIATION OF EXPORT BILL

(Under and Not under Letter of Credit)

When a bill is drawn under a letter of credit, the bank has the credit to look for the conditions to be fulfilled in the preparation of the documents. But where the transaction is not covered by a letter of credit, only the sale contract between the exporter and the importer should be relied upon. The bank may have a general scrutiny of the sale contract to see that the documents tendered are in order. Besides, specific instructions should be obtained from the exporter regarding such matters as the tenor of the bill, whether the documents should be delivered against payment or acceptance, the bank through whom the documents are to be submitted, the commission and other charges to be recovered from the drawees or from the proceeds, case-in-need if any for the bill, etc. The bill is purchased at the bill buying rate.

❑ Procedure on Purchase/Negotiation of Bill

1. All documents should be verified along with the covering schedule received from the exporter. They should be branded with the bank's round/collection stamp. FBP/FBN number should be entered on all documents. While entering the number, the bank should follow the uniform procedure suggested by the Reserve Bank.*
2. The documents will normally be sent in two sets unless the letter of credit or the instructions of the drawer prevents it. All documents are endorsed in favour of the collecting bank before they are sent.

* The uniform numbering suggested by Reserve Bank includes an alphabetical prefix N (bills negotiated), P (bills purchased), D (bills discounted), C (bills sent for collection), A (consignment export (account sale)), M (others (miscellaneous)) and a six digit serial number starting with 000001 on 1st January every year.

25 Post-shipment Finance

The exchange exchange control regulations stipulate that within 21 days of shipment of goods from India, the exporter should submit the relative documents for collection/purchase to an authorised dealer. The documents prepared would be as per requirements of the letter of credit, if one exists, or as per the sale contract between the exporter and the importer.

For those parties who have been granted a packing credit, the understanding is that the packing credit would be adjusted out of the bills tendered under the export contract. Therefore, along with sanctioning of the packing credit limit, the party would have been sanctioned foreign bills purchase/negotiation limit also. For others, depending upon their requirements, only the bills purchase/negotiation limit might have been sanctioned. For such of the parties who only make occasional exports, regular limit for purchase may not have been sanctioned, but depending upon the worth of the party, bills tendered may be purchased on an *ad hoc* basis. Thus bills drawn by the exporter may be:

(*a*) purchased/negotiated by the bank where it is drawn under a letter of credit;
(*b*) purchased/negotiated by the bank where it is not drawn under a letter of credit; or
(*c*) taken for collection by the bank.

25.1. SCRUTINY OF BILLS DRAWN UNDER LETTER OF CREDIT

Bills under a letter of credit may be received for negotiation from a customer of the bank. Bills may also be received from a person other than its customers where the credit is restricted to the bank or it is named the paying banker under the credit. While negotiating documents under a letter of credit, the bank will adhere to the *principle of strict compliance*. That is, the documents presented should agree with the stipulation of the credit in toto. Non-compliance with the terms of the credit, however minor such discrepancy may be, would provide a ground for the issuing bank to reject the documents and refuse payment under the credit.

When approached to negotiate documents under a credit, the bank should verify the credit itself to see that it is valid (*i.e.*, it has not expired) ; that it attaches no onerous clauses on the negotiating bank and that payment is not made conditional. It should verify individual documents tendered and satisfy that they are in agreement with the terms of the credit. Any alteration in the document should have been authenticated. Further it should scrutinise the documents *inter se* (*i.e.*, one with the other, like bill of lading with invoice) to see that there is no discrepancy. The common discrepancies that may be found in the documents tendered under a letter of credit are listed below.

The discrepancies listed are by no means exhaustive.

❑ 1. Bill of Exchange

1. The bill is drawn on the importer instead of on the issuing bank as required in the credit.
2. Reference to the letter of credit is missing.
3. Tenor of the bill is different from that required under the credit.
4. Interest clause is missing, where stipulated.
5. Amount in words and figures differs.
6. In case of usance bill, it is inadequately stamped/unstamped.
7. The name of the party is misspelt.
8. It is not drawn/signed by the beneficiary of the credit.
9. The bill is not drawn payable/endorsed to the bank.

❑ 2. Invoice

1. The invoice is not addressed to the importer.
2. The amount exceeds the limit under the credit or the unit price exceeds that mentioned in the credit.
3. The amount differs from that mentioned in the bill of exchange.
4. The details of the cost, insurance and freight and other charges are not shown separately where it is required under the credit.
5. The description of the goods does not agree with the description in the credit.
6. The number of packages/quantity differs from the credit requirements. The difference may be with respect to the quantity or number of packages mentioned in the bill of lading also.
7. Invoice is not certified as correct/signed by the exporter.
8. It does not certify the origin of goods, where a certified invoice is required.
9. Any other certification required by the credit is not furnished with the invoice.
10. Reference to the import licence number as required by the credit is missing.
11. The markings, *etc.* differ from that appearing on the bill of lading.
12. Charges not permitted by the terms of contract are included.
13. The number of copies is less than the number required.

❑ 3. Bill of Lading

1. The full set of negotiable copies of bill of lading is not submitted. The bill of lading would mention the number of copies issued. All copies are to be submitted.
2. Bill of lading is claused.
3. Bill of lading is not manually signed by the master or an authorised agent of the shipping company (rubber stamp so acceptable).
4. The number of packages/weight differs from that in invoice.
5. Bill of lading is issued by forwarding agents.
6. Bill of lading does not indicate that goods have been received on board the ship.
7. Bill of lading indicates that goods are carried on deck.
8. Where the credit is on CFR or CIF basis, freight payable bill of lading is submitted instead of freight paid bill of lading.
9. Bill of lading is drawn with the importer as consignee instead of the exporter.
10. It is not endorsed in blank or in the name of the bank as required.
11. The bill of lading is dated subsequent to the latest date of shipment.
12. Bill of lading is presented after undue delay. That is, it is presented after the time allowed in the credit or, where there is no provision in the credit it is presented after 21 days from the date of issue.
13. Bill of lading indicates transhipment when it is not allowed under the credit.
14. Description of goods does not agree with the invoice.
15. Port of shipment and port of destination do not agree with the stipulations in the credit.
16. Bill of lading is issued under a charter party.
17. Bill of lading indicates a third party as shipper when it is prohibited by the credit.
18. The notation 'on board' on a receipt for shipment bill of lading is not authenticated by the carrier or his agent.

❑ 4. Insurance Documents

1. The amount covered is low. The minimum coverage should be for CIF value plus ten per cent.

3. The bank has an obligation to Reserve Bank to see that the proceeds are received in India in full. To do so, the bank may provide columns in the export bills register for entering the GR/PP form number, due date of payment, the period for which ENC Statement covering the transaction was sent, the period of Return with which the duplicate GR form is submitted to Reserve Bank. For GR procedure please see Section 25.8.
4. In respect of bills purchased or negotiated, the bank should submit to the Reserve Bank a statement in form ENC every fortnight along with R Returns.
5. On purchase/negotiation of the bill, the account of the customer is credited with the value of the bill, converting it into Indian rupees by applying the sight bill buying rate in the case of sight bill and relevant usance bill buying rate in the case of usance bills. If a forward contract had been booked for the export, the conversion would be at the contracted rate.
6. The commission and/or discount declared by the exporter in GR form should be recorded against relative entry in bills register to facilitate reference while dealing with application for remittance/deduction from invoice on account of commission/discount.
7. Simultaneous with purchase of the bill, the bank should recover interest for the normal transit period plus usance of the bill at the rate applicable for exports. There are two exceptions to this rule:
   (*i*) In the case of TT (documentary) bills, wherein reimbursement for Documentary bills is obtained by TT, banks shall recover interest at the time of negotiation for 5 days. If, however, the bank is permitted to draw a TT directly in respect of negotiation under the letter of credit, no such interest shall be charged to the customer.
   (*ii*) In the case of export bills despatched by courier service interest shall be charged for a period of 10 days only provided :
      (*a*) courier charges are recovered from the customer, and
      (*b*) courier service pertains only to point-to-point service and it is not up to a point other than final destination of the documents (place of the importer).

   The method of calculation of interest and the concept of normal transit period are explained in the chapter on Ready Exchange Rates.
8. The bank should follow up the bills sent and keep a watch that payment advices are received from the collecting bank in time. In case of delay, it should take up the matter both with the collecting bank and the exporter. If the bill was drawn under a letter of credit and the documents were in order, the prime responsibility of the credit opening bank exists. If the documents bore some discrepancies or the documents were not drawn under a letter of credit, the purchasing bank should arrange for taking care of the goods. In many countries where the import is subject to import control, it may not be possible for the collecting bank to clear the goods and arrange for their storage, in the absence of import licence. But if import into bonded warehouse facilities are available, they may be availed.
9. If the importer defaults, the bank may ask the exporter to find out an alternative buyer. If an alternative buyer cannot be found on suitable terms, the goods may be reimported. The decision will depend upon the cost of reimporting (*i.e.*, additional freight involved against the value of the goods).
10. If the shipment is lost before payment against the consignment is received, the bank should prefer claim with the insurance company for the loss.
11. For any reason (other than the bank's own default or negligence) if the bill is not paid, the bank should lodge claim with ECGC under the policy and guarantee issued by the Corporation covering the transaction.

❑ Post Negotiation Procedures

Follow-up of Overdue Bills

The bank should closely watch realisation of bills through Bills Register. Where a bill remains outstanding beyond the due date for payment, the matter should be taken up with the exporter concerned. If the exporter fails to arrange for delivery of the proceeds on the due date, the matter should be reported to Reserve Bank, unless the exporter had sought permission for extension of time. Banks are required to follow up export outstandings with exporters systematically and vigorously so that action against defaulting exporters does not get delayed.

The bank should furnish to Reserve Bank half-yearly consolidated statement in form XOS, giving details of all export bills outstanding beyond the period prescribed for realisation, as at the end of June and December every year. This statement should be submitted (in triplicate) within fifteen days from the close of the relative half year.

Shipments Lost in Transit

When shipments from India for which payment has not been received are lost in transit, the bank should see that the insurance claim is made as soon as loss is known. The duplicate copy of GR/PP form should be forwarded to Reserve Bank with the following particulars regarding insurance:

(*a*) Amount for which shipment was insured.
(*b*) Name and address of the insurance company.
(*c*) Place where claim is payable.

If claim is payable abroad, the bank must arrange to collect the full claim through the medium of its overseas branch/correspondent bank and forward the duplicate copy of GR/PP form to Reserve Bank only after the amount is collected.

In case the settlement is partially settled by shipping company/airline under carrier's liability, the bank should ensure that amounts of such claims if settled abroad are also repatriated to India by exporters.

Payment of Claim by ECGC

Settlement of a claim by ECGC does not absolve the exporter of the obligation on the GR/PP form to realise proceeds of the export within prescribed period. In such cases, exporter should, in consultation with ECGC, take all necessary steps for realising the proceeds. The bank should continue to hold the duplicate copy of GR/PP form in its custody and initiate follow-up measures in the normal manner.

Accounting for Non/Delayed Realisation

When the bill is purchased, the transaction is reported as purchase of foreign exchange by the bank to the Reserve Bank in R Returns. If the bill is not realised within 30 days from its due date, following procedure advised by FEDAI should be followed:

1. For bills remaining unpaid for a period of 30 days after the transit period in case of demand bills and the due dates in case of usance bills, the foreign currency amount shall be reversed from the "export bills purchased portfolio" on the 30th day. In case, 30th day happens to be holiday, or Saturday, it shall be reversed on the next working day. The rate applicable to such reversal shall be the ready TT selling rate of exchange on that day and shall be reported as "Notional Sale" of foreign currency. The rupee equivalent of the foreign currency thus reversed shall be held in the advances portfolio of the bank under the head "advances against overdue export bills realisable account".
2. Export bills payable in countries with externalisation problems shall also be crystallised into rupee liability like any other unpaid export bill notwithstanding receipt of advice of payment in local currency.

3. If the rupee liability crystallised on the overdue bill is less than the amount originally advanced against it, the shortfall shall be recovered from the customer. If it is higher than the original advance the surplus will not be passed on to the customer but treated as additional advance by bank.
4. Interest shall be recovered for the period from notional due date to date of crystallisation at the appropriate rate of interest as directed by Reserve Bank for overdue export bills.
5. The unpaid bill shall be treated as outstanding under the sanctioned limit of the customer in a separate folio with the exchange risk open against the customer.
6. On receipt of realisation advice, the bank shall apply the TT buying rate on that date and adjust the advance created in the books against the bill as given above. Any shortfall/excess shall be recovered from/paid to the customer. The bank shall report 'purchase' of foreign currency. Interest for the overdue period shall be recovered at the rate permissible by Reserve Bank for overdue export bills.
7. If the export bill is returned unpaid the bank shall adjust the advance created in their books against the bill. Such adjustment would be by recovering in rupees from the customer. Interest shall be recovered from the date of purchase of the bill to the date of adjustment at the domestic rate or rate applicable to overdue bills whichever is higher.
8. If the post-shipment credit is adjusted out of rupee resources received from ECGC under their transfer delay guarantee, interest applicable to overdue bills shall be applied even if it is outstanding beyond six months from date of shipment.
9. If the bill is dishonoured before the crystallisation date, the bank shall recover from the customer:
   (a) The rupee equivalent of the bill arrived at the current spot TT selling rate or the amount originally advanced, whichever is higher.
   (b) All foreign currency charges converted at the ruling spot TT selling rate.
   (c) Other charges, if any.
   (d) Interest at the domestic rate or that applicable for overdue export bills, whichever is higher.
10. In the case of highly volatile currencies, it is up to the bank to negotiate the bill at the risk and responsibility of the customer.

❑ Interest on Post-shipment Advance

For Normal Bills

Interest on post-shipment credit up to 90 days is chargeable at a rate not exceeding PLR minus 2.5% and from 91 days and up to 6 months at not exceeding PLR plus 0.5% p.a. For periods beyond six months banks are free to fix their own interest rates.

The concessional rate is applicable only up to the notional due date/actual due date (where ascertainable) whichever is earlier.

If the bill is realised earlier than the due date, the excess interest collected should be refunded.

The revision of interest rates made from time to time is applicable to fresh advances as also to existing advances for the remaining period of credit.

For Overdue Bills

For the overdue period, the rate fixed for ECNOS – Export Credit Not Otherwise Specified (for post-shipment stage) should be charged.

If export proceeds are not realised and the credit is adjusted out of rupee resources, interest at ECNOS should be charged, provided the ECGC has admitted

the claim of transfer delays. In all other cases of adjustment out of rupee resources, interest at commercial rates or ECNOS, whichever is higher, should be charged for the entire period of post-shipment advance. The excess can be refunded if the export is realised in an approved manner subsequently.

25.4. POST-SHIPMENT CREDIT IN FOREIGN CURRENCY

(Export Bills Rediscounting Abroad Scheme)

Exporters who availed the preshipment credit in foreign currency have necessarily to avail the post-shipment credit also in foreign currency. Those who availed the preshipment credit in rupee terms can avail the post-shipment credit either in rupee terms or in foreign currency.

There are three avenues through which the post-shipment credit can be made available in foreign currency:

(*a*) Use of on-shore foreign currency funds;
(*b*) Banks raising foreign currency funds abroad;
(*c*) Exporters raising foreign currency funds abroad.

Use of On-shore Foreign Currency Funds

Banks may use funds from following on-shore sources to extend post-shipment credit in foreign currency:

(*i*) Funds available in Exchange Earners Foreign Currency Accounts, Resident Foreign Currency Accounts, Foreign Currency (Non-Resident) Account (Banks) Scheme. These funds can be used for discounting usance bills and retaining them in the portfolio of the bank without rediscounting. In case of demand bills, the facility can be extended in the form of foreign exchange loan.

(*ii*) A bank which has availed Bankers Acceptance Facility abroad and having unutilised limits there may offer rediscounting facility to another bank in India.

(*iii*) Banks may avail of lines of credit from other banks in India subject to the condition that ultimate cost to the exporter should not exceed 0.75 per cent above Libor*.

Banks Raising Funds Abroad

Banks may arrange a *Bankers Acceptance Facility (BAF)* for rediscounting export bills without any margin and duly covered by collateralised documents. The BAF limit can be fixed with an overseas bank or a rediscounting agency or factoring agency (on without recourse basis for factoring). The facility can be against bills portfolio or on bill-to-bill basis in case of large value transactions.

Exporters Arranging Funds Abroad

Exporters themselves can arrange lines of credit abroad with an overseas bank or any other agency, including a factoring agency. Direct discounting of export bills by an exporter with overseas bank/agency will be done through the branch of bank designated by him for this purpose. The designated bank will be the bank from whom the packing credit facility has been availed of. In case, the bills are routed through any other bank, the latter will first arrange to adjust the amount outstanding under packing credit with the concerned bank out of the proceeds of the rediscounted bills.

Report to Reserve Bank

Details of the BAF/line of credit arranged by the bank/exporter should be reported to Reserve Bank.

* In this chapter, the term Libor refers to Libor, Euro Libor as well as Euribor. For meaning of these terms, please refer to Chapter 31 on International Financial Markets.

The Scheme

(*i*) The scheme covers export bills with usance period up to 180 days from the date of shipment. Demand bills may be included if the overseas institution has no objection to it.
(*ii*) Prior permission from RBI is required for discounting bills with usance exceeding 180 days.
(*iii*) The facility can be offered in any convertible currency.
(*iv*) EBR facility can be extended to exports to ACU countries also.
(*v*) As the discounting of bills/extension of foreign exchange loans (DP bills) will be in actual foreign exchange, the appropriate spot rate will be applied and the rupee equivalent held in bank's books distinct from existing post-shipment credit accounts.
(*vi*) The interest applicable is not exceeding 0.75% over Libor, up to 6 months from the shipment provided the bill is not overdue.
(*vii*) In case of overdue bills interest at 2% above the rediscounting rate for normal bills will be charged from due date to date of crystallisation. Interest rate applicable for rupee post-shipment credit will be charged from the date of crystallisation.
(*viii*) If the export bill is unpaid, the bank can remit the amount of bill discounted to the overseas bank/agency, without the prior approval of Reserve Bank.

25.5. COLLECTION OF EXPORT BILLS

An export bill which is not purchased or negotiated by the bank may be taken up for collection. While collecting the bill for the customer, the banker acts as an agent for the former. He takes steps to collect bill on behalf of and on account of the customer and in accordance with the instructions of the latter. The amount of the bill is credited to the customer's account only after realisation of the bill. Therefore, there is no risk involved for the bank. However, the work involves expense. Further, the bank has an obligation to see that the exchange control requirements are not violated. Therefore, this service is rendered only to known and worthy customers of the bank.

❑ Uniform Rules for Collection

Collection of a foreign bill involves many parties: the exporter (principal or drawer), his banker (remitting bank), the importer (the drawee), and the bank in his country (collecting bank). To have a common code of understanding and standardised procedure and practice for the purpose, the Uniform Rules for the Collection of Commercial Paper, a publication of the International Chamber of Commerce, was first brought out in 1956. It was revised in 1967 and further in 1978, and was titled 'Uniform Rules for Collection'.

The current 1995 revision of the rules (Publication No. 522 of the International Chamber of Commerce) has been adopted with effect from 1st January, 1996. They have been accepted in many countries. They are binding on the parties involved in the collection of foreign bills in the countries where they have been accepted, unless otherwise expressly agreed. FEDAI has approved the adoption of the rules in India.

The Rules cover comprehensively the procedure to be followed for presentation, payment, acceptance, protest, advice of fate, etc., and the responsibilities and liabilities of the bank involved. In the discussion that follows, the provisions of the Rules have been taken into account ; the Articles referred to are of the Uniform Rules for Collection.

❑ Drawer's Instructions

When approached by his customer to collect a bill, the bank should get from him a 'collection order' giving complete and precise instructions. The collection order should cover, *inter alia*, the following points:

1. If the exporter would like the documents to the drawee through any specified bank in the drawee's country. Where no indication is made in the collection order, the bank can utilise the services of any bank of its own or another bank's choice. The utilisation of the services of other banks would be for the account of and at the risk of the drawer (Article 5). Normally, the bills are sent to banks with whom the remitting bank has correspondent relationship.
2. In case of usance bills, if the documents are to be delivered against acceptance (D/A) or against payment (D/P). In the case of D/A bills, the bill of lading and other documents would be handed over to the drawee when he accepts the bill on presentation to him. The drawee is free to get the goods released and deal with them in any manner he likes. The payment will be made on the due date of the bill. The drawer, therefore, loses his hold on the goods before payment is received. In the case of D/P bills the documents are released to the drawee only when payment is made. In the absence of instructions on this point in the collection order the documents will be released only against payment (Article 7).
3. The place at which the documents are to be presented. Full address of the drawee should be given to enable the collecting bank to contact the drawee.
4. Currency and amount to be collected from the drawee. In case the collection order requires collection of interest from the drawee, and no provision is made in the bill of exchange to this effect, it should be specifically stated that the interest should not be waived. In the absence of specific prohibition the collecting bank will deliver the documents without collecting such interest if the drawee refuses to pay the interest (Article 20). Similarly, if the collection charges and other expenses are to be recovered from the drawee, the collection order should expressly state that such charges and expenses should not be waived. In the absence of specific prohibition the collecting bank may deliver documents to the drawee without collecting the charges and expenses, if he refuses to pay such charges and expenses. When the charges and expenses are refused by the drawee, they would be deducted from the proceeds to the drawer (Article 21).
5. If the advice of payment and other matters such as non-payment or non-acceptance is to be sent by mail or cable. In the absence of specific instructions, the collecting bank would send the advice by the method of its choice at the cost of the remitting bank (and ultimately the drawer) (Article 26).
6. In the case of non-payment/non-acceptance by the drawee, the manner in which the bill is to be dealt with. If the drawer nominates a representative to act as case-of-need, in such an event the collection order should clearly and fully indicate the powers of such case-of-need. In the absence of such indication, banks will not accept any instructions from the case-of-need (Article 25).
7. Care of goods in the case of non-payment/non-acceptance by drawee, if the goods should be cleared, insured and stored at the expense of the drawer. Banks have no obligation to take any action in respect of goods. Nevertheless, in case the banks take action for the protection of the goods, whether instructed or not, they are not liable or responsible for the condition or fate of the goods. Any charges and expenses incurred by banks for the protection of the goods will be for the account of the drawer (Article 10).
8. In case of non-payment/non-acceptance, if protest is to be made. In the absence of specific instruction, banks have no obligation to have the documents protested. Any charges incurred by banks in connection with such protest will be for the account of the drawer (Article 24).
9. In the case of usance bills, if any rebate is to be allowed for early payment.

❑ Procedure at the Bank

The bank which receives the bill for collection should verify that the collection order gives complete instructions as required. It should verify that all documents as listed in the collection order are received. In case of any discrepancy it should immediately be brought to the notice of the drawer. The bill should be sent without delay to a bank in the drawee's country. In its covering letter, all the instructions of the drawer should be clearly incorporated.

All advices received from the collecting banker should be promptly intimated to the drawer. Similarly, when intimation of payment is received from the collecting bank the proceeds of the bill should be forthwith placed to the credit of the customer's account, subject, of course, to the advances if any, made by the bank to the drawer against the bill.

The rate of exchange to be applied on realisation of the bills is the TT buying rate. Since the rate does not include bank's commission, it is recovered separately at the rates prescribed by FEDAI.

As an authorised dealer, the obligation of the bank to the exchange control to see that the export proceeds are received into India is there in the case of collection also. Along with the documents, the drawer should submit to the bank the duplicate of GR form relative to the export. The bank should submit to Reserve Bank the statement ENC, when the bill is sent for collection. The duplicate copy of GR form should be submitted to the Reserve Bank, along with R Returns, when the bill amount is realised in full.

If the bill is drawn in foreign currency, the bank may advise the drawer to book a forward contract to avoid exchange risk. The due date of the forward contract should be the probable date of realisation of the bill. If a forward contract has been booked, the bank should apply the agreed rate on realisation of the bill.

25.6. ADVANCE AGAINST BILLS UNDER COLLECTION

An exporter, whose bill has been taken for collection by the bank, may accommodate him by allowing an overdraft or granting a loan up to a certain percentage of the bill under collection.

The major difference between an advance against bill for collection and purchase of a bill is that the former is a rupee advance and the exchange risk remains with the customer. The final amount that the customer realises, in rupees, on the bill will be determined by the rate of exchange prevailing on the date of realisation by the bank.

Secondly, when a bill is purchased the full value of the bill is paid to the exporter. If margin is stipulated, the full value less the margin is paid to him. Normally, advance against the bill under collection is made only up to a percentage of the bill value.

Thirdly, when a bill is purchased, the bank becomes the holder of the bill. When an advance is made against the bill under collection, the bank continues to be an agent of the exporter. The bank retains the right to reimburse itself from the proceeds of the bill. If the bill is dishonoured, or otherwise there is undue delay or difficulty in realising the bill, the bank can recover the advance from the exporter.

The difference between purchase of a bill and advance against it while under collection would be clear from an example.

Illustration. The exporter tenders a bill for USD 10,000. The bill buying rate for US dollar as on the date is Rs. 48.50.

Purchase. If the bill is purchased, the amount that would be paid to the customer is Rs. 4,85,000. Interest on this amount will be charged till the date of realisation of the bill.

Advance against bill for collection. If the above bill is taken for collection, the rate of Rs. 48.50 is not applicable for the transaction. The bank may grant a loan

of, say Rs.3,50,000. Interest will be charged on Rs. 3,50,000 till the date of realisation of the bill and adjustment of the advance. The balance amount payable to the customer will depend upon the TT buying rate prevailing on the date of realisation.

The Need. The need for advance against bills for collection may arise in the following cases:

(*a*) The bill has discrepancies ; but the exporter is trustworthy.

(*b*) There is likelihood of undue delay in the realisation of export proceeds. If the export is to a country like Nigeria which presents difficulties in realisation of export proceeds, the bank may be reluctant to purchase the bill. Instead, the bill may be taken for collection. The exporter may be granted an advance of a lower amount to meet his immediate requirements.

(*c*) The currency in which the bill is denominated is ruling low, but the exporter expects it to gain value soon.

25.7. CONSIGNMENT EXPORTS

In a consignment export, the goods are sent to the exporter's agent abroad. The agent receives the goods on behalf of the exporter, arranges for their storage and sale and remits the sale proceeds after the sale is effected. Consignment export is allowed only in respect of selected commodities like cashew, tea, coffee, *etc.*

No bill of exchange normally accompanies the documents covering a consignment export. The documents are taken for collection by the bank. The bank should submit the statement ENC to the Reserve Bank when the documents are forwarded for collection. The proceeds may be received over a period as and when sales are effected by the agent abroad.

The important exchange control regulations relating to consignment exports (in addition to the above) are:

(*i*) While forwarding shipping documents to its overseas branch/correspondent, the bank should instruct them to deliver the documents only against trust receipt/undertaking to deliver sale proceeds by a specified date furnished by the agent/consignee. The date specified should be within the period prescribed for realisation of proceeds of the export.

(*ii*) The agent/consignee may deduct from sale proceeds of goods, expense normally incurred over the receipt, storage and sale of the goods and remit net proceeds to the exporter.

(*iii*) Freight and marine insurance must be arranged in India.

(*iv*) Declaration in account sales should be supported by bills/receipts in original except in case of petty items like postage/cable charges, stamp duty etc.

Interest

Export on consignment sale should be treated at par with exports on outright sale basis for charging interest. Even if extension of time limit is granted by Reserve Bank for realisation of export proceeds, the concessional interest should be charged only up to the notional due date, subject to a maximum of 180 days.

However, in the following cases, where longer period for realisation of export proceeds is permitted by Reserve Bank, the concessional rate can be charged for longer period as indicated:

(*a*)	Consignment exports to CIS and East European countries	Up to 12 months
(*b*)	Consignment exports by Export Houses/Trading Houses/Star Trading Houses/Super Star Trading Houses to Russian Federation against repayment of State Credit in rupees	Up to 360 days
(*c*)	Exports through the Warehouse-cum-Display centres abroad	Up to 15 months

with commercial banks in Sri Lanka, ADs in India will arrange to credit equivalent amount of US dollar to the account of the Reserve Bank with Federal Reserve Bank of New York on the value date. The Reserve Bank will arrange to credit equivalent amount in ACU dollar to the accounts of the ADs in Sri Lanka through the Central Bank of Sri Lanka on the value date.

The excess liquidity in the ACU dollar accounts is repatriated by ADs by selling to a local commercial bank which desires to fund its ACU dollar account in that participating country concerned or by instructing their correspondents in the participant countries to surrender ACU dollars to the central banks of the concerned countries. In the latter case, upon instructions from that central bank, the Reserve Bank arranges to credit US dollars to the account of the AD in India with the correspondent in New York through the Federal Reserve Bank of New York.

For the purpose of funding or repatriation of excess liquidity, the Reserve Bank receives and pays the US dollar without exchange of any Indian rupee. The Reserve Bank does not undertake any forward purchase of the ACU dollar from the ADs.

The settlement of transactions between the participant member countries takes place at the end of 2 months by payment of US dollars by net debtor country to the country which has net credit position. The account at the ACU headquarters is maintained in Asian Monetary Unit (AMU) which is equivalent to one ACU dollar or one US dollar.

26 Project Exports and Investments Abroad

The last chapter reviewed financing of exports by commercial banks, confining mainly to short-term exports, *i.e.*, where the export proceeds are to be realised within a period of 180 days from the date of shipment. Most of the traditional items are exported under this term. Export of non-traditional items, especially engineering item, requires provision of longer terms of credit to the importer. Exports where the proceeds are to be realised beyond a period of 180 days are known as deferred payment exports on deferred payment terms and execution of turnkey projects and civil construction contracts are collectively referred to as Project Exports.

26.1. DEFINITIONS

To facilitate better understanding certain terms often used in connection with project exports are defined below.

1. Seller's Credit

The financing of an export transaction can be through seller's credit or buyer's credit.

Seller's credit or supplier's credit is the normal procedure where the exporter avails the credit himself from the bank or uses his own funds and allows the importer to pay at a later date. The transaction is financed by the exporter (seller or supplier) or by his borrowing and hence it is known as the supplier's or seller's credit. The exporter may avail pre-shipment finance from his bank which enables him to procure the raw meterials required, manufacture as finished product and ship it to the improper. At the post-shipment stage he may allow the importer to pay the amount in instalments. He would then avail post-shipment finance for a similar term from his bank. In addition to granting pre-shipment and post-shipment finance the exporter's bank may be required to execute performance guarantee on behalf of the exporter guaranteeing the performance of his obligations under the contract of sale.

The seller has given an undertaking to his bank to repay the loan he has borrowed. This undertaking is independent of the payment of the contract amount by the importer. Therefore, seller bears the risk of non-payment by the importer (this risk is known as the credit risk). Further his borrowing from the bank would be in the local currency while the contract may be in the foreign currency. Therefore, the exporter faces the risk of fluctuation of exchange rates when payment is actually made by the importer (this is known as the exchange risk). The exporter should, therefore, take adequate steps to guard himself against this risk. In India, ECGC's Exchange Risk Credit Policy protects the exporter against exchange risk.

2. Buyer's Credit

Under buyer's credit the exporter's bank directly finances the importer or the importer's bank. The exporter gets payment immediately. At the pre-shipment stage, the buyer's credit may take the form of the importer opening a 'red clause' letter of credit authorising the exporter's bank to extend pre-shipment finance to the exporter. At the post-shipment stage the exporter's bank would make immediate payment to the exporter by extending loan to the importer. That is, the exporter is paid out of the loan granted to the importer. The importer's bank would guarantee the repayment of the loan by the importer. Or, the loan may be granted to the importer's bank instead of to the importer.

The seller receives the amount due under the contract immediately and is not responsible for payment by the importer. Therefore, the credit risk is borne by the bank in the buyer's credit. If the loan is granted in foreign currency repayment would come in that currency and therefore the bank is bearing the exchange risk also.

The exchange control regulations in India require that banks should obtain prior approval of the Reserve Bank before agreeing to extend buyer's credits to importers abroad. It is also stipulated that the exporter will have either to provide in the contract itself for the exchange fluctuations risk to be borne by the financial institution in India.

3. Deferred Payment Exports

An export contract providing for payment extending beyond a period of six months from the date of shipment is known as deferred payment contract. Payment may be made by the importer over a period in instalments. All deferred payment contracts require prior approval of the Reserve Bank Export on deferred payment terms are allowed in respect of selected engineering goods.

4. Turnkey Projects

Projects which involve rendering of services like design, civil construction, erection, commissioning of plant or supervision thereof, along with the supply of equipment are known as turnkey projects. All requirements of projects like issuing of guarantees by bank on behalf of exporters, opening of site offices, opening and operating of foreign currency accounts abroad, bridging finance by way of remittance from India on repatriation basis or overdraft arrangements with overseas banks, third country imports and payment of commission to agents are governed by exchange control regulations. All proposals for turnkey projects, whether on deferred payment terms or not, require prior approval of the Reserve Bank.

5. Construction Contracts

The turnkey project as defined above may be entrusted to two different exporters, one undertaking the construction contract and the other exporting services/technical know-how. Thus construction contract involves erection, civil works and commissioning apart from supply of equipment.

6. Export of Consultancy Services

In the case of pure service contracts/assignments involving supply of technical/ managerial know-how, engineering services, professional consultancy, etc., the contractor is not responsible for organising supplies of machinery, equipment and/ or materials going into the turnkey/construction projects. At best he may have to procure tools, instruments, etc., for his own personnel for performing the jobs. In certain cases he may be called upon to give performance guarantee limited to the scope of his work and for satisfactory performance of the personnel supplied and technical services rendered.

26.2. FINANCING OF PROJECT EXPORTS

☐ Working Group

Various aspects of project contracts require approval of several institutions in India such as Reserve Bank, Exim Bank, ECGC and the financing bank. With a view to obviating the necessity for exporters to approach different agencies for obtaining approval and avoiding delay, a working group comprising representatives of Exim Bank, Reserve Bank, ECGC and the bankers of the exporter with Exim Bank as the focal point is functioning to grant package clearance to proposals submitted by exporters. In case of contracts of high value representatives of Finance

and Commerce Ministries of Government of India will also ordinarily participate in the meetings of the Working Group. In order to obtain immediate clarification and thus quicken the disposal by the Working Group, exporters are also associated with the meetings. With the same object, participation of the main sub-suppliers, sub-contractors and their bankers in such meetings is also encouraged, particularly where high value proposals are involved.

For executing a project abroad, the exporter has to pass through the following stages:

(*i*) Obtaining pre-bid clearance from the Working Group;
(*ii*) Submission of bids to the employer;
(*iii*) Obtaining post-bid clearance from the Working Group; and
(*iv*) Taking up and completion of the project.

❑ Pre-bid Clearance

Exporters desiring to submit bids for deferred payment exports or turnkey projects should apply to their bankers in form DPX-1 in ten copies, at least ten working days before the last date for submission of the bid. If the contract is for Rs. 25 crores or less the bank concerned, and if the contract is for value above Rs. 25 crores but within Rs. 100 crores the Exim Bank can grant clearance in principle provided the following conditions are fulfilled:

(*a*) The period of deferred credit should conform to the maximum period allowed by exchange control regulations. For capital/producer goods and turnkey projects the period of credit that maybe offered is as under:

Contract Value	Capital/Producer Goods	Turnkey Projects
Up to Rs. 10 lakhs	3 years	4 years
Over Rs. 10 lakhs but not exceeding Rs. 50 lakhs	5 years	6 years
Over Rs. 50 lakhs but not exceeding Rs. 1 crore	8 years	9 years
Over Rs. 1 crore	11 years	12 years

Consumer durables and miscellaneous engineering goods should ordinarily be exported only on cash terms. In exceptional cases deferred payment terms may be extended up to one year from the date of shipment. Where the value of individual export order is Rs. 10 lakhs or more, credit period may be increased up to a maximum of two years.

(*b*) Moratorium for repayment of principal should not exceed one year in respect of export of capital/producer goods and two years for turnkey projects. No moratorium for export of consumer durables and for payment of interest.

(*c*) Deferred receivables should be received in equal half yearly instalments over the agreed period with relation to the mean date of shipment or the date of respective shipments.

(*d*) The rate of interest on deferred receivables should normally cover the cost of post-shipment credit to the exporter at the prevailing rate.

(*e*) Down payment together with advance payment should not be less than 10 percent of the contract value. The rate of agency commission should not exceed 5 percent of the contract value.

(*f*) Down payments and deferred payments receivable should be secured by a letter of credit/bank guarantee or promissory note from the foreign government.

(*g*) Bridge finance for meeting temporary shortfalls in working capital should not normally exceed 10 percent of the contract value.

Proposals not conforming to the above and those in excess of Rs. 100 crores should be got cleared by the Working Group.

Once the proposal is cleared the bankers of the exporter may furnish the bid bond. If the bid is successful, the exporters may enter into the contract with the overseas buyer and apply for post-award clearance.

❑ Post-bid Clearance

Within fifteen days of entering into contract, the exporter should submit to his bankers an application in form DPX-3 (in respect of deferred payment supply contract) or in form PEX-4 (in respect of civil construction contracts), in ten copies along with eight copies of the contract. If there are any Indian sub-contractors, they should be advised by the prime contractor to submit similar application to the bankers of the prime contractor for obtaining approval of the portion of the contract entrusted to each sub-contractor.

Depending upon the fact whether the pre-bid clearance was granted by the bank itself, Exim Bank or by the Working Group, the bank will grant the post-bid approval or forward the application to Exim Bank or the Working Group as the case may be for their approval. The approvals given by these institutions are only approvals in principle. In all cases, the final approvals for various fund-based and non-fund-based facilities as well as requisite exchange control approvals will be issued separately by the concerned institutions and the exporter's bankers on the basis of the decisions taken while granting package post-award clearance.

All exports under deferred payment terms should be declared on GR/PP form bearing domicile prefix of that office of Reserve Bank in whose jurisdiction their Head Office is functioning. Likewise, all sub-suppliers should declare their exports on forms bearing the same domicile prefix as that used by the prime contractor for the latter's export, irrespective of the location of the office of the sub-supplier.

All GR/PP forms should bear a suitable notation on the top of the form indicating the projects/job for which suppliers are being made and number and date of Reserve Bank's approval. The handling of GR forms is same as discussed in the previous chapter.

26.3. EXPORT OF SERVICES

Contracts for export of consultancy, technical and other services generally fall under the following categories:

(*a*) Preparation of projects/feasibility reports, drawings, designs etc.

(*b*) Supply of technical know-how/engineering services in different fields.

(*c*) Operations, maintenance and supervision of manufacturing plants, buildings and structures, etc.

(*d*) Management contracts for commercial concerns.

Service contracts undertaken on 'cash' term and requiring no fund-based or non-fund-based facility do not require clearance from Reserve Bank or Working Group. The income earned abroad less expenses should be promptly repatriated to India. In case of service contract in computer software, income equivalent to at least 30% of contract value should be repatriated to India and balance can be retained abroad to meet contract related expenses.

❑ Pre-bid Clearance

Pre-bid clearance should be obtained in the case of export on cash basis but requiring fund-based or non-fund-based facilities, from authorised dealer and Exim Bank where the value of contract exceeds Rs. 5 crores and Rs. 10 crores respectively. Cash exports beyond Rs. 10 crores and all deferred payment exports require clearance by Working Group.

The contract should fulfill the following requirements:

(*a*) The value of the contract should not be less than Rs. 20 lakhs, if deferred payment terms are to be offered. The credit period should not exceed the following limits:

	Contract Value	Maximum credit period (including moratorium)
(i)	Over Rs. 20 lakhs, up to Rs. 3 crores	3 years
(ii)	Over Rs. 3 crores, up to Rs. 5 crores	4 years
(iii)	Over Rs. 5 crores	5 years

(b) The rate of interest on deferred receivables should cover cost of export credit in India.

(c) Advance payment up to 25% should be provided for in the contract. In exceptional cases it may be reduced to 5%. In any case, the advance/progress payment should fully cover the foreign exchange outgo and personnel expenses on the project.

(d) Payment of instalments should be secured by letters of credit/bank guarantee or by Government guarantee in respect of public sector units.

(e) The rate of agency commission should not exceed 12.5% of contract value.

The exporter should apply to his bank in Form TCS1 in ten copies at least ten working days before the last date for submission of the bid to the overseas employers. The bank will give in principle sanction where the bid/offer is Rs. 5 crores or less. If the proposal is exceeding Rs. 5 crores, the bank will communicate detailed comments and recommendations to Exim Bank in form TCS2. Contracts up to Rs. 10 crores will be cleared by Exim Bank and those above Rs. 10 crores by the Working Group.

❑ Progress Reports

Exporters should submit quarterly progress reports to all members of the Working Group.

26.4. EXPORT GUARANTEES

Apart from extending credit, an important and useful service rendered by commercial banks to exporters is that of issuing various guarantees. Bank guarantee is an undertaking by the issuing bank to the importer or importer's bank or the government of the importer's country that in the eventuality of the exporter not fulfilling the conditions of the contract, the bank would compensate them for the loss, subject to the maximum amount specified in the guarantee.

Thus the bank guarantee is an assurance to the importer that the exporter would be able to execute the contract of the standard required and within the time specified. If the exporter fails, the importer is compensated for the loss incurred by such failure.

The bank safeguards the importer by issuing a guarantee in his favour. It secures its own position by getting an undertaking from the exporter on whose behalf the guarantee is issued that in case the bank is made to pay under the guarantee he should indemnify the bank of the loss. This undertaking from the importer is known as the counter-guarantee.

The rationale of a bank guarantee is similar to that of a letter of credit. The importer and exporter may not know each other so well. The bank's promise in the form of the guarantee assures the importer that the contract terms would be fulfilled. The importer relies on the superior credit of the bank when he entrusts the work to the exporter. For the exporter too the bank guarantee is useful as he is enabled to get the contract which may not be possible for him without the guarantee.

❑ Types of Guarantee

An export contract may run into various stages : (i) acceptance of the contract by the exporter, (ii) actual supply/erection of the machinery, etc., and (iii) proper functioning of the machinery for a minimum period. Various types of guarantee have been evolved to cover these aspects separately.

1. ***Bid Bond Guarantee*** The importer, in the case of construction contracts and turnkey projects and other contracts involving huge amounts, may call for global tenders. To participate in the tender the contractors are required to furnish bank guarantees for the value of about 5% of the contract amount. Under the guarantee, known as the bid bond guarantee, the bank undertakes to pay the amount fixed under the guarantee if the contract is allotted to the contractor but he fails to take it up. Thus the bid bond guarantee assures the importer that only those contractors with reasonable means and capacity to execute the work participate in the tender and the contract would be taken up by the bidder when allotted to him. The bid bond is normally issued for short periods of three to six months and is terminated on the contractor taking up the contract or on the expiry of the period. Bid bond guarantee is also known as tender bond guarantee.

2. ***Performance Guarantee*** If the contract is awarded to the contractor he would be required to furnish a guarantee whereby his execution of the contract as per terms and conditions agreed is guaranteed. This is known as the performance guarantee. The value of the guarantee should normally be about 10% of the contract amount. The importer is thus assured that the exporter would execute the contract of the same standard and specifications as agreed and within the specified period. In case of failure on these counts he can claim from the bank under the guarantee. The liability of the issuing bank under this guarantee is normally to meet the financial obligation up to the amount guaranteed in the case of failure of the contractor and a claim being preferred on the bank. In some countries the obligation of the issuing bank may be to arrange for performance of the contract, instead of monetary payment.

3. ***Advance Payment Guarantee*** Some contracts may provide for payment by the importer of some advance amount to the exporter to enable him to execute the contract. In such cases the importer may require a bank guarantee that the amount of advance would be repaid to the importer if the contract could not be fulfilled by the exporter. The difference between the performance guarantee and the advance money guarantee is that in the former the bank undertakes to pay up to a certain percentage of the contract amount on the failure of the exporter. In the case of advance payment guarantee, the exporter has received some advance and the amount equivalent to this would be paid by the bank to the importer in case of exporter's failure. Advance payment guarantee is also known as repayment guarantee.

4. ***Retention Money Guarantee*** Many of the turnkey projects and construction contracts provide that a part of the contract amount be retained by the importer to be paid after a period during which time the proper functioning of the work executed could be verified by him. For example, the contract may provide that on completion of the contract 95% of the contract amount be paid to the exporter. The balance 5% would be paid to him after a period of, say, 6 months, during which time the importer would be watching the performance of the work executed to verify that it is of the required standard and does not develop any problem. If this condition is satisfied the 5% amount retained would be paid to the exporter. Otherwise, it would be forfeited. Where the contract involves large amounts, retention of 5% of the contract may mean locking up of a sizeable amount for the exporter. As an alternative arrangement, the contract may provide for payment of 100% of the contract amount on its execution and furnishing of a bank guarantee which provides that in case the work executed is found to be defective within the specified period the bank would pay the specific percentage of the contract amount to the importer. This guarantee which secures release of retention money to the exporter is known as the retention money guarantee.

❑ Uniform Rules for Contract Guarantees

The export guarantees mentioned above, also known as contract guarantees, have the difficult task of creating a fair equilibrium among the legitimate interests of

the three parties involved, *viz.*, the exporter, importer and the issuing bank. They should also define the rights and obligations of the three parties with sufficient precision to avoid disputes. But in practice it is found that lack of experience in certain cases, or abuse by a party of its dominant position in other cases, has tended to create inequitable situations, leading to dispute and distrust. This state of affairs is hindrance to the development of international commerce.

To remedy the situation the International Chamber of Commerce adopted Uniform Rules for Contracts Guarantee [ICC Publication No. 325 (1978)] which endeavours to secure the uniformity of practice. The rules define the different guarantees, and specify the rights and obligations of the parties, clarify the last date of claim, the expiry of guarantee, and details the claim procedures.

The application of the Rules to a guarantee is voluntary. Therefore, it must be evidenced by a specific statement in the guarantee document itself that the guarantee is "subject to the uniform Rules for Tender, Performance and Repayment Guarantees ("Contract Guarantees") of the International Chamber of Commerce (Publication No. 325)."

❑ Exchange Control Regulations

1. Authorised dealers themselves can issue bid bonds, advance payment/ performance guarantees in cases where they have been empowered to approve the proposal without reference to the Working Group.
2. Where the proposal requires approval of Exim Bank/Working Group, the guarantee can be issued by the bank only after the approval is received.
3. The bid bond can be extended for a period not exceeding the period for which they were originally issued in case the proposals were approved by the Working Group. In case of proposals approved by Exim Bank or the bank itself further extension can be made for a reasonable period.
4. Where exporters executing turnkey/civil construction/service contracts abroad are granted an approval in principle by the Working Group/Exim Bank to raise foreign currency loans/overdrafts abroad against counter guarantees of their bankers in India, for bridging temporary shortfalls in the cash flows, the authorised dealer may issue the requisite guarantee.
5. Authorised dealers may make remittances under the guarantees issued. A special report should, however, be sent to the Reserve Bank where the amount of remittance exceeds USD 5,000.
6. Authorised dealers can give on behalf of their customer and overseas branches and correspondents, guarantees in the ordinary course of business in respect of missing or defective documents, authenticity of signature and other minor purposes.

❑ Security

The counter-guarantee executed by the exporter forms the primary security for the guarantee issued by the banks. In addition, the bank may require margin. Depending upon the rating of the customer by the bank, the margin required for issue of guarantee would vary. It may vary from 20% to 100% of the amount guaranteed and may be required to be kept in deposit with the bank. In some cases, instead of margin or in addition to the margin, some tangible assets of the customer may be required to be charged to the bank.

❑ Precautions

1. The creditworthiness of the customer should be studied with emphasis on their ability to execute the contract. The balance sheet of the customer for the past few years may help the bank in this task.
2. The local conditions in the country where the contract is to be executed (in the case of turnkey projects and exports on deferred payment terms) and their economic and political conditions should be studied.

3. Where approval of the Reserve Bank/Working Group is required for issue of guarantee, it should be obtained.
4. A counter-guarantee from the customer should be obtained for the guarantee issued.
5. Commission for the period of the guarantee should be recovered from the customer at the rates prescribed by FEDAI.
6. ECGC's Export Performance Guarantee should be taken which would afford reasonable cover for the risk faced by the bank in issuing the guarantee.

26.5. INDIAN INVESTMENTS ABROAD

Investment abroad by Indian residents may take the form of:

(*a*) investment by Indian entities in overseas joint ventures (JV);
(*b*) investment by Indian entities in wholly owned subsidiaries abroad (WOS); and
(*c*) investment by a person in shares and securities issued abroad.

Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2000 governs such investments.

General permission has been granted to residents for purchase/acquisition of securities:

(*a*) out of funds held in RFC accounts;
(*b*) issue as bonus shares on existing holding of foreign currency shares; and
(*c*) sale of shares/securities so acquired.

General permission has also been granted to a person resident in India for purchase of securities out of their foreign currency resources outside India as also for sale of securities so acquired.

For the purpose of investment in foreign securities in other cases the Regulations have been divided in two parts *viz*.:

Part I – Direct Investment outside India
Part II – Investment in Foreign securities other than by way of Direct Investment.

Direct Investment abroad

1. ***Permitted investment*** An Indian part has been defined as a company incorporated in India or body created under an Act of Parliament, making investment in a Joint Venture or Wholly Owned Subsidiary abroad, including any other entity as may be notified by Reserve Bank. Any Indian party can make investment in overseas joint venture/wholly owned subsidiary to the extent and subject to the conditions mentioned below:

(*a*) Investment upto USD 100 million, or its equivalent in a block of three financial years, except investment in Nepal & Bhutan;
(*b*) Investment in Indian Rupees upto Rs. 350 crores in Nepal and Bhutan in a block of three financial years. (The ceiling will include contribution to the capital of the overseas JV/WOS, loan granted to the JV/WOS, and 50% of guarantees issued to or on behalf of the JV/WOS.)
(*c*) The investment should be in a foreign entity engaged in the same core activity (*i.e.*, activity which constitutes at least 50% of the turnover in the previous accounting year) carried on by Indian company;
(*d*) The Indian party should not have been on Reserve Bank's caution list or under investigation by Enforcement Directorate.
(*e*) All transactions relating to a joint venture/wholly owned subsidiary should be routed through a branch of an authorised dealer to be designated by the Indian party.

2. Funding The investment may be funded out of one or more of the following sources:

(i) Balances held in EEFC accounts of Indian party;
(ii) By remittance from India up to the extent of 50 per cent of Indian party's net worth as on the last audited balance sheet;
(iii) Utilisation of proceeds of foreign currency funds raised through ADR/GDR issues.

Where the investment is entirely funded out of balances in EEFC account the conditions referred to in clause (c) of paragraph 1 will not apply.

3. Investment out of funds raised through ADR/GDR issues An Indian party is permitted to make direct investment without any monetary limit to the extent of 50 per cent of funds raised through ADRs/GDRs (inclusive of any investment already made out of proceeds of ADRs/GDRs.

4. Investment in financial sector Where the Indian party seeks to make investment in an entity outside India engaged in financial sector it should also fulfil the following conditions:

(a) It has earned net profit during the preceding three financial years from the financial services activities;
(b) It is registered with the appropriate regulatory authority in India for conducting the financial services activities;
(c) It has a minimum net worth of Rs. 15 crores as on the date of the last audited balance sheet; and
(d) It has fulfilled the prudential norm relating to capital adequacy as prescribed by the concerned regulatory authority in India.

5. Investment under swap or exchange of shares arrangement An Indian party engaged in information technology and entertainment software or pharmaceutical or biotechnology sector is permitted to acquire shares of a company outside India which is also engaged in the same activity in exchange of ADRs/GDRs issued to the latter for the shares so acquired, provided:

(a) the investment does not exceed USD 100 million, or its equivalent; or
(b) an amount equivalent to 10 times the export earnings of Indian party during preceding financial year inclusive of any other direct investment made during the same financial year, including investment made under (a) above.

The Indian party acquiring shares under swap or exchange of shares arrangement should comply with the conditions specified in this behalf.

6. Approval of Reserve Bank In all other cases of direct investment abroad which are not covered by general permission referred to in previous paragraphs, Reserve Bank's approval would be required. For this purpose applications should be made in:

(a) Form ODI if investment in overseas JV/WOS.
(b) Form ODB if the investment is by way of swap or exchange of shares.

7. Capitalisation of exports and other dues The Indian party is permitted to capitalise the payments due from the foreign entity towards exports made to it (other than those which have remained outstanding for more than 6 months) as also fees, royalties or any other payments due from the foreign entity within the ceilings applicable for investment in overseas JV/WOS. The related GR/SDF/SFTEX form should be superscribed as "Export against equity participation in the JV/WOS abroad". Within 15 days of effecting the shipment, the Indian party should submit to the Reserve Bank a customs certified copy of the invoice through the authorised dealer. Within six months from the date of export, or any further time allowed by Reserve Bank, copies of share certificates or any other document issued by JV/WOS abroad as evidence of investment made.

8. Acquisition of a foreign company through bidding or tender procedure Authorised dealers have been permitted to remit earnest money deposit or issue a

bid bond guarantee on behalf of an Indian party for acquisition of a foreign company through bidding and tender procedure and also allow subsequent remittances.

9. ***Obligation of Indian party*** The Indian party is under obligation to (*a*) receive share certificates or any other document as an evidence of investment, (*b*) repatriate to India the dues receivable from foreign entity and (*c*) submit the documents/Annual Performance Report to Reserve Bank.

10. ***Transfer of shares by way of sale*** Sale of shares of JV/WOS abroad held by an Indian party would require approval of Reserve Bank.

11. ***Credit facilities*** The Indian party has been permitted to pledge the shares of JV/WOS to an authorised dealer or a financial institution in India for availing of any credit facility for itself or for the JV/WOS abroad.

12. ***Reporting to RBI*** Any investment made in terms of Regulations contained in Part I should be reported to Reserve Bank in form ODA.

❑ Other Investments

These regulations relate to investment by residents in foreign securities other than by way of direct investment.

1. General permission has been granted to a person resident in India.
   (*a*) to acquire foreign securities as a gift from any person resident outside India;
   (*b*) to acquire shares under Cashless Employees Option Scheme issued by a company outside India;
   (*c*) to acquire shares by way of inheritance from a person whether resident in or outside India;
   (*d*) who is an employee or a director of Indian office or branch of foreign company or of a subsidiary in India of a foreign company or of an Indian company in which foreign equity is not less than 51 per cent to purchase equity shares offered by the said foreign company under the Employee Stock Option Scheme provided (*a*) such shares are issued at a concessional price and (*b*) the amount of consideration for purchase of shares does not exceed USD 20,000 or its equivalent in calendar year. Authorised dealers have been permitted to allow remittances for purchase of shares under the scheme by eligible persons.
2. The shares acquired by persons resident in India in accordance with the provisions of the Act, Rules or Regulations made thereunder are allowed to be pledged for obtaining credit facilities in India from an authorised dealer.
3. Reserve Bank would consider applications from residents for acquisition of foreign securities in following cases:
   (*a*) Acquisition of qualification shares for becoming a director of a company outside India.
   (*b*) Purchase of rights shares of a company outside India provided the consideration therefor does not exceed USD 10,000 in a block of five calendar years.
   (*c*) Purchase of shares of a JV/WOS abroad by employees/directors of an Indian promoter company in the field of software subject to the certain conditions specified.
   (*d*) Purchase of foreign securities under ADR/GDR linked stock option schemes by resident employees of Indian software companies including working directors provided purchase consideration does not exceed USD 50,000 or its equivalent in a block of five calendar years.
4. Reserve Bank would, on application, permit Mutual Funds in India to purchase foreign securities subject to such terms and conditions as it may stipulate.

27 Export-Import Bank of India*

The Export-Import Bank of India (Exim Bank) is a public sector financial institution, established on January 1, 1982. It was established by an Act of Parliament for the purpose of financing, facilitating, promoting foreign trade of India. It is the principal financial institution for coordinating the working of institutions engaged in financing export and import. The Exim Bank Act also empowers the Bank to finance export of consultancy and related services, assist Indian joint ventures in third countries, conduct export market studies, finance export-oriented industries and provide international merchant banking services. Exim Bank concentrates on medium and long-term financing, leaving the short-term financing to be handled by commercial banks.

Externally oriented companies form the target group for the Bank. The Bank's primary objective is to develop commercially viable relationships with such companies by offering them a comprehensive range of products and services, aimed at enhancing their internationalisation efforts. Its fee based services help identify new business propositions, source trade and investment related information, create and enhance presence through joint network of institutional linkages across the globe. Services include search for overseas partners, identification of technology suppliers, negotiating alliances, and development of joint ventures in India and abroad. The Bank also supports Indian project exporters and consultants to participate in projects funded by multilateral funding agencies.

The activities of the Bank extend to different fields of lending, offering advisory services and promotional activities. The activities of the Bank can be grouped as under:

1. Lending
   (a) to Indian companies
   (b) to foreign Government/companies
   (c) to Indian banks
2. Guaranteeing
3. Advisory
4. Promotional

27.1. LENDING TO INDIAN EXPORTERS

❑ Finance for Project and Service Exports

1. Supplier's Credit for Deferred Payment Exports

Exim Bank offers Supplier's Credit in Rupees or in Foreign Currency at post-shipment stage to finance export of eligible goods and services on deferred payment terms. Supplier's Credit is available both for supply contracts as well as project exports; the latter includes construction, turnkey or consultancy contracts undertaken overseas.

Finance up to 100% of post-shipment credit extended by exporter to overseas buyer is available under the scheme. The facility can be availed of in Indian Rupees or in Foreign Currency. The rate of interest for Supplier's Credit in Rupees is a fixed rate. Supplier's Credit in foreign currency is offered by Exim Bank on a floating rate basis at a margin over LIBOR dependent upon cost of funds.

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* Based on pamphlets and website of Exim Bank.

As already noted in the previous chapter, the credit extended to exporters on deferred payment terms is subject to stipulations of the Reserve Bank with regard to period of credit, quantum of finance, security etc. Accordingly, the facility should be secured by way of acceptable letter of credit and/or guarantee from a bank in the country of import or any third country is necessary, as per RBI guidelines.

Period of credit is determined for each proposal having regard to the value of contract, nature of goods covered, security, competition. Repayment period for Supplier's Credit facility is fixed coinciding with the repayment of post-shipment credit extended by Indian exporter to overseas buyer. However, the Indian exporter will repay the credit to Exim Bank as per agreed repayment schedule, irrespective of whether or not the overseas buyer has paid the Indian exporter.

Exim Bank enters into Supplier's Credit Agreement with Indian exporter as also with exporter's commercial bank in the event of the latter's participation in the Supplier's Credit. The Agreement covers details of draw-down and repayment.

Commercial bank negotiates export documents and seeks reimbursement of Supplier's Credit amount from Exim Bank along with particulars of shipment/s made and copies of shipping documents. Exim Bank either credits the amount in Rupees under Rupee Supplier's Credit into the account of the commercial bank, maintained with Reserve Bank of India (RBI) at Mumbai, or the commercial bank's Nostro Account under Foreign Currency Supplier's Credit and advises details of the amount credited to bank/exporter.

The exporter repays principal amount of credit to Exim Bank as per agreed repayment schedule. Interest amounts are payable to Exim Bank half-yearly without any moratorium.

2. Consultancy and Technology Services Finance Programme

Indian consultants executing overseas contracts involving consultancy and technology services, wherein deferred payment terms need to be offered to the client, can utilise the facility. The credit will be extended by Exim Bank in participation with commercial banks or the commercial bank may finance and obtain refinance from Exim Bank.

Loan will be generally in Indian rupees. Loan in other currencies can also be considered, if necessary.

The exporter is normally expected to obtain an advance/down payment of 25% of contract value and remaining portion would be covered by credit under the programme. The currency of the credit would normally be Indian rupees. Loans in other currencies can also be considered, if required.

The loan is to be secured by guarantee of foreign government or a guarantee/ irrevocable letter of credit of a bank acceptable to Exim Bank. The exporter would also be required to obtain ECGC insurable cover.

3. Pre-shipment Rupee Credit

Credit is available to eligible exporters to buy raw materials and inputs required to produce capital equipment that has to be exported. Exim Bank participates in the credit, if the requirement is for periods in excess of 180 days. Pre-shipment credit up to 180 days is available from commercial banks and, therefore, Exim Bank does not entertain proposals not exceeding this period.

4. Foreign Currency Pre-shipment Credit (FCPC)

Under this programme, short-term foreign currency finance is available to eligible exporters for financing inputs for export production such as raw materials, components and consumables. The finance is repayable in foreign currency from proceeds of the relative exports.

Exporting companies and Commercial Banks for on lending to exporting customers can avail this facility. FCPC can be a cost effective funding source as

compared to rupee export credit as well as overseas supplier's credit depending on market conditions for loans under FCPC. As far as commercial banks are concerned, loans availed of from Exim Bank are exempt from Cash Reserve Ratio, Statutory Liquidity Ratio and Incremental Credit-Deposit Ratio requirements.

The interest rate shall not exceed 2% over LIBOR. In case FCPC is extended through commercial bank which does not have foreign branches, the interest rate should not exceed 2.5% over LIBOR or any other rate as specified by Reserve Bank of India from time to time. Interest on refinance to commercial banks will be mutually agreed upon. The loan is repayable within 180 days from the date of disbursement.

5. Finance for Rupee Expenditure for Project Export Contracts (FREPEC)

This programme seeks to finance Rupee Expenditure incurred/required to be incurred for execution of overseas project export contracts such as for mobilisation/ purchase/acquisition of materials and equipment, mobilisation of personnel, payments to be made in India to staff, sub-contractors, consultants and to meet project related overheads in Indian Rupees.

Indian project exporters who are to execute project export contracts overseas secure on cash payment terms or those funded by multilateral agencies will be eligible. Upto 100% of the peak deficit as reflected in the Rupee cashflow statement prepared for the project is eligible. Exim Bank will not normally take up cases involving credit requirement below Rs. 50 lakhs. Where feasible, credit may be extended in participation with sponsoring commercial bank(s).

Disbursements will be made in Rupees through a bank account of the borrower company against documentary evidence of expenditure incurred, accompanied by a certificate of chartered accountants.

Repayment of credit would normally be out of project receipts. Period of repayment would depend upon the project cashflow statements, but will not exceed 4 (four) years from the effective date of project export contract. The liability of the borrower to repay the credit and pay interest and other moneys will be absolute and will not be dependent upon actual realisation of project bills.

❑ Facilities for Export Capability Creation

1. Lending Programme for Export-oriented Units

Units set up/proposed to be set up in Export Processing Zones, Export-oriented Units, units importing capital goods under Export Promotion Capital Goods Scheme, and units undertaking expansion/modernisation/upgradation/ diversification programmes of existing export-oriented units with export orientation of minimum 10% or sales of Rs. 5 crores per annum, whichever is lower, are eligible.

The facility may take the form of term loans in Indian rupees/Foreign Currency and/or Deferred Payment Guarantee for import of capital goods. The interest on Rupee term loan linked to Bank's minimum lending rate. Foreign currency term loan is available at floating or fixed interest rates based on Bank's cost of funds. The repayment can be extended upto ten years, based on projected cash flows inclusive of suitable moratorium.

2. Working Capital Term Loan Programme for Export-oriented Units (WCTL)

The eligible units are as under the previous scheme. Working capital term loans in Indian rupees or in foreign currency, upto 80% of the demand loan component of working capital with a minimum 20% margin.

Interest rate is also similar to the previous scheme. The loan is granted upto 2 years, depending upon the projected funds flow of the borrower company. Repayment can be a bullet payment at the end of the loan tenor or semi-annual instalments. Rollover of WCTL may be considered at the discretion of Exim Bank.

3. Long Term Working Capital Programme for Export-oriented Units

Finance is provided as long term working capital in Indian rupees or foreign currency to financially sound companies with a minimum export orientation (present or targeted) of 10% of their net sales or export sales of Rs. 5 crores (per year), whichever is lower. Interest rate is as applicable to EOUs. The loan is repayable in 1-5 years, determined on the basis of projected cashflows with suitable moratorium.

4. Production Equipment Finance Programme

Under the Production Equipment Finance Programme (PEFP), Exim Bank seeks to finance non-project related capital expenditure of export-oriented units. PEFP is structured as an umbrella arrangement under which various equipment, imported and indigenous, can be financed, thus obviating the need to arrange finance for every such procurement. It is not necessary to identify specific equipment sought to be financed at the time of application; this could be done at the time of disbursement. PEFP is a fast-disbursing window available to export-oriented units.

Existing export-oriented units with minimum export orientation (present or targeted) of 10% of total sales or Rs. 5 crores in value, whichever is lower, are eligible.

Term loans in Indian rupees/foreign currency are made available for a period of one year from the date of sanction at interest rates as for EOUs. A minimum margin of 10% is prescribed.

5. Import Finance

Term loans in Indian rupees/foreign currency is available to Indian manufacturing companies for import of capital goods/plant and machinery, technology/know-how.

The interest rate will be based on prevailing market rates. Rupee term loan is linked to Bank's minimum lending rate and the foreign currency term loan at floating or fixed interest rates based on Bank's cost of funds. Maximum period for repayment is seven years.

6. Bulk Import Finance Programme (BIF)

Short term working capital finance in Indian rupees or foreign currency is provided to manufacturing companies to access consumable inputs. The import of eligible items should be with a minimum order size of Rs. 1 crore.

For Rupee loans interest rate will be 1% below the rate on cash credit facility charged by the commercial (lead) banker subject to a minimum interest rate fixed by Exim Bank. For foreign currency loan interest will depend on cost of funds to Exim Bank with a maximum of 0.75% over LIBOR. Repayment is in 1 year.

7. Programme for Export Facilitation

Exim Bank offers term finance and non-funded facilities to Indian corporates to create infrastructure facilities to facilitate India's international trade & thereby enhance their export capability. Infrastructural facilities covered under the programme are:

- Software
- Port Development
- Any other infrastructural facility for promoting India's international trade

Financing Port Development Indian companies undertaking minor port projects and suppliers of equipment to minor port development projects can avail term loans for construction of ports/jetties and acquisition of fixed assets for individual activities such as stevedoring, cargo handling, storage and related activities like dry docks, ship breaking.

Interest Rate is linked to Bank's Minimum Lending Rate. For term loans in foreign currency loans interest rates be at floating for fixed rates. In the case of non-funded facilities, applicable rate of commission is charged. Repayment Period will be 7 to 10 years inclusive of moratorium.

Lending Programme for Software Training Institutes Established software exporting company with good export track record and sound financials and reputed software training institutes engaged in high end software training can avail term loans in Indian rupees or foreign currency for (*a*) acquisition of fixed assets including land, building, hardware, software and related equipment; (*b*) extending loans towards tuition fees and other charges; and (*c*) any other activity connected with training that may be agreed to by Exim Bank. Interest rate will be as under previous scheme. The repayment period is maximum of five years, based on projected cash flows inclusive of suitable moratorium.

8. Export Marketing Finance Programme

Under the lending programme for Export Marketing Finance, the term finance requirements for a structural and strategic export marketing and development effort of Indian companies are met.

Activities associated with export marketing and export capability creation are financed under the programme. Typical activities eligible for finance under this programme are desk/field research, minor product adaptation, overseas travel, training, quality certification, product launch, investment in machinery and equipment, testing/quality control equipment, and factory premises.

Term loan in Indian Rupees/US dollar is repayable within five years inclusive of moratorium. Interest rate is linked to Exim Bank's Minimum Lending Rate for rupee loans. For foreign currency it can be floating or fixed. Margin required is 20%.

9. Export Product Development Programme

The programme aims to support systematic export product development plans of established exporting enterprises with focus on industrialised markets.

Eligible Activities include (*a*) product design and development activities; and (*b*) research and development activities including cost of manufacture of prototypes development, pilot plants, product testing, development of toolings, jigs & fixtures, process development costs and product launch.

Rupee Term loan is provided on soft term basis with interest rate decided on case-to-case basis. The repayment can be spread over 5-7 years. The margin required is 20%.

10. Programme for Financing Export Vendor Development (EVD)

The scheme provides finance for export strategic vendor development plans for export companies with a view to enhancing exports through creation, strengthening of backward linkages with vendors.

Export companies and Trading Houses and manufacturer-exporters with strategic plan for vendor development for exports are eligible to seek finance under this programme. Companies purchasing from vendors finished, semi-finished or intermediate products with the exporter adding value to the product in the form of further processing or marketing them are also eligible.

Activities undertaken by exporters to develop and upgrade vendors that will lead to export additionality are eligible for finance under EVD. Examples are:

- acquisition of production machinery;
- purchase of toolings, moulds, jigs, dies and ancillary equipment;
- core working capital assistance extended by exporters to vendors;
- 'soft' expenditure on vendor development such as vendor training, technical assistance to vendors.

Rupee Term loans including soft loan component is made available with a margin of 20% and repayable in 7 years. Soft loan carries interest at 7.5% subject to a maximum of Rs. 50 lakhs. The rupee loan carried interest linked to bank's minimum lending rate.

11. Programme for Financing Research & Development

Companies with a minimum export orientation of 20% of their net sales can avail finance under the scheme for the eligible research activities and research expenditure. Basic research with no identified application, academic research and normal process control, quality control, inspection, repairs and maintenance, contract research will not be eligible under this Programme.

The facility is available as Term Loan in Indian Rupees (subject to a maximum of Rs. 15 crores per company. Amounts in excess of Rs. 15 crores will attract normal interest rate). Concessional interest rate at 50% of the normal interest that the borrower company would be eligible for subject to a minimum of 8% p.a., payable with quarterly rests. Default in loan servicing will attract liquidated damages/penal charges @ 2% over the normal interest rate. Repayment is generally not to exceed seven years, with appropriate moratorium.

❑ **Facilities for Joint Ventures Abroad**

1. Overseas Investment Finance

Any Indian promoter making equity investment in an existing company or a new project overseas with the requisite approval for such investment from the Reserve Bank of India (RBI)/Government of India as also from the government and other concerned authorities in the host country is eligible for finance under the scheme.

The facility will take the form of (*a*) Rupee term loan to Indian companies for financing their equity investment overseas; (*b*) Rupee term loan for on lending to their overseas joint venture/wholly owned subsidiaries; and (*c*) Guarantee for raising finance overseas for equity investment and for working capital requirements for overseas joint ventures/wholly owned subsidiaries.

Interest rate on Rupee term loan is linked to Bank's minimum lending rate. Foreign currency term loan is made at floating or fixed interest rates based on Bank's cost of funds.

Margin is maximum upto 80% of the Indian company's equity contribution in overseas JV/WOS.

An overseas investment insurance policy should be obtained by the company from ECGC/MIGA and assigned in favour of Exim Bank. Exim Bank provides 100% refinance to commercial banks in respect of rupee term loans extended by them to Indian promoter company for equity contribution in overseas JV/WOS. As per prevailing RBI guidelines, commercial banks can consider loan for equity investment only under Exim Bank's Refinance scheme.

2. Asian Countries Investment Partners Programme (ACIP)

The programme aims to promote joint ventures in India between Indian companies & companies from Asian countries through four facilities that address different stages of the project cycle. ACIP seeks to catalyse investment flows into India by creation of Joint Ventures in India between Indian companies and companies from East Asian countries. ACIP is proposed to be a funding instrument providing finance at various stages of a Joint Venture project cycle *viz.*, sector study, project identification, feasibility study, prototype development, setting up project and technical, managerial assistance.

27.2. LENDING TO FOREIGN GOVERNMENT, COMPANIES, ETC.

1. Buyers' Credit

Credit is extended by Exim Bank to buyers abroad to enable them to import engineering goods and projects from India on deferred credit terms. Similar to direct lending to exporters, the facility is to be secured by a letter of credit or bank guarantee or guarantee from government or promissory note from government. An

undertaking letter from the central bank of the country regarding prompt release of exchange towards receivables may also be required.

Exim Bank will directly enter into an agreement with the overseas borrower outlining the terms and conditions of the credit covering the export contract.

2. Lines of Credit

Exim Bank extends lines of credit to overseas governments or agencies nominated by them, to enable buyers in these countries to import capital/engineering goods from India on deferred credit terms. This facility enables Indian exporters to offer deferred credit to customers in these countries, as per terms and conditions already negotiated between Exim Bank and the overseas government. The exporter can obtain payment from Exim Bank against negotiation of shipping documents, without recourse to the exporters.

The lines of credit are denominated in convertible foreign currencies or Indian Rupees and extended to sovereign governments/agencies nominated by them or financial institutions. Such governments/agencies are deemed to be the borrowers, with Exim Bank as the lender. Terms and conditions of different lines of credit are subject to variation and particulars can be obtained for each line of credit from Exim Bank. It would also need to be ascertained from time to time that the lines of credit have come into effect and are available for utilisation.

The buyer arranges to obtain allocation of funds under the credit line from the borrower. The exporter then enters into contract with the buyer, for the eligible items covered under Line of Credit. The contracts would conform to the basic terms and conditions of the respective line of credit.

The buyer arranges to comply with procedural formalities as applicable in his country and then submits the contract to the borrower for approval. The borrower in turn forwards copies of the contract to Exim Bank for approval.

The Exim Bank advises approval of the contract to the borrower, with copy to the exporter. The buyer, on advice from the borrower, establishes an irrevocable letter of credit and advises it through a bank in India designated by Exim Bank.

On shipment, the exporter submits the documents to the designated bank for negotiation. Bank forwards documents to the buyer and copies of the documents to Exim Bank. Exim Bank reimburses the eligible value to the negotiating bank for onward payment to the exporter. It then debits the borrower's account and arranges to collect interest and principal receivable on due dates under the terms of the line of credit agreement between Exim Bank and the respective government agency.

3. Re-lending Facility

Credit is made available to overseas banks for their lending to importers of capital goods from India. Overseas banks thus would intermediate between foreign buyer and Exim Bank, who intermediates with the supplier.

The borrowing bank may be a commercial bank, a central bank, an investment bank or merchant bank of a country with a good credit standing. The loan made by these banks to the importers should be for import of capital goods/equipments and/or services from India. The credit limit for each bank would normally be USD 5-10 million and may be raised to USD 15 million in select cases.

The loan is extended up to 85% to 90% of any single contract. The limit sanctioned should be availed of within 1 year from effective date of agreement. The repayment period may vary from 2 to 5 years including a moratorium of 6 months to 1 year. The currency of the loan is US dollars and requirement should be in the same currency. The minimum value of contract should be USD 1 lakh.

The borrowing bank will make sub-loans, within its own discretion, in developing countries with which India has trade relations. Repayment period of sub-loan should be in conformity with the loan. Interest rate charged by the borrowing bank is to be not higher than 1% above the loan interest rate, unless Exim Bank agrees

otherwise. The borrowing bank will take the political and credit risk on the end borrower.

27.3. LOANS TO COMMERCIAL BANKS IN INDIA

1. Refinance of Export Credit

Under this programme, commercial banks in India, which are authorised dealers in foreign exchange, can obtain from Exim Bank 100 per cent refinance term loans extended for export of eligible Indian goods. Such credit enables Indian exporters to offer credit terms to foreign importers. An export contract up to Rs. 3 crores can alone be brought under this programme. For contracts above Rs. 3 crores, commercial banks can obtain financing participation under Exim Bank's other programmes, including Risk syndication facility.

2. Export Bills Rediscounting Facility

Commercial banks (authorised dealers) can rediscount their short-term usance export bills portfolio with Exim Bank. Exim Bank provides funds under this programme for a period of 90 days against export bills that have equal period to run before realisation. The bill eligible for rediscount, should not have a usance exceeding 180 days and at the time of rediscount, should have an unexpired usance of 90 days. On rediscount the commercial bank is paid 100% of the bill value (less rediscounting charges).

3. Syndication of Export Credit Risks

Under this, commercial banks can support export proposals without blocking their funds for long terms. They can participate in the syndication arrangement.

At the Working Group meeting which accords clearance to the export proposals, the participation arrangement for the funding of export credit is also determined. Exim Bank and other banks participating in the funding of the loan would syndicate the respective credit risks to other eligible commercial banks, who would then assume part of the total risk.

Risk will be assumed by risk participating banks as a percentage of the credit extended for a particular contract, expressed in Indian rupees, irrespective of the currency of the contract. The risk is assumed pro rata on all outstanding amounts by way of principal, interest and other moneys which become due and payable by the borrower.

Commission is payable in advance by risk selling bank/funding bank to risk participating bank, every half year, till due repayment date at 0.5% p.a. *pro rata* on outstanding principal amount, plus interest accruing for the period.

Export credit is secured by securities availed of from the exporter/foreign importer as well as ECGC policy. Risk participating banks can look to these securities, and amounts received would be distributed *pro rata* to participants, who may have met claims against risk undertaken.

Risk participating banks are expected to furnish in favour of Exim Bank/Risk selling banks a standby letter of credit, guaranteeing to assume proportionate risk and pay on demand in the event of any default by borrower.

27.4. NON-LENDING SERVICES

Guaranteeing of Obligations

Exim Bank issues guarantees on behalf of exporters of construction and turnkey projects.

Exim Bank issues following guarantees directly or in participation with other banks, for project export contract:

Bid Bond Bid Bond is generally issued for a period of six months.

Advance Payment Guarantee Exporters are expected to secure a mobilisation advance of 10-20% of the contract value which is normally released against bank guarantee and is generally recovered on a pro-rata basis from the progress payments during project execution.

Performance Guarantee Performance guarantee for 5-10% of contract is issued, valid upto completion of maintenance period normally one year after completion of contract period and/or grant of Final Acceptance Certificate (FAC) by the overseas employer. Format of guarantee is expected to be furnished by exporter, at least four weeks before actual issue, to facilitate discussions and formal approval.

Guarantee for Release of Retention Money This enables the exporter to obtain the release of retention money (normally 10% of contract value) before obtaining Final Acceptance Certificate (FAC) from client.

Guarantee for Raising Borrowings Overseas Bridge finance may be needed at the earlier phases of the contracts to supplement the mobilisation advance. Bridge finance upto 25% of the contract value may be raised in foreign currency from an overseas bank against this guarantee issued by a bank in India. Request for overseas borrowings must be supported by currency-wise cash flows, also indicating the outstanding letters of credit and L / C drawal schedule.

Other Guarantees e.g. in lieu of customs duty or security deposit for expatriate labour.

Exim Bank participates with commercial banks in India in the issue of guarantee.

❑ Guarantee facility for Banks

Under this scheme Exim Bank extends guarantee to commercial banks against the post-shipment suppliers' credit—from one year to three—and the amount of cover is equivalent to the amount covered by the exporter under ECGC. The guarantee commission payable by the bank as per the FEDAI rule is 1.8% on an annualised basis.

Banks can avail refinance facility from Exim Bank at 1% lesser than the RBI facility. In case of defaults, the guarantee will be converted to a refinance facility and the interest rate charged will be 2% below the rate charged by the banks to their customers, subject to a minimum of 13% per annum. Since Exim Bank will pay under the guarantee within 30 days, it will protect the loan asset from being classified as non-performing asset by the bank. Also, if the claim is rejected by ECGC, the amount will be written off by Exim Bank and commercial bank will not be liable to repay.

❑ Advisory Services

Through its International Merchant Banking Division, Exim Bank offers the following advisory services :

(*i*) work closely with Indian companies in designing financing packages for joint ventures in third countries;

(*ii*) advise Indian companies, executing contracts abroad, on sources of favourable financing overseas;

(*iii*) provide access to euro financing sources and global credit sources to Indian companies engaged in exports;

(*iv*) advise on exchange control practices globally;

(*v*) advise and design financial packages for export-oriented industries in India.

These services are being added to, in order that tailor-made financing packages for high value export contracts are available.

❑ Promotional Activities

Under the Export Import Bank of India Act, 1981, the promotional activities expected of Exim Bank are :

(i) undertaking and financing of research, surveys, techno-economic or another study in connection with the promotion and development of international trade;

(ii) providing technical, administrative and financial assistance of any kind for export and import.

(iii) planning, promoting, developing and financing export-oriented concerns; and

(iv) collecting, compiling and disseminating market and credit information in respect of international trade.

Multilateral Agencies Funded Projects Overseas (MFPO)

Exim Banks provides information and support services to Indian companies to help improve their prospects for securing business in multilateral agencies funded projects through:

- Dissemination of business opportunities in funded projects
- Providing detailed information on projects of interest
- Information on Procurement Guidelines, Policies, Practices of Multilateral Agencies
- Assistance for Registration with Multilateral Agencies
- Advising Indian companies on preparation of Expression of Interest, Capability Profile
- Bid Intervention

Promoting Indian Consultancy

Exim Bank encourages Indian consultants to gain and enhance their international exposure by assisting them in securing assignments overseas.

Assignments are awarded under programme sponsored by International Finance Corporation (IFC) in Washington to promote private sector development in select countries and regions. Arrangements set in place cover:

- Africa Project Development Facility
- African Management Services Company
- Africa Enterprise Fund
- South-east Europe Enterprise Development Facility
- Mekong Project Development Facility
- Business Advisory and Technical Assistance Services (BATAS)
- Other Technical Assistance & Trust Funds

Exim Bank assists these agencies in the recruitment of Indian consultants and meets the professional fees of the consultant selected by IFC. Consultancy assignments undertaken comprise pre-feasibility studies, project and investment related services, management information systems, operations and maintenance support mainly for SMEs in a variety of sectors like agriculture, agro-industry, consumer goods, light engineering, telecom.

26.5. FORFAITING

❑ Factoring and Forfaiting

Factoring is the system of advancing against book debts. Factoring involves assignment of book debts by clients in favour of the factoring company for a consideration. The factor assumes the credit and collection function for its client by purchasing his receivables, maintaining the sales ledger, attending to other book-keeping duties and performing ancillary functions.

Factoring differs from bills discounting inasmuch as the factor purchases the entire debts of the unit and is responsible for their collection, while in bills discounting the credit risk rests with the seller. Factoring can be with or without recourse but the former is more common. For the customers (sellers) factoring affords a number of advantages like availability of liquid cash immediately after

sales, reduction of bad debts, reduction in the cost of managing book debts, etc. Factoring can be both for domestic and export trade. Following the recommendation of a Study Group on Factoring Services headed by Shri C.S. Kaluanasundaram, Reserve Bank has permitted few subsidiaries of banks to undertake the factoring service.

Forfaiting is similar to export factoring with a difference that while export factoring is generally for short term, forfaiting is for medium term to cover exports on deferred basis. Forfaiting affords advantage of better liquidity and faster turnover of resources, avoidance of credit risks, elimination of exchange risks, etc., to the exporter.

❑ Forfaiting by Exim Bank

Exim Bank has introduced a scheme of forfaiting as an instrument of financing exports. The arrangement envisages discounting by Indian exporters of bills of exchange/promissory notes relating to export transactions which are 'avalised' or guaranteed by the buyers' bankers with overseas forfaiting agencies on 'without recourse' basis.

Briefly, the procedure involved in the scheme of forfaiting by the Exim Bank is as follows :

(*a*) Exporter initiates negotiations with the prospective overseas buyer with regard to the basic contract price, period of credit, rate of interest, etc.

(*b*) After successful negotiations, he furnishes the relevant particulars such as name and country of overseas buyer, contract value, nature of goods, tenor of credit, name and country of guaranteeing bankers to the Exim Bank and requests for an indicative discounting quote. Exim Bank obtains the indicative quote of forfaiting discount together with commitment fee and other charges, if any, to be paid by the exporter, from an overseas forfaiting agency.

(*c*) On receipt of the indicative quote from the Exim Bank, the exporter finalises the terms of contract, loading the discount and other charges in the value and approaches Exim Bank for obtaining a firm quote. Exim Bank arranges to get the same from an appropriate overseas forfaiting agency and furnishes the same to the exporter. At this stage, exporter would be required to confirm acceptance of the arrangement to Exim Bank within a specific period as stipulated by that bank.

(*d*) The export contract should clearly indicate that the overseas buyer shall prepare a series of avalised promissory notes in favour of the exporter and hand them over against the shipping documents to his banker. The promissory notes will be endorsed with the words 'without recourse' by the exporter and handed over to his banker in India for onward transmission to the Exim Bank.

(*e*) Alternatively the export contract may provide for exporter to draw a series of Bills of Exchange on the overseas buyer which will be sent with the shipping documents through latter's banker for acceptance by the overseas buyer. Overseas buyer's banker will handover the documents against acceptance of bills of exchange by the buyer and signature of 'aval' or the guaranteeing bank. Avalised and accepted bills of exchange will be returned to the exporter through his banker. Exporter will endorse avalised bills of exchange with the words 'without recourse' and return them to his banker for onward transmission to the Exim Bank.

(*f*) Exim Bank will forward the bills of exchange/promissory notes after verification to the forfaiting agency for discounting by the latter.

(*g*) Exim Bank will arrange to collect the discounted proceeds of promissory notes/bills of exchange from the overseas forfaiting agency and effect payment to the nostro account of the exporter's bank as per the latter's instructions.

The role of Exim Bank is as an intermediary between the Indian exporter and the overseas forfaiting agency. Exim Bank will receive avalised bills of exchange or promissory notes, as the case may be, and send them to the forfaiter for discounting and arrange for crediting the discounted proceeds to the nostro account of the exporter's bank who will repatriate the proceeds to India for payment to the Indian exporter.

Exim Bank will issue a certificate to the exporter with a copy to his bank indicating the rate of forfaiting discount. While completing the respective GR/PP form(s), the exporter should indicate the total invoice value of the goods inclusive of the forfaiting discount and should show the amount of discount against the item 'other deductions' to arrive at net realisable value. Copies of these certificates should be attached to both the copies of GR/PP form.

Exim Bank will also issue a certificate to the exporter, once the exporter accepts the firm forfaiting quote, indicating the rate of commitment fee payable by the exporter to the overseas forfaiting agency together with other service charges, if any. It would be in order for authorised dealers to allow remittance of commitment fee/ service charges payable by the exporter as certified by the Exim Bank. Such remittance may be permitted in advance in one lump-sum or at monthly intervals as certified by the Exim Bank. Payment of these fees may be treated analogous to bank charges. In case, however, the commitment fee and other charges exceed 1.5% of the invoice value, the exporter should be advised to obtain prior approval of the Reserve Bank of India. Exim Bank will charge a service fee for rendering above services to the Indian exporter, which will be payable in Indian rupees.

ANNEXURE

EXIM BANK—LENDING AND SERVICE PROGRAMMES

Programme	Use
For Indian Entities	
Export (Supplier's) Credit	Enables Indian exporters to extend term credit to overseas importers of eligible Indian goods.
Finance for Consultancy and Technology Services	Enables Indian exporters of consultancy and technology services to extend term credit to overseas importers.
Pre-shipment Credit	Enables Indian exporters to buy raw material and other inputs for export contracts involving cycle time exceeding six months.
Finance for Deemed Exports	Enables Indian companies to meet cash flow deficits of contracts secured in India and financed by multilateral funding agencies.
Foreign Currency Pre-shipment Credit	Enables eligible exporters to access finance for import of raw materials and other inputs needed for export production.
Finance for EOUs & Units in EPZs	Enables Indian companies to acquire indigenous and imported machinery and other assets for export production.
Foreign Currency Lines of Credit for Imports	Enables eligible export-oriented units to acquire imported machinery for export production.
Export Vendor Development Finance	Enables vendors of export-oriented units to acquire plant and machinery and other assets for increasing export capability.
Export Product Development	Enables Indian firms to undertake product development, R & D for exports.
Overseas Investment Finance	Enables Indian promoters to finance equity contribution in joint ventures/WOS set up abroad.
Software Training Institutes	Enables setting up of institutes for software training.
Export Marketing Finance	Enables exporters to implement market development programmes and finances productive capabilities through loan financing.
Production Equipment Finance	Enables eligible export-oriented units to acquire equipment.
Services	
Underwriting	Enables Indian exporters to raise finance from capital markets through public/rights issues of equity shares/debentures with the backing of Exim Bank's underwriting commitment.
Forfaiting	Enables Indian exporters to convert credit sale to cash sale on without recourse basis.
Guarantee Facility.	Enables Indian companies to provide requisite guarantees to facilitate execution of export contracts and import transactions.

L/C Confirmation	Confirmation of L/Cs covering import of capital goods.
Project Preparatory Services Overseas	Enables Indian consultancy firms to undertake project preparatory studies in developing countries by grant/loan financing.
Business Advisory & Technical Assistance Services Overseas	Enables Indian consultancy firms to undertake specific assignments in select countries through grant financing.
Cooperation Arrangement with African Management Services Co. (AMSCO), Amsterdam	Enables Indian consultants to secure assignments in various projects that are managed by AMSCO in different parts of Sub-Saharan Africa, through grant financing.
Africa Enterprise Fund	Enables Indian Consultancy Firms to undertake specific assignments to assist small and medium entrepreneurs in Sub-Saharan Africa.
Africa Project Development Facility	Enables Indian consultancy firms to undertake specific assignments in Sub-Saharan Africa through grant financing.
EC Investment Partners Facility	Enables setting up of joint ventures in India between Indian companies and enterprises in the European Community.

For Commercial Banks

Refinance of Export (Supplier's) Credit	Enables banks to offer credit to Indian exporters of eligible goods, who extend term credit of over 180 days to importers overseas.
Export Bills Rediscounting	Enables banks to rediscount export bills, with usance not exceeding 180 days.
Small Scale Industry (SSI) Export Bills Rediscounting	Enables banks to rediscount export bills of their SSI customers with usance not exceeding 90 days.
Re-lending Facility	Enables banks overseas to make availab' term finance to their clients, for import of eligible Indian goods.
Refinance of Term Loans to EOUs	Enables banks to offer credit to eligible export oriented units to acquire indigenous and imported machinery and other assets for export production.
Bulk Import Finance	Enables banks to offer finance to importers for bulk import of consumable inputs.
Guarantee-cum-Refinance Supplier's Credit	Enables banks to protect their own cash flow as also its exporter client's cash flow on account of default by overseas buyer. Protects the Bank by not treating the Advance as a Non-performing Asset for provisioning purposes.

For Overseas Entities

Lines of Credit	Enables overseas financial institutions, foreign governments, their agencies to onlend term loans to finance import of eligible goods from India.
Buyer's Credit	Enables overseas buyer to import eligible goods from India on deferred credit terms.

28 Export Credit Insurance

International trade is highly competitive. To be successful, an exporter has to offer good quality material at competitive prices and provide longer and liberal terms of credit to importers. At the same time, selling in international markets is highly risky. Some of the risks are in common with those involved in internal trade. Some risks are aggravated in or are peculiar to international trade.

Two major risks in international trade are : (i) risk of loss of or damage to the goods, and (ii) risk of non-realisation of export proceeds. The former is a risk which is covered by general insurers (under marine insurance). The latter risk is the financial risk or credit risk which is not covered by general insurer.

Non-receipt of export proceeds may be due to failure of the buyer to accept and/ or pay for the goods. This is known as commercial risk. Non-realisation may also be due to reasons beyond the control of the buyer. Such difficulties may be attributed to political and economic changes. An outbreak of war or civil war may block or delay the payment for goods exported. Economic difficulties or balance of payments problems may lead a country to impose restrictions on either import of certain goods or on transfer of payments for goods imported. The loss on account of these risks may spell disaster for any exporter. Nevertheless, too cautious an approach by the exporter in evaluating risks and selecting buyers may result in loss of hard-to-get business opportunities. It is in the broader interests of the country too that exports should be encouraged. The need, therefore, arises for a scheme of export credit insurance designed to protect exporters from the consequences of payment risks, both political and commercial, and to enable them to expand their overseas business without fear of loss. In India, the Export Risks Insurance Corporation (ERIC) was set up by the Government of India in July 1957 to undertake this function.

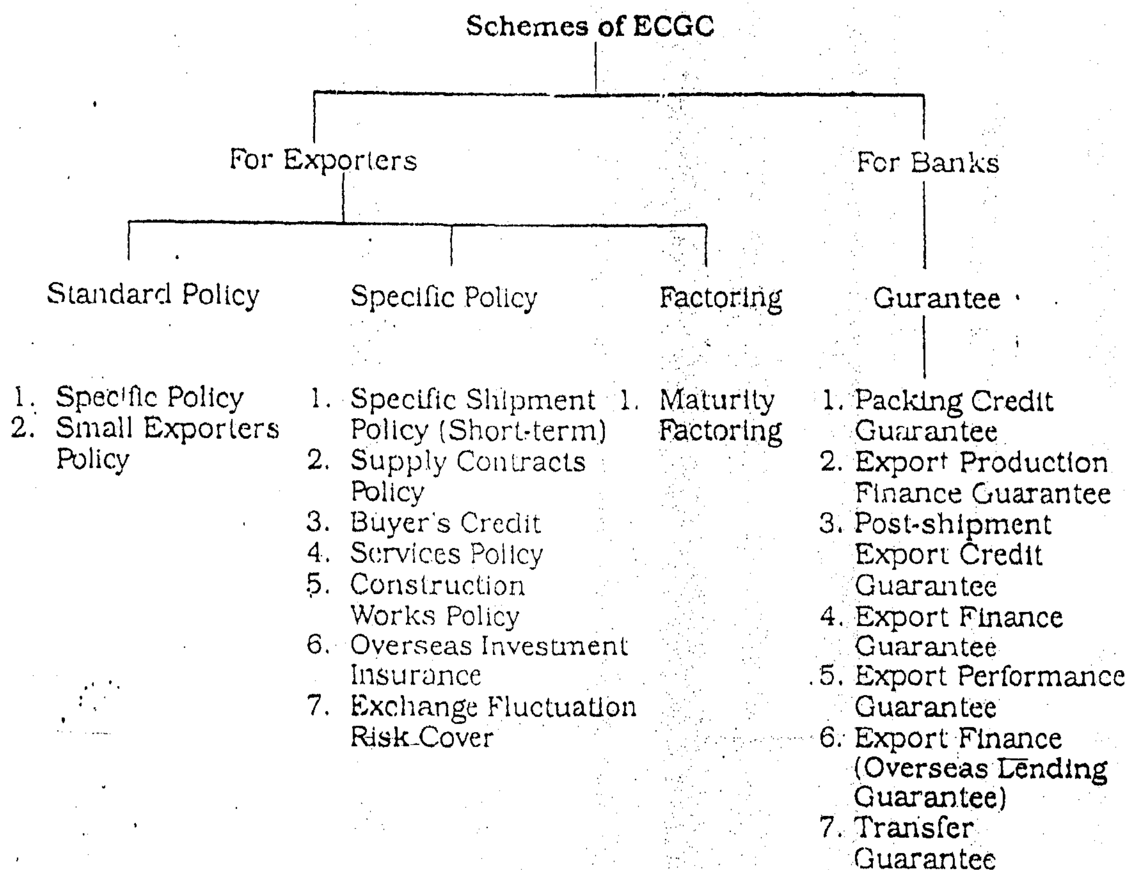
While the policies issued by ERIC provided adequate cover to exporters, it was thought that its functions should be extended. Encouragement to exporters consisted not only in affording protection against credit risks, but also in facilitating their getting timely and liberal credit facilities from banks. The availability of policies to the exporter was an indirect benefit to banks and should encourage their lending to exports sector. But this incentive was not thought to be sufficient to prompt the flow of bank finance to exports. As a direct encouragement to banks, guarantees were begun to be issued in their favour. The guarantee, fundamentally, protects the bank against failure of the exporter to repay the bank advance. Consequently, the ERIC was transformed into Export Credit and Guarantee Corporation Ltd., in 1964. It has since been renamed Export Credit Guarantee Corporation of India Ltd.

ECGC is a company wholly owned by the Government of India. It functions under the administrative control of the Ministry of Commerce and is managed by a Board of Directors representing Government, banking, insurance, trade, industry, etc.

Emerging Scenario

With the liberalisation of the insurance sector, export credit insurance is now being offered by General Insurance companies also. But their impact is yet to be felt. Similarly, ECGC is also expanding its activities and is now offering maturity factoring.

The functions of ECGC are reflected in the different schemes it has evolved to protect the exporter and the exporter's bank. The schemes of ECGC are classified broadly in the chart below.



In the following pages a brief description of the different schemes of ECGC is attempted.

28.1. STANDARD POLICIES

The standard policies issued by ECGC are meant to provide cover for shipments on short-term credit on whole turnover basis.

(1) ***Risks Covered*** The risks covered may be broadly grouped into (*a*) commercial risks, and (*b*) political risks.

Commercial risks covered are :

(*i*) insolvency of the buyer ;

(*ii*) buyer's protracted default to pay for goods accepted by him ; and

(*iii*) buyer's failure to accept goods subject to certain conditions.

Political risks covered are :

(*i*) imposition of restrictions on remittances by the government in the buyer's country or any government action which may block or delay payment of the exporter;

(*ii*) war, revolution or civil disturbances in the buyer's country ;

(*iii*) new import licensing restrictions or cancellation of a valid import licence in the buyer's country ;

(*iv*) cancellation of export licence or imposition of new export licensing restrictions in India ;

(*v*) payment of additional handling, transport or insurance charges occasioned by interruption or diversion of voyage which cannot be recovered from the buyer ; and

(*vi*) any other cause of loss occurring outside India, not normally insured by commercial insurers, and beyond the control of the exporter and/or the buyer.

(2) ***Risks Not Covered*** The following risks are not covered by the policies :

(*i*) commercial disputes raised by the buyer, unless the exporter obtains a decree from a competent court of law in the buyer's country in his favour;
(*ii*) causes inherent in the nature of the goods;
(*iii*) buyer's failure to obtain necessary import or exchange authorisation from authorities in his country;
(*iv*) insolvency or default of an agent of the exporter or of the collecting bank;
(*v*) loss or damage to goods which can be covered by commercial insurers;
(*vi*) exchange fluctuation.

(3) ***Types of Policies*** The policy issued may cover risks from the date of shipment or from the date of contract. In either case, the policy may cover both political and commercial risks (comprehensive policy) or it may cover only political risks. Thus the policy may be any one of the following :

(*i*) Shipment (Comprehensive Risks) Policy ;
(*ii*) Shipment (Political Risks) Policy ;
(*iii*) Contract (Comprehensive Risks) Policy ; or
(*iv*) Contract (Political Risks) Policy.

Where the export is covered by a letter of credit or where the export is made to an associate concern risk due to failure of the buyer is not envisaged. Therefore in those cases the policy covering political risk alone may be preferred.

Contract policies, which cover risks from the date of contract, are issued only in special cases when the goods to be exported are manufactured to non-standard specifications of a buyer. In such a case, if the export is frustrated, the exporter may not find an alternative buyer.

(4) ***Extent of Cover*** ECGC normally pays 90 per cent of the losses on account of political or commercial risks. In the event of loss due to repudiation of contractual obligations by the buyer, ECGC indemnifies the exporter up to 90 per cent of the loss if final and enforceable decree against the overseas buyer is obtained in a competent court of law in the buyer's country. The corporation, at its discretion, may waive such legal action where it is satisfied that such legal action is not worthwhile and in that event losses are indemnified up to 60 per cent. Recoveries made after the payment of the claim are shared with the ECGC in the same proportion in which the loss was borne.

The Corporation's liability is subject to two limits : (*a*) maximum liability, and (*b*) credit limit.

Maximum liability is the limit up to which ECGC would accept liability for shipments made during the period of the policy. If the policy is issued for four years, the maximum liability is in respect of each policy year. The exporter should therefore estimate the maximum outstanding payments due from overseas buyers at any time during the policy period and obtain policy with maximum liability for this amount. The maximum liability fixed under the policy can be enhanced subsequently, if necessary.

Credit limit is the limit up to which ECGC accepts claims in respect of each buyer. The exporter should give complete information regarding the buyer and his banker in the credit limit application. In case the exporter has already obtained a credit report on the buyer, it may be furnished to ECGC. In other cases, ECGC fixes suitable credit limits on overseas buyers, as commercial risks are not covered in the absence of a credit limit on buyer before making shipment.

(5) ***Obtaining the Cover*** The exporter should submit a proposal to the ECGC. After examining the proposal, ECGC would send him an acceptance letter stating the terms of its cover and premium rates. The policy will be issued after the

exporter conveys his consent to the premium rates and pays the stipulated non-refundable policy fee.

The shipments made are covered by the policy on the basis of monthly declarations made by the exporter. He should send to ECGC, by the fifteenth of each month, a declaration of shipments made in the previous month. Under the contracts policy, a declaration of all outstanding contracts should be made immediately after the policy is issued. Thereafter the exporter should send a monthly declaration of contracts concluded and shipments made during the previous month.

The exporter is required to insure all shipments that may be made by him during the currency of the policy, except those made against advance payment or irrevocable letters of credit confirmed by banks in India. However, with prior approval of ECGC, exports of certain commodities or exports to certain countries can be excluded. This would mean adjustments in premium rates.

When payment risks become too high in a country, ECGC provides cover on such countries on a restricted basis. Policyholders intending to export to such countries are required to obtain specific approval of ECGC for each shipment/contract upon payment of a specific approval fee. If such approval is not taken cover is not available even for political risks.

(6) ***Exclusions*** Where an exporter is dealing with several distinct items, ECGC may agree to exclude all shipments of certain agreed items, provided that what is offered for insurance consists of all items of an allied nature and offers the Corporation a reasonable portion of the exporter's total business with a fair spread of risks.

Exporters who fall within the category of Trading Houses and above as defined by the Director General of Foreign Trade (DGFT) may be allowed the following exclusions under the Shipment (Comprehensive Risks) Policy:

- shipment to any country/countries or a group/groups of countries *viz.* A1, A2, B1, B2, C1, C2, D;*
- shipments of any commodity or commodities
- any combination of the above

Option to exclude can be exercised at the time of issue/renewal of the policy or at any time during its currency, which will be excluded prospectively.

(7) ***Premium*** The premium rates are closely related to the risks involved and vary according to countries to which goods are exported and the payment terms. Premium is payable along with the monthly declarations.

(8) ***Reporting Defaults*** In the event of non-payment of any bill, exporter should take prompt and effective steps to prevent or minimise loss. A monthly declaration of all bills which remain unpaid for more than 30 days should be submitted to ECGC in the prescribed form, indicating action taken in each case.

Granting extension of time for payment, converting bills from D.P. to D.A. terms or resale of unaccepted goods at a lower price require prior approval of ECGC.

(9) ***Settlement of Claims*** A claim will arise when any of the risks insured under the policy materialises. If an overseas buyer goes insolvent, the exporter becomes eligible for a claim one month after his loss is admitted to rank against the insolvent's estate or after four months from the due date, whichever is earlier. In case of protracted default, claim is payable after four months from the due date. Claims in respect of additional handling, transport or insurance charges incurred by the exporter because of interruption or diversion of voyage outside India are payable after proof of loss is furnished. In all other cases, claim is payable after four months from the date of the event causing loss.

In case proceeds of shipments are held up due to foreign exchange shortage in the buyer's country, ECGC considers claims after the waiting period as applicable

* The classification of the country for the purpose of premium calculations, based on the risk perception.

for the country concerned. Exchange transfer delay claims should be made with documentary proof to the effect that :

(a) the buyer has made the payment in local currency; and

(b) he has complied with all exchange control regulations necessary to effect transfer of the payment.

❑ Small Exporter's Policy

The small exporter's policy is basically the standard policy, incorporating certain improvements in terms of cover. It is issued to exporters whose anticipated export turnover for the next 12 months does not exceed Rs. 25 lakhs.

The small exporter's policy differs from the standard policy in the following respects :

(i) *Period of policy*. Issued for 12 months as against 24 months in the case of standard policy.

(ii) *Minimum premium*. The minimum premium payable is 0.3% of the anticipated turnover on DP and DA terms of payment, plus where the exporter seeks cover also for LC shipments, 0.10% of the anticipated turnover on LC terms or Rs. 1,000 whichever is higher.

(iii) *Declaration of shipments*. Shipments need to be declared only twice : in the seventh month and the thirteenth month.

(iv) *Declaration of overdue payments*. Monthly declarations of all payments remaining overdue by more than 60 days from the due date, as against 30 days in the case of standard policy.

(v) *Percentage of cover*. 95% for loss due to commercial risk and 100% if due to political risk. Cover is 90% in both cases in standard policy.

(vi) *Waiting period for claim*. Two months as against four months in standard policy.

(vii) *Change in terms of payment or extension of credit period*.

(a) A small exporter may, without the prior approval of ECGC, convert a DP bill into DA bill, provided he has already obtained suitable credit limit on the buyer on DA terms.

(b) Where the value of the bill is not more than Rs. 3 lakhs, conversion of DP bills into DA bills is permitted even if credit limit on buyer has been obtained on DP terms only, but not more than one claim can be considered during the policy period on account of losses arising from such conversions.

(c) Due date of payment of a DA bill can be extended, provided a credit limit on the buyer on DA terms is in force at the time of such extension.

(viii) *Resale of unaccepted goods*. If, upon non-acceptance of goods by a buyer, the exporter sells the goods to an alternate buyer without obtaining prior approval of ECGC as required under the policy, ECGC may consider payment of claims up to an amount considered reasonable by it, provided it is satisfied that the exporter did his best under the circumstances to minimise the loss.

(ix) *Claims due to loss or damage to goods*. ECGC may also consider payment of claim up to an amount considered by it as reasonable where loss is due to loss of or damage to the goods due to certain risks which are not normally included in general/marine insurance policies. The exporters should, in such cases, have exercised normal care in obtaining the general/marine insurance policies.

In all other respects, the small exporter's policy is the same as the standard policy.

28.2. SPECIFIC POLICIES

The standard policy, discussed in the previous section, is a whole turnover policy designed to provide a continuing insurance for the regular flow of an exporter's shipments of raw materials, consumer goods and consumer durables for which credit period does not exceed 180 days. Contracts for export of capital goods or turnkey projects or construction works or rendering services abroad are not of a repetitive nature. Such transactions are, therefore, insured by ECGC on a case-to-case basis under specific policies. Exception to the general arrangement that standard policy is for short term exports and specific policies are for long term exports is the new specific shipment policy (short term) available on individual shipment basis covering short term exports.

1. Specific Shipment Policy (Short term)

Specific Shipment Policy (Short term) offers to cover one or more shipments only under a particular contract. Option is available to cover both commercial and political risks or only political risks. The risks covered are the same as under the Standard Policy. A separate policy is available to cover shipments made under letter of credit against the risks of insolvency and default of the L/C opening bank and political risks. The percentage of cover is 80.

This policy cover can be availed of by exporters who do not hold the Standard Policy or even by those holding it to cover the shipments specifically permitted to be excluded from the purview of the Standard Policy.

2. Specific Policy for Supply Contracts

Specific policy for supply contracts covers exports of commodities for period beyond 180 days. The policy may take any of the following four forms :

(*i*) Specific Shipments (Comprehensive Risks) Policy—to cover both commercial and political risks at the post-shipment stage ;

(*ii*) Specific Shipments (Political Risks) Policy—to cover only political risks at the post-shipment stage in cases where the buyer is an overseas Government or payments are guaranteed by a Government or by banks, or are made to associates;

(*iii*) Specific Contracts (Comprehensive Risks) Policy ; and

(*iv*) Specific Contracts (Political Risks) Policy.

Contracts policy provides cover from the date of contract. Losses that may be sustained by an exporter at the pre-shipment stage due to frustration of contract are covered under this policy in addition to the cover provided by the Shipments policy.

3. Insurance Cover for Buyer's Credit & Lines of Credit

Financial institutions in India, like those in several other countries, lend directly to buyers or financial institutions in developing countries for importing machinery and equipment from India. This kind of financing facilitates immediate payment to exporters and frees them from the problems of credit management as well as from the fear of loss on account of overseas credit risks.

Financing may take the form of Buyer's Credit or Line of Credit. Buyer's Credit is a loan extended by a financial institution, or a consortium of financial institutions, to the buyer for financing a particular export contract. Under Lines of Credit, a loan is extended to government or financial institutions in the importing country for financing import of specified items from the lending country.

ECGC has evolved schemes to protect financial institutions in India which extend these types of credit for financing exports from India. Insurance Agreement will be drawn up on a case-to-case basis, having regard to the terms of the credit.

4. Services Policy

When Indian firms render services to foreign parties they would be exposed to payment risks similar to those involved in export of goods. Services Policy offers protection to Indian firms against such payment risks. The policy has been designed broadly on the lines of ECGC insurance policies covering export of goods, and is issued to cover specific transactions. Two types of policies are issued : (*a*) Specific Services Contract (Comprehensive Risks) Policy to cover commercial as well as political risks ; (*b*) Specific Services Contract (Political Risks) Policy to cover political risks only. Where the contracts are with overseas governments or payments are guaranteed by overseas governments or are covered by bank guarantees/letters of credit, or are to associates, political risks policies are issued.

A wide range of services like technical or professional services, hiring or leasing can be covered under the policies.

The Comprehensive Risks Policy covers the following risks :

(*i*) the insolvency of the buyer ;
(*ii*) protracted default in payment ;
(*iii*) restriction on remittances in the buyer's country or any Government action which may block or delay payment to the exporter ;
(*iv*) war between India and the buyer's country ;
(*v*) revolution or other civil disturbances in the buyer's country ;
(*vi*) Government action in India or in buyer's country which prevents the performance of the contract ; and
(*vii*) any other case of loss occurring outside India and beyond the control of the buyer or the seller.

The policies do not cover losses arising from events preventing the completion of the contract in circumstances where such frustration could free the buyer from his obligation to make payment under the contract.

The policy covers 90 per cent of the loss suffered by the seller. The claim is payable after four months from the due date of payment if the loss arises due to the risk of protracted default. In case of insolvency, claim is payable after four months from the due date of payment or one month after the loss is admitted to rank against the insolvent's estate whichever is earlier. It is payable after four months from the due date or the date of the event which is the cause of loss, as the case may be, if the loss is caused by any of the other risks.

Premium rates are closely related to the risks involved and vary according to the country of the buyer and the terms of payment.

The Services Policy covers such contracts under which only services are to be rendered. Contracts under which rendering of services is part and parcel of a bigger contract for supply of goods or machinery or erection of a plant are covered under Construction Works Policies.

5. Construction Works Policy

ECGC's Construction Works Policy covers civil construction jobs as well as turnkey projects involving supplies and services. It provides cover for all payments that fall due to the contractor under the contract.

Two types of policies have been evolved to cover contracts with (*i*) Government buyers, and (*ii*) Private buyers. The former covers political risks in respect of contracts with overseas Governments or where the payments are guaranteed by Government. The latter covers comprehensive risks. In case of contracts with private employers, the policy may be issued to cover only political risks if the payments are guaranteed by a bank or covered by Letter of Credit.

The following risks are covered in case of contracts with Government employers or if the payments are guaranteed by the employer's government :

(i) default of the government employer;
(ii) delay in the transfer of payment to India;
(iii) war between India and the employer's country;
(iv) civil war or similar disturbances in the employer's country;
(v) imposition of import or export licensing (or cancellation of an existing licence) for goods or materials manufactured or purchased by the contractor after the date of contract, for use on the contract, and for which on the date of loss the buyer has no obligation to pay in terms of the contract;
(vi) additional handling, transport or insurance charges due to interruption or diversion of voyage; and
(vii) the employer's failure to pay to the contractor sums awarded in arbitration proceedings under the contract.

The percentage of loss payable by ECGC in 85 under policies issued to cover contracts with Government employers and 75 in case of policies covering contracts with private employers.

The policy is issued on the basis of estimated basic contract price, estimated interest and other payments due under the contract. Premium is payable at the outset on the estimated figures. Proportionate refund of premium is allowed where the actual contract price and interest charges fall below the estimate.

Cover can also be provided for the contractor's equipments (such as cranes, bulldozers and trucks which are used for construction) against the risk of confiscation, by means of an endorsement to the policy if the contractor so desires.

6. Overseas Investment Insurance

ECGC has evolved a scheme to provide protection for involvement of exporters in capital participation in overseas projects. Any investments made by way of equity capital or untied loan for the purpose of setting up or expansion of overseas projects will be eligible for cover under investment insurance.

The investment may be either in cash or in the form of export of Indian capital goods and services. The cover would be available for the original investment together with annual dividends and interest payable.

The risks of war, expropriation and restriction on remittances are covered under the scheme. As the investor would be having a hand in the management of the joint venture, no cover for commercial risks would be provided under the scheme. For investment in any country to qualify for investment insurance there should preferably be a bilateral agreement protecting investment of one country in the other or, in its absence, an investment protection code. ECGC may consider providing cover in the absence of any agreement or code, provided it is satisfied that the general laws of the country afford adequate protection to the Indian investment.

The period of insurance cover may be extended for a period of 15 years. In case of projects involving loan, erection period cover may be extended for a period of 15 years from the date of completion of the project subject to a maximum of 20 years from the date of commencement of investment. Amount insured shall be reduced progressively in the last five years of the insurance period.

7. Exchange Fluctuation Risk Cover Schemes

The Exchange Fluctuation Risk Cover Schemes are intended to provide a measure of protection to exporters of capital goods, civil engineering contractors and consultants who have often to receive payments over a period of years for their exports, construction work or services. Where such payments are to be received in foreign currency, they are open to exchange fluctuation risk and the forward exchange market does not provide cover for such deferred payments.

The Exchange Fluctuation Risk Cover is available for payments scheduled over a period of 12 months or more, up to a maximum of 15 years. Cover can be obtained from the date of bidding right up to the final instalment.

At the stage of bidding, an exporter/contractor can obtain Exchange Fluctuation Risk (Bid) Cover. The basis for cover will be a "reference rate" agreed upon. The reference rate can be the rate prevailing on the date of bid or a rate approximating it. The cover will be provided initially for a period of twelve months and can be extended, if necessary. If the bid is successful, the exporter/contractor is required to obtain Exchange Fluctuation (Contract) Cover for all payments due under the contract. The reference rate for the contract cover will be either the reference rate used for the bid cover or the rate prevailing on the date of contract, at the option of the exporter/contractor. If the bid is unsuccessful, 75% of the premium paid by the exporter/contractor is refunded to him.

The Exchange Fluctuation Risk (Contract) cover can be issued only if the payments under the contract are scheduled to be received beyond 12 months from the date of contract but in such cases, the cover will apply for any instalments falling due within 12 months as well. Cover will be available for all amounts receivable under the contract, whether it is payment for goods and services or interest or any other payment. Contracts coming under buyer's credit and lines of credit are also eligible for cover under the schemes. The exporter has also an option to terminate the contract at expiry of the third year, by giving three months' advance notice.

Cover under the schemes is available for payments specified in US dollar, pound-sterling, Euro, Japanese yen, Australian dollar, UAE dinar and Swiss franc. However, cover can be extended for payments specified in other convertible currencies at the discretion of the ECGC.

Exchange fluctuation risk cover will normally be provided along with suitable credit insurance cover. There is, however, provision to grant the cover independently also.

The Contract cover provides a franchise of two per cent. Loss or gain within a range of 2 per cent of the reference rate is to the exporter's account. If loss exceeds 2 per cent, ECGC will make good the portion of loss in excess of 2 per cent but not exceeding 35 per cent of the reference rate. In other words, losses up to 2 per cent and beyond 35 per cent of the reference rate will be to the exporter's account. If there be a gain in excess of 2 per cent of the reference rate, the portion which is beyond 2 per cent and up to 35 per cent will be turned over to the ECGC.

The Scheme has been extended to cover export-linked import transactions and advance payments for exports on terms similar to the above. The cover is issued for the entire period of transaction subject to a maximum of 10 years.

The rate or premium is 40 paise per Rs. 100 per year.

28.3 MATURITY FACTORING FACILITY

A new service provided by ECGC is maturity factoring facility to the exporters. Under maturity factoring the factor initially undertakes only sales ledger administration and collection functions. The factor pays the amount of each invoice to the client at the end of the credit term or on the agreed maturity date.

Under the facility offered by ECGC it renders the services of credit protection, sales ledger maintenance and collection. Export transactions involve granting of credit to the buyer for a period not exceeding 180 days. The exporter's bank will discount the export bill in the usual way. The exporter has to remit factoring charges to ECGC through the bank with copies of bill of exchange, order/contract/invoice/proforma invoice, bill of lading/airway bill, GR form and bank's forwarding letter to overseas bank immediately after submission of export documents by the exporter. Bank can claim payment from ECGC 15 days after due date if payment is not received from overseas buyer by then. ECGC will make payment about 10 days after that.

Maturity factoring services are provided on whole-turnover basis for the period of agreement. All shipments involving credit made to the buyers on whom permitted limits have been approved to be offered for factoring.

Exporters with good track record can avail of the facility. Initially the facility will be available to only selected exporters for their exports to selected buyers. An exporter holding ECGC's shipment policy can exclude the factored transactions from the purview of the policy. Banks can exclude the factored bills from Individual Post Shipment Guarantee/Whole-turnover Post Shipment Guarantee.

The exporter has to apply for the approval of the factoring facility (by routing the application through the banks) and enter into a factoring agreement. A separate application is to be made for sanction of permitted limit in respect of each buyer (permitted limit is the maximum amount up to which the Corporation commits to compensate the exporter for shipments made to the buyer).

Factoring facility and permitted limit on the buyer are provided at a nominal cost. The factoring charge for individual invoice varies between 1.8% to 2.5% depending upon usance period and country of destination.

Benefits to Banks

- The maturity factoring facility offered by ECGC does not disturb the existing system of banking arrangement.
- Banks would be able to finance against the factored bills at zero risk, as they would be protected even in case where the non-payment is due to dispute between the exporter and the buyer.
- As the discounting of the bill under the scheme is to be done by the exporter's bank, they would not face any hassle in adjusting advances granted at the packing credit stage.

Benefits to Exporters

- 100% risk protection in respect of transactions where the buyer accepts the bills/documents without recourse to the exporter.
- Sharing of loss in case of non-acceptance of goods/documents due to insolvency or financial difficulty.
- Receivable management and sales ledger maintenance.
- Enables the exporter to avail bank finance on easier terms.
- The exporter can avail of the above benefits without disturbing existing system of banking arrangements.

Exclusions

- Insolvency or default of the agent of the exporter or of the collecting bank.
- Failure of the buyer to obtain authority as per the regulations of the country.
- Failure or refusal on the part of the buyer to pay due to dispute and the resultant counter claim thereof.
- Risk normally covered by General Insurers.

Even in respect of these exclusions, the banks are fully protected to the extent of advances granted against the bill in question.

28.4. GUARANTEES TO BANKS

ECGC's guarantees protect the banks from losses on account of their lendings to exporters. These guarantees have been designed to encourage banks to give adequate credit and other facilities for exports, both at pre-shipment and post-shipment stages, on a liberal basis.

ECGC offers following types of guarantees to provide for varying requirements of bank. They are :

1. Packing credit guarantee ;
2. Export production finance guarantee ;

3. Post-shipment export credit guarantee ;
4. Export finance guarantee ;
5. Export performance guarantee ;
6. Export finance (overseas lending) guarantee ; and
7. Transfer guarantee.

1. Packing Credit Guarantee

This guarantee covers advances granted to exporters at the pre-shipment stage for the purpose of purchase, manufacture, processing and/or packing of goods meant for export against firm contracts of sale, whether on credit terms or against irrevocable letters of credit. Advances given by banks to Indian firms engaged in export of services or to those which take up construction work abroad to meet preliminary expenses in connection with such contracts are also eligible.

The guarantee protects the bank against failure of the exporter to repay the advance because of his insolvency or protracted default to repay. The guarantee covers advances made by the bank over a period of time, normally a year. On or before tenth of every month, the bank has to submit to ECGC a declaration of credits granted and repayments received during the previous month. The premium is payable at 10 paise per Rs. 100 per month or part thereof on the basis of monthly declarations on the highest amount outstanding on any day during the month.

ECGC bears loss to the extent of $66\frac{2}{3}$% subject to a maximum liability fixed under the guarantee. In case of guarantees on account of advances not exceeding Rs. 2 lakhs granted to small merchant exporters ECGC's share is 90% of the loss.

2. Export Production Finance Guarantee

The purpose of this guarantee is to enable banks to sanction advances at the pre-shipment stage to the full extent of cost of production when it exceeds the FOB value of the contract/order, the difference representing incentives available. The extent of cover and the premium rate are the same as of Packing Credit Guarantee.

3. Post-shipment Export Credit Guarantee

Post-shipment finance given to exporters by banks through purchase, negotiation or discount of export bills or advances against such bills qualifies for this guarantee. It is necessary, however, that the exporter concerned should hold suitable policy of ECGC to cover the overseas credit risks.

The premium rate for this guarantee is 7 paise per Rs. 100 per month. The extent of loss covered is 75%.

This guarantee can also be had, even where an exporter does not hold an ECGC policy for finance granted against LC bills, provided that the exporter makes shipments solely against LCs. The premium rate is 10 paise for Rs. 100 per month on the highest amount outstanding on any day during the month. Cover is 75%. Advances against bills under LCs opened by banks in countries placed under restricted cover is subject to prior approval of ECGC.

4. Export Finance Guarantee

This guarantee covers post-shipment advances granted by banks to exporters against incentives receivable in the form of cash assistance, duty drawback, etc. The premium rate is 7 paise per Rs. 100 per month and the cover is 75%.

5. Export Performance Indemnity

The indemnity which is in the nature of a counter guarantee is issued to the exporter's bank to protect against losses that it may suffer on account of guarantees given by it on behalf of the exporters.

The cover is available for such guarantees as bid bond guarantee, performance guarantee, advance money guarantee, retention money guarantee, guarantee to a

foreign bank for finance raised overseas, in case of participating in foreign tenders; guarantees issued for obtaining import licences with export obligations; guarantees to customs for clearing goods without payment of duty; guarantee in respect of export obligation to export promotion councils, commodity boards, the State Trading Corporation of India, the Minerals and Metals Trading Corporation of India, or recognised export houses.

Normally cover is extended up to 75% of loss, but in the case of guarantees in connection with bid bonds, performance bonds, advance payment and local finance guarantees and guarantees in lieu of retention money, the cover may be increased up to 90% subject to proportionate increase in premium.

The premium rate for indemnity issued to cover bonds relating to exports on short-term credits is 0.9% p.a. for 75% cover and 1.08% for 90% cover. For bonds, relating to exports on deferred credit and projects the rate of premium is lower at 0.8% p.a. for 75% cover and 0.95% p.a. for 90% cover.

6. Export Finance (Overseas Lending) Guarantee

If a bank financing an overseas project provides a foreign currency loan to the contractor, it can protect itself from the risk of non-payment by the contractor by obtaining Export Finance (Overseas Lending) Guarantee. Premium rate will be 90 paise per annum for 75% cover and Rs. 1.08 per annum for 90% cover. Premium is payable in Indian Rupees. Claims under the guarantee will also be paid only in Indian Rupees.

7. Transfer Guarantee

This guarantee seeks to safeguard the banks on the confirmation they might add to letters of credit opened by banks abroad in favour of Indian exporters. The guarantee covers risks of :

(*i*) insolvency of the opening bank ;

(*ii*) failure of the opening bank to pay within four months from the due date of payment ;

(*iii*) operation of law which prevents, restricts or controls transfer of the amount of the credit to India, in circumstances outside the control of the opening bank and confirming bank ;

(*iv*) occurrence of war between the country of opening bank and India ;

(*v*) occurrence of war, hostilities, civil war, rebellion, insurrection or other disturbances in the country of the opening bank.

The guarantee covers 75% of the loss in respect of risks (*i*) and (*ii*) and 90% for risks (*iii*) to (*v*).

The premium charges will normally be at the rates applicable under the ECGC's insurance policy covering export of goods. The actual rate will depend upon the country in which the letter of credit is opened and length of the period to be covered.

28.5. ECGC GUARANTEES ON WHOLE TURNOVER BASIS

The two most popular guarantees issued by ECGC are the packing credit guarantee and post-shipment guarantee. As a further incentive to large-scale use of these guarantees, ECGC offers them on whole turnover basis also. When a bank opts for whole turnover packing credit guarantee or whole turnover post-shipment guarantee, it agrees to cover under the scheme all eligible advances by declaring them to ECGC and paying premium on monthly basis.

The advantages that emanate from the use of whole turnover guarantee schemes are mainly three : (*i*) the bank gets higher percentage of cover ; (*ii*) the rate of premium is reduced ; and (*iii*) the trouble of getting individual guarantees is avoided.

1. Whole Turnover Packing Credit Guarantee

The salient features of Whole Turnover Packing Credit Guarantee (WTPCG) are as under :

(i) *Advances covered.* The WTPCG is issued to a bank if it is prepared to cover under the guarantee all its packing credit advances with the exception of packing credit advances to (a) small-scale industrial units, and (b) Government of India enterprises. No exception is available for advances granted to state government or joint sector units.

(ii) *Premium.* The rate of premium on the guarantee is 6 paise per Rs. 100 per month as against 10 paise in the case of individual packing credit guarantee. Further, the guarantee fee is calculated on the average daily product instead of on the highest balance outstanding in the month.

Illustration. During April, a packing credit account had the following balances :

On 1st	Rs. 50,000
On 10th	Rs. 60,000
On 22nd	Rs. 90,000

The premium can be calculated as under :

50,000 × 9 days	=	4,50,000
60,000 × 12 days	=	7,20,000
90,000 × 9 days	=	8,10,000
	=	19,80,000

$$\frac{\text{Rs. } 19,80,000}{30} = \text{Rs. } 66,000$$

$$\text{Premimum at 6 paise per Rs. } 100 = \frac{66,000 \times 6}{100 \times 100} = \text{Rs. } 396$$

(iii) *Extent of cover.* The extent of cover provided is 75% as against the normal $66\frac{2}{3}$%. In respect of advances to small-scale exporters with annual export turnover not exceeding Rs. 10 lakhs and his total annual turnover not exceeding Rs. 25 lakhs, the extent of cover is 90%.

(iv) *Discretionary limit.* Every guarantee mentions a limit up to which the bank can allow packing credit advances to any of its exporter-clients without ECGC's approval. This limit, known as the 'discretionary limit', varies from bank to bank and may change from one guarantee year to another. All limits in excess of the discretionary limit need the approval of ECGC. If this approval is not obtained, the Corporation's liability is limited to the extent under the discretionary limit.

(v) *Declarations.* A packing credit gets the cover under the guarantee by its declaration in the form specified and payment of premium to the Corporation. The money declaration along with the premium is to be submitted by the Head/Zonal/Regional office of the bank before the end of the succeeding month.

(vi) *Annual statement.* A complete statement of limits in force at the commencement of the guarantee is to be furnished to the Corporation by the Head Office of the bank while obtaining the WTPCG for the first time. Annual statements are thereafter to be furnished as on 30th September each year. Whenever new limits are sanctioned or existing limits are enhanced, reduced or cancelled, they should be reported to the Corporation immediately but in any case within 30 days.

(vii) *Specific approval list.* The Corporation issues once a year a list containing names of exporters advances to whom will be covered only on specific approval of the Corporation being obtained by the bank. The approval is required even if the limit is within the discretionary limit of the bank.

(viii) *Advance against incentives.* For banks which have taken WTPCG, the concession of reduced premium and extended coverage of 75% is also available to advances made by them at the pre-shipment stage under export production finance guarantee. Declarations should be submitted separately under the export production finance guarantee on these bases.

(ix) *Extending due dates of advance.* No permission from the Corporation is required for extension of due date of an advance up to 270 days from the date of advance. Extension beyond this period requires approval of ECGC.

(x) *Default report.* If the bank, apprehending losses in an account, stops granting fresh advances it should recall the balance outstanding in the account and send a 'report of default' to the Corporation, within 30 days. Premium need not be paid on an account after the occurrence of default. The bank should keep the Corporation informed of the recovery action taken by it. It should also take such other steps as may be suggested by the Corporation.

(xi) *Nursing Programme.* If in respect of a defaulted account, the bank agrees for a nursing programme, it should place the terms and conditions for such programmes before the Corporation for approval. If the nursing programme is approved by the Corporation, such accounts should not be included in the monthly declarations under WTPCG. Instead a separate packing credit guarantee will be issued for the account.

(xii) *Claims.* If the recovery efforts made by the bank fail to recover the entire debt within four months from the date of occurrence of default, the bank can invoke the guarantee. Claim should be filed after four months from the date of default but within 12 months from the date of expiry of guarantee. No fresh advance should be made to an exporter who has defaulted.

2. Whole Turnover Post-shipment Guarantee

The salient features of Whole Turnover Post-shipment Guarantee (WTPSG) are as under :

(i) *Advances covered.* The bank should include all post-shipment advances, except letter of credit transactions. There is no restriction that the exporter should have obtained shipment policy of the Corporation. The bank has the option to cover L/C transactions under the guarantee. Advances against exports on consignment basis are eligible for cover under the scheme. Banks have the option to cover post-shipment advances granted to small-scale industries and public sector undertakings.

(ii) *Premium.* Premium is payable on daily product basis instead of highest amount outstanding on any day during the month. The rate of premium is 5 paise per Rs. 100 per month if only non-L/C transactions are covered and 4 paise per Rs. 100 per month if L/C transactions are also covered.

(iii) *Percentage of cover.* The percentage of cover under the guarantee would be 85 (instead of 75 under individual guarantee) in case of exporters who are ECGC policy holders and 60% in respect of exporters who do not hold ECGC policy. In respect of small-scale exporting units, the cover is 90% and 65% respectively. Similarly, if L/C transactions are also included, the cover available is 90% and 65% respectively.

(iv) *Discretion to sanction limits.* Limits on individual exporters may be fixed by the bank itself up to the amount indicated by the Corporation in the guarantee. Sanction of limits beyond the discretionary limits requires prior approval of ECGC.

(v) *Countries under restricted cover.* Banks are advised from time to time of the countries placed under restricted cover. Exporters holding ECGC policy are required to obtain ECGC's prior approval for each shipment which

should be checked by the bank before granting advances in such cases. For non-policy holders, the bank should obtain ECGC's concurrence for each shipment.

(vi) *Extension of due date*. Extension in the due date of payment of bills can be allowed by banks up to 180 days. Beyond this period, extension of time requires ECGC's permission.

(vii) *Term exports*. WTPSG applies only to short-term exports. For advances in connection with deferred term exports, construction contracts or services, the bank has to obtain a separate guarantee. The same concessions as under WTPSG, including lower premium rate, will be extended for such guarantees also.

(viii) *Claims*. In case of default, a claim should be preferred by banks under the guarantee within one year from the due date of the advance or the extended due date as the case may be. Where the bill of the exporter is not paid by the buyer on the due date, bills drawn on other buyers can be advanced against till the bank prefers a claim with the Corporation. However, if the exporter is also unable to pay back to the bank the advance and a claim is preferred under WTPSG, no further advance should be given by the bank to the exporter. In case bank desires to nurse the account, it would do so in consultation with the Corporation.

29 Financing Imports

Imports continue to exceed exports causing balance of trade deficit. However the current emphasis is not on import restriction; rather, it is on encourage export oriented imports. This chapter takes a look at the trade regulations in India so as to provide proper background to the aspects of financing of imports.

29.1. AN OVERVIEW OF TRADE REGULATIONS

As in the case of exports, the statutory basis for regulation of imports into India is found in the Foreign Trade (Development and Regulation) Act, 1992 which empowers the Central Government to prohibit or otherwise control imports. Deriving powers under this Act, Central Government has notified the Export and Import Policy, 2002-07 (Exim Policy). The policy specifies the importability or exportability of specific goods. According to the current policy capital goods, raw materials, intermediaries, components, consumables, spares, parts, accessories, instruments and other goods may be imported without any restriction except to the extent such imports are regulated by the book titled "ITC (HS) Classification of Export and Import Items" or any other provisions of Exim Policy or any other law for the time being in force. As seen under exports, the items are classified into:

(*a*) Free goods,

(*b*) Restricted goods. Items which can be imported only against a licence or as per Public Notice;

(*c*) State traded goods, which can be imported only through the specified state trading agency, and

(*d*) Prohibited goods, import of which is prohibited.

❑ Director General of Foreign Trade (DGFT)

DGFT is authority vested with the duty of advising the Central Government on the formulation of export import policy and administering the policy. The office of the DGFT is at New Delhi. He is assisted by Joint DGFTs and Deputy DGFTs at the regional level. DGFT is the licencing authority under schemes under the Exim Policy.

❑ Importer-Exporter Code Number

Every importer/exporter is required to obtain Importer-Exporter Code Number (IEC) by applying to the regional licensing authority concerned. The importer should quote his code number on the relevant bill of entry. The customs authorities will not allow import unless the above condition is fulfilled. In the case of a company/ firm having branches, code number obtained for the Head Office should be used by all its branches also.

In the following cases, the importers/exporters are exempt from obtaining code numbers:

(*i*) Importers covered by Clause 3(1) [except sub-clauses (e) and (l)] and exporters covered by Clause 32 [except sub-clauses (i) and (k)] of the Foreign Trade (Exemption from application of rules in certain cases) Order, 1993,

(*ii*) Ministries/Departments of Central or a State Government,

(*iii*) Persons importing/exporting goods for their personal use, not connected with trade or manufacture of agriculture, and

(*iv*) Persons importing/exporting goods from/to Nepal/Myanmar provided the CIF value of a single consignment does not exceed Rs. 25,000.

❑ Import licences

Licences are now required for import under certain special schemes like advances licences. Licences are issued by the Joint/Deputy/Assistant Director General of Foreign Trade of the region concerned.

Salient Features of a Licence

(1) ***Issued in Duplicate*** Licences are issued in two copies_(i) customs purposes copy, and (ii) exchange control copy. The customs purposes copy is to be presented to the customs authorities along with Bill of Entry for obtaining clearance of goods imported. The exchange control copy is to be presented to the bank for opening a letter of credit or for making remittance of foreign exchange against imports made under the licence. The bank should deal with the exchange control copy of the licence only.

(2) ***Period of Validity*** The licence will state the period of validity. The validity may range from 12 months to 24 months depending upon the scheme under which it is issued.

The validity of an import licence is decided with reference to the date of actual shipment/despatch of goods from the supplying country and not the date of arrival of goods at an Indian port. Therefore, the relevant date would be the date of the bill of lading, air consignment note or date stamp of the office of despatch of post parcel, depending upon the mode of transport. In case of landlocked countries, it would be the date of despatch by train, road or other recognised mode of transport.

Where the date of expiry of an import licence falls before the last date of a month, the licence will automatically be valid up to the end of the month. Also, in calculating the validity date, the date on which the licence is issued is excluded.

(3) ***Actual User Condition*** It means the imported goods should be used only by the importer for his own manufacture or trading or service activity. Where the licence is issued the actual user alone may import such goods unless the actual user condition is specifically dispensed with by the licencing authority.

(4) ***Value, Description and Quantity*** The licence shall indicate the value (on CIF basis), the quantity and the description of specific goods that can be imported.

(5) ***Export Obligation*** The licence issued under a specific scheme may indicate the export obligation to be fulfilled by the beneficiary of the licence in fulfilment of the condition laid down in the scheme. This condition will not affect the importability of eligible goods, as the export obligation is to be fulfilled only in the future.

❑ Schemes under the Exim Policy

The schemes under the Exim Policy are aimed at either encouraging exports or facilitating exports by making available the imported capital goods and raw materials at concessional duty or completely duty fee.

Duty Exemption Scheme

Duty exemption scheme enables duty free import of inputs required for export production. Under this scheme an advance licence is issued to allow import of inputs which are physically incorporated in the export product free of customs duty. The licence is subject to actual user condition which means the licence or the material imported thereunder is not transferable even after completion of the export obligation. The export obligation is that there should be a positive value addition (*i.e.*, FOB value of exports by the licence holder should exceed the CIF value of imports of inputs under the licence) within a period of 18 months.

Duty Remission Scheme

Duty remission scheme enables post-export replenishment/remission of customs duty paid on inputs in the export product. The beneficiary can obtain either :

(a) Duty Free Replenishment Certificate, or
(b) Duty Exemption Pass Book.

***Duty Free Replenishment Certificate* (*DFRC*)** is issued to an exporter for the import of inputs used in the manufacture of goods without payment of customs duty. Within 6 months from the realisation of export proceeds, the exporter should apply to the licencing authority for grant of DFRC. DFRC is subject to a minimum value addition of 33%. Therefore, it will be issued for the vlaue of 75% of the FOB value of the exports. The DFRC and the material imported under it are freely transferable. The validity of the licence is 18 months.

***Duty Entitlement Pass Book* (*DEPB*)** is issued with the objective of neutralising the incidence of customs duty on the import content of export product. Under this scheme an exporter is eligible to claim credit at a specified percentage of FOB value of exports of specified commodities made in freely convertible currency. The credit thus earned can be used to import any freely importable commodity without payment of customs duty. DEPB is valid for a period of 12 months. DEPB and/or the items imported thereunder are freely transferable.

Export Promotion Capital Goods Scheme

Export Promotion Capital Goods (EPCG) Scheme allows import of new capital goods as well as computer software systems at 5% customs duty subject to an export obligation equivalent to 5 times CIF value of capital goods imported to be fulfilled over a period of 8 years. In respect of EPCG licences for Rs. 100 crores or more, the export obligation can be fulfilled in 12 years.

Status Holders

Exports who fulfil the minimum export turnover are given status certificates under Exim Policy as under:

Category of Status	Average FOB value of exports during the preceding 3 years Rs. Crores
Export House	15
Trading House	100
Star Trading House	500
Super Star Trading House	2000

Status holders are eligible for the following facilities:

(i) Licence for both imports and exports on self-declaration basis.
(ii) Priority finance for medium and long term capital requirements as per conditions notified by RBI.
(iii) Exemption from compulsory negotiation of documents through banks. The remittance, however, would continue to be received through banking channels.
(iv) 100% retention of foreign Exchange in EEFC account.
(v) Enhancement in normal repatriation period from 180 days to 360 days.

❑ Export Zones

Export Processing Zone (EPZ) is an industrial estate, cordoned off from domestic tariff area, where trade barriers applicable to the rest of the economy do not apply and where export-oriented units can operate free of import duties or quantitative restrictions and are given other advantages including tax exemptions. Seven free trade zones have been set up in India at Santa Cruz (Mumbai), Kandla, Chennai, Cochin, Noida, Falta (Calcutta), and Visakhapatnam.

Units in the free trade zone and export-oriented units (outside the zone) are similarly placed with regard to conditions and benefits bestowed on them.

An EOU/EPZ unit can import free of duty raw materials, capital goods, equipments, etc., required for production.

The entire production of EOU/EPZ should be exported except rejects upto 5% which can be sold in the domestic tariff area (DTA) subject to payment of duties. 25% of the production may also be sold in the DTA area provided the use of the indigenous inputs is more than 30% in value terms.

The unit should achieve a minimum value addition of 20% ; in case of units engaged in manufacture or production of specified items higher limits are prescribed.

Supplies made to EOU/EPZ units by units in the domestic tariff area are treated as 'deemed exports' entitled for export benefits.

Benefits. These units enjoy the following benefits :

(*i*) The units set up in the EPZs are eligible for concessional rent for lease of industrial plots and standard design factory buildings/sheds for the first three years.

(*ii*) EOU and EPZ units are exempt from payment of corporate income tax for a block of five years in the first eight years of operation.

(*iii*) Foreign equity upto 100% is permissible.

Units in Electronic Hardware Technology Park (EHTP) and Software Technology Park (STP) also enjoy similar status as untis in EPZs.

Special Economic Zone (SEZ) is a specifically delineated duty free enclave and is deemed to be foreign territory for the purpose of trade operations and duties and tariffs. Goods going into the SEZ area from DTA are treated as deemed exports and goods coming from SEZ are a into DTA are treated as imports.

29.2. EXCHANGE CONTROL REGULATIONS

The exchange control regulations relating to imports mainly cover (*a*) payment against import, (*b*) evidence for imports (*c*) opening of letters of credit, (*d*) handling of import bills and (*e*) booking of forward contracts for importers. Opening of letters of credit and handling of import bills are discussed in subsequent sections. Forward contracts were discussed in an earlier chapter. Other exchange control regulations are briefly discussed below. The current exchange control regulations are contained in Annexure to AP (DIR Series) Circular No. 9 dated 24th August 2000 issued by RBI.

❑ Payment against Imports

(*1*) ***Method of Payment*** For shipments made from Bangladesh, Myanmar, Iran, Pakistan and Sri Lanka (members of Asian Clearing Union), payment should be made in ACU dollar. For imports from other countries payment can be made in any permitted currency, including Indian rupee.

(*2*) ***Manner of Rupee Payment*** For payment of import bills, the bank should collect rupees from the importer by debit to the importer's account or by a crossed cheque drawn by the importer on his bankers. Cash payment should not be accepted.

(*3*) ***Application for Remittance*** For making payment against imports, the importer has to apply to the bank in form A1. Foreign exchange obtained should be utilised for the purpose declared by the importer or for any other purpose permitted under the regulations. Where used for imports, proof of utilisation should be submitted to the bank (detailed subsequently).

(*4*) ***Time Limit for Payment*** Normally payment against imports should be made within six months from the date of shipment. Normal usance interest or overdue interest is allowed to be payable against import bills for a period of six months. If there is delay beyond six months, bank may allow the payment provided the reasons for delay are satisfactory to the bank. No interest should be paid for the period beyond six months. However, if the overseas supplier insists, interest may be paid up to 60 days beyond 180 days from date of shipment, provided the

import bill is paid within that period. Deferred payment arrangements involving payments beyond a period of six months requires permission of Reserve Bank.

(5) ***Interest on Import Bills.*** In case of prepayment of usance import bills, remittances can be made only after reducing the proportionate interest for the unexpired portion of usance at the rate at which the interest has been claimed or the 'prime' rate of the country in the currency of which the goods are invoiced or LIBOR for the currency, whichever is applicable.

(6) ***Endorsement on Import Licence*** When letters of credit are opened or remittances are made against imports, endorsements should be made by the bank in appropriate column at the back of the import licence. Similar endorsement should be made when the bank opens a back-to-back inland letter of credit on behalf of duty free licence holders. The exchange control copy of the licence should be retained by the bank opening the letter of credit till scrutiny by the internal audit or inspection is completed.

(7) ***Advance Remittance*** Advance remittance against imports is permitted subject to the following conditions:

(*a*) The importer holds a valid licence, where required.

(*b*) Remittance is made direct to the suppliers.

(*c*) Remittance in excess of USD 1,00,000 may be allowed provided a guarantee or counter-guarantee or standby letter of credit from an international bank of repute situated outside India has been provided in favour of the importer.

(*d*) The importer should give an undertaking to import within a period of three months (twelve months for capital goods) from the date of remittance and furnish documentary evidence within 15 days from thereon. The bank may permit extension of time for import not exceeding one month (three months for capital goods) provided the reasons for seeking extension of time are convincing. If the advance remittance has been made against a bank guarantee, where necessary, it may be amended to cover the extended period.

(*e*) In the event of non-import of goods, the amount should be repatriated to India or utilised for a permitted purpose.

❑ Ensuring import of goods

Provisions have been made to ensure that imports against which payment in foreign exchange is made do take place. Where the value of import exceeds USD 5,000 the importer is required to submit to the authorised dealer through whom the relative remittance was made, the exchange control copy of the relative bill of entry or customs assessment certificate or postal wrapper as evidence to show that the goods have actually been imported into India.

On receipt of the documentary evidence, the bank should issue an acknowledgement to the importer containing the following particulars:

(*a*) importer's name, address and code number;

(*b*) import licence number and date (where applicable);

(*c*) bank's reference of letter of credit number, etc., if any;

(*d*) number and date of the bill of entry/postal appraisal form or customs assessment form and the amount of import; and

(*e*) particulars of goods imported.

The documentary evidence should be duly verified and preserved for inspection by their auditors/inspectors. The documents should be retained by the bank for one year after certification by the auditors/inspectors. In respect of cases under investigation by investigating agencies, the documents can be destroyed only after obtaining clearance from the investigating agency concerned.

In case an importer does not furnish the exchange control copy of the customs bill of entry or the postal wrapper, as the case may be, within 3 months from the date of remittance, the bank should rigorously follow up for the next 3 months, including issue of registered letters to the importer to produce it forthwith.

The branch should forward to the Reserve Bank within 15 days from end of every half year, a statement in Form 'BEF' furnishing the details of transactions exceeding USD 5,000 in respect of which the importers have not submitted the documentary evidence within six months from the date of remittance. For transactions up to Rs. 3 lakhs, it is the responsibility of the authorised dealer to rigorously follow up till the documentary evidence is furnished by the importer.

The following two cases need not be considered as default:

(a) The advance remittance was used for any permitted purpose other than that for imports;
(b) Into Bond Bill of Entry is submitted as a provisional evidence of import into India.

Imports through Courier Where the CIF value of the consignment imported through courier service is Rs. 1 lakh or more importers are required to submit exchange control copy of the bill of lading for home consumption as in case of other imports. In case import is for less than Rs. 1 lakh, the bank may accept a copy of bill of entry in the prescribed form issued by the Customs in the name of the Courier Company, duly certified by the Courier Company itself.

Import of Software Where imports are made in non-physical form, *i.e.*, software or data through internet/datacom channels and drawings and designs through e-mail/fax a certificate from a chartered accountant that the software/data/drawing/design has been received by the importer should be submitted.

29.3. OPENING A LETTER OF CREDIT

❑ Appraisal

Banks can open letters of credit only on behalf of their own customers who maintain accounts with them and are known to be participating in the trade. By opening a letter of credit, the bank undertakes to make payment on behalf of the customer to the extent of the amount of the credit. The bank should, therefore, appraise the creditworthiness of the customer as if an advance is made to him.

In particular, the bank would require the following information from the customer for considering sanction of the facility:

(a) Nature of business of the unit-manufacturer, importer, exporter or trader.
(b) Amount of the import requirements and the amount of limit required.
(c) Terms of payment-sight or usance.
(d) Nature of goods to be imported and if import licence is obtained.
(e) Details of past dealings of the unit (financial statements for the last three years may be required).
(f) Security for the facility; additional security, if any, in addition to charging of the goods to be imported.
(g) Margin money agreed to be deposited for the facility. The margin agreed by the bank will depend upon various factors such as the Reserve Bank stipulations, the creditworthiness of the applicant, nature of the commodity to be imported, etc. The margin may be deposited by the applicant or by a third party.
(h) In case the limit is for a large amount, details of the parties from whom the applicant intends to import may be obtained. The bank may obtain credit report on important intended exporter.

The Reserve Bank has suggested that this letter of credit should be opened normally for customers who enjoy credit facilities with the bank. In case a request to open a letter of credit is received from a customer who is having only current account with the bank, it should be satisfied that-

(a) there is genuine need for establishing the credit;
(b) the customer has ability to retire the documents under the credit without approaching the bank for credit limits to retire such documents;

(c) the customer's financial position as evidenced by the financial statements is satisfactory. His income and wealth tax assessment is also to be verified; and

(d) adequate margin is taken; additional securities are also obtained.

Where the customer has facilities with another bank and only a current account with the credit opening bank, the bank should obtain in writing from the customer the reason for not approaching the other bank. Concurrence of the existing bank who had sanctioned facilities to the customer should also be obtained along with satisfactory report about him.

The limit will be sanctioned after a careful scrutiny of the proposal. For importers with large turnover, where more than one letter of credit may be established, a general limit for opening of letters of credit may be sanctioned. Individual letters of credit are issued as and when required by the party, within the overall limit sanctioned. Where frequency of transactions is not as expected, sanction may be accorded for individual letter of credit, as and when required by the party.

❑ Documents to be verified

After obtaining sanction of the facility, when the importer wants a letter of credit to be established, he should produce to the bank the following:

(a) Application-cum-agreement for opening the credit;

(b) Exchange control copy of the Import Licence or reference to ITC classification; and

(c) The sale contract between exporter and importer.

(i) ***Application for Opening the Credit*** The application for letter of credit is a stamped document which, besides giving details required for opening the credit, also acts as an agreement between the bank and the customer. It stipulates the conditions governing the letter of credit, contains an undertaking by the customer to make funds available in his account with the bank when bills would be presented under the credit. It also grants right to the bank over the goods covered by the documents presented under the credit till payment is made by the customer. In the application the customer agrees to subject the credit to the provision of Uniform Customs and Practice of Documentary Credits. The Bank should verify that particulars required for opening the credit are clearly stated in the application. The application is a printed form calling for information like:

(a) Name and address of the beneficiary;

(b) Nature of credit-revocable or irrevocable, confirmed or unconfirmed, transferable, etc.,

(c) Amount of the credit and currency;

(d) Details of goods to be imported, their nature, quality, specification, quantity and unit price;

(e) Trade terms-whether the price is on FOB, CFR or CIF basis;

(f) Details of bill of exchange to be drawn-tenor and draw;

(g) Mode of transport and document evidencing shipment/bill of lading, airway bill, etc.;

(h) Documents to be tendered-nature of documents and the number of copies of each document;

(i) If Insurance policy is to be obtained, risks to be covered and value;

(j) Latest date of shipment and for negotiation;

(k) Whether partial shipments are allowed; and

(l) Whether transhipment is allowed.

(ii) ***Import Licence*** If the import is covered by a specific licence, the exchange control copy of the licence should be obtained. The details that are available in the licence have been discussed in the previous section.

(*iii*) ***Sale Contract*** The sale contract between the exporter and the importer should be verified by the bank and a note of verification should be made on the credit application. If the customer is not in a position to submit the sale contract, any one of the following documents may be accepted for scrutiny by the bank:
(*a*) Order together with the order confirmation of overseas supplier.
(*b*) Proforma invoice of overseas supplier duly countersigned by importer.
(*c*) Indent/Order from overseas supplier or his authorised agent.

❑ Scrutiny of Documents

While scrutinising the documents tendered by the applicant, the bank should pay attention to the following:

(*a*) The documents are signed, dated and complete in all respects.
(*b*) The licence is not reported lost or cancelled by the Reserve Bank/ITC authorities.
(*c*) The commodity to be imported is the same in all the documents.
(*d*) Quantity restriction, if any, imposed in the licence is not exceeded.
(*e*) The value of the consignment is permitted under the licence. Licences are issued for CIF value. If the import is made on FOB basis, the licence cannot be utilised to its full value on FOB basis. Provision has to be made on the FOB value for insurance at 1% and for freight at 10% for carriage by sea and at 20% for carriage by air. For example, if the import is for Rs. 20,000 on FOB basis, it is taken that the licence is utilised to the extent of Rs. 22,200 calculated as under:

FOB value	Rs.	20,000
Insurance-1%	Rs.	200
Freight-10%	Rs.	2,000
	Rs.	22,200

(*f*) Country of origin of goods, whether permissible.
(*g*) Currency of letter of credit, if permissible.
(*h*) Last date of shipment. It should not be beyond the validity of licence.
(*i*) Date of expiry of letter of credit. The payment for imports should be made within six months from the date of shipment. Therefore, in case of letters of credit calling for usance bills, it should be ensured that the credit provides for payment within six months from the latest date of shipment allowed in the licence.
(*j*) If the contract term is CIF, the letter of credit calls for freight paid bill of lading and insurance policy. If on FOB or CFR basis, the importer should arrange for insurance of goods.
(*k*) If transhipment is allowed, the insurance covers transhipment risk also.

Establishing a Letter of Credit

(*i*) ***Limit*** The importer would submit an application for opening the letter of credit to the bank. When the application is received, it should be verified that the outstandings under the letter of credit and bills paid thereunder but still not released by the customer together with the amount of the credit now required to be opened do not exceed the limit sanctioned to the customer.

(*ii*) ***Issue of Letter of Credit*** Each bank has its own printed form of letter of credit. The letter of credit is prepared in 5 to 7 copies depending upon the requirements of the bank. The minimum is five copies to be used as:
(*a*) the beneficiary's copy (the original);
(*b*) Advising bank's copy;
(*c*) copy to the applicant;
(*d*) copy to Head Office of the bank; and
(*e*) file copy.

The letter of credit should be complete and precise in all respects.

The original of the credit and the copy meant for the advising bank are sent to the advising bank for onward transmission of the original to the beneficiary. If the advising bank is required to confirm the credit, it will be specifically stated in the covering letter.

(*iii*) ***Advance copy*** If the applicant desires that only the information about the establishment of the credit be sent by cable, a short cable message may be sent to the advising bank. The message gives only the essentials like the names of the beneficiary and the applicant, amount, brief description of goods, last date of shipment and negotiation. The opening bank should make clear its intention that the message is only for information and not to be treated as letter of credit by adding the words 'airmailing details' or 'details to follow'. The regular letter of credit should indicate prominently that it is in confirmation of the cable message already sent.

(*iv*) ***Reimbursement Clause*** If the opening bank maintains an account with the advising bank, it may authorise the latter to debit that account when bills are tendered under the credit. The credit may also provide reimbursement to the negotiating bank at any other bank in the same centre or some other centre. In such a case the reimbursing bank will be sent a copy of the letter of credit with authority to debit the account of the opening bank with it when the negotiating bank informs it that bills have been negotiated under the credit as per the terms stipulated.

(*v*) ***Margin*** Margin as stipulated in the sanction letter should be obtained and kept in the 'Margin on Letter of Credit Opened Account' or other similar account.

(*vi*) ***Endorsement on Documents*** The fact of establishment of the credit should be endorsed on:

(*a*) the licence; and

(*b*) the sale contract.

(*vii*) ***Commission*** The commission to be recovered is prescribed by FEDAI Rules. In addition to commission, the bank is entitled to recover actual cable charges and postage.

(*viii*) ***Accounting Entries*** On opening the letter of credit, the following vouchers are passed:

Dr. Customer's Liability on Letter of Credit Issued

Cr. Bank's Liability on Letter of Credit Issued.

The rate applied for opening the accounts is the bills selling rate prevalent on the date of opening of the letter of credit.

❑ Amendments

Subsequent to the opening of letter of credit, the applicant may approach the bank for advising certain amendments. The amendments may relate to (*a*) the amount, (*b*) the date of shipment/negotiation, or (*c*) any other requirement of the credit. Such amendment may be advised by the opening bank provided they do not exceed the licence provisions. The amendment is advised through the advising bank.

If the amendment involves increasing the limit of the letter of credit, additional commission should be recovered. Further, for the enhanced limit accounting entries should be passed. If it involves extension of time limit of the credit, additional commission for the extended period, if chargeable, should be recovered.

❑ Cancellation

The liability under the letter of credit is reversed as and when bills are received and paid under it. If, at the end of the period of negotiation allowed under the credit, a portion or full value of the credit is unutilised, it is automatically cancelled. However, the date is valid for negotiation at the other end. Therefore, the opening

bank should wait for a reasonable period after due date of the credit, say, for a month; and then reverse the entries passed on opening the letter of credit. Cancellation of the credit should be intimated to the beneficiary through the advising bank.

29.4. PAYMENT OF IMPORT BILLS

Bills drawn on the importer may be received by the bank:

(a) under a letter of credit opened by it; or

(b) other than under a letter of credit, i.e., Foreign Inward Bill for Collection.

❑ Bill Received under a Letter of Credit

When a bill is received under a letter of credit opened by it, the bank should first verify that all the documents as mentioned in the covering schedule received from the negotiating bank are in fact received. It should then subject the documents to a thorough scrutiny to ensure that they strictly conform to the stipulation of the letter of credit.

If any discrepancies are found in the documents, the bank should immediately inform the negotiating bank of the discrepancy and hold the documents at the disposal of the negotiating bank. Simultaneously an intimation of the arrival of documents and discrepancies found therein should be sent to importer asking him to call on the bank to verify the documents and see if they could be accepted. If the importer refuses to accept the document, the fact should be intimated to the negotiating bank seeking their further advice in the matter. To the extent of the bills received, the liability in the letters of credit issued account should be reversed. In all other respects the procedure is same as if the bills were received for collection by the bank.

If the documents received are in order, the bank should immediately pay the negotiating bank, if reimbursement has not already been obtained by it. An intimation should be sent to the importer asking him to retire the bills immediately.

The bill is received in foreign currency and, therefore, the exact liability of the importer in rupees is determined only when he makes payment against bills. On the date of retirement of the bill by the importer, the ruling bill selling rate is applied and the amount of the bill and bank charges thereon are converted into rupees.

However, if the importer does not retire the bill within ten days of receipt of the bill by the bank, on the tenth day, the bank should convert the foreign currency amount into rupees at the ruling bill selling rate by passing the following vouchers:

Dr. Advance Bills

Cr. Nostro Account

If a forward contract had been booked for the import, the conversion should be done at that rate. If the tenth day happens to be a bank holiday or a Saturday, the conversion should be done on the succeeding working day.

The customer is liable to pay interest on the import bill at the following rates:

(a)	From the date of negotiation of bill abroad to the date of debit to advance bill account	Rate applicable to non-priority sectors
(b)	From the date of debit to advance bills account to date of retirement of the bill	Penal rate

Usance Bills Usance bills are to be stamped according to the current rates of stamp duty converting the foreign currency value into rupees at the rates prescribed by Government of India from time to time. The bill should be presented to the customer for acceptance. If the bill is on D/A terms, the documents should be delivered to the customer retaining the accepted bills.

On receipt of the bill under the credit, the liability entries, passed at the time of opening of the letter of credit, are reversed. At the current bill selling rate the following entries are passed:

Dr. Customer's Liability on Acceptances
Cr. Bank's Liability on Acceptances

On payment to the negotiating bank on the due date of the bill, the above entries are reversed.

❑ Foreign Inward Bills for Collection

Exchange Control Regulations

Exchange Control requires that banks should exercise due care while handling import bills upon collection basis on behalf of importer customers with reference to their line of business, financial standing, frequency of import, etc., to establish the genuineness of the import. In the case of bills involving large value, they should satisfy themselves that the importer is known to be trading in the items mentioned in the shipping documents or that the items are required for his actual use. In case of importers who are not their constituents, they should, at the time of acceptance of the documents/making payment, call for detailed Certificate-cum-Report from their bankers in support of the genuineness of imports.

Direct Receipt of Documents from Sellers

Import bills and documents should be received from the banker of the seller by the banker of the buyer in India. Direct receipt of bills direct from the overseas seller is permitted only in the following cases:

(*a*) Where the value of the import bill does not exceed USD 10,000.
(*b*) Import bills received by wholly owned Indian subsidiaries of foreign companies from their principals.
(*c*) Import bills received by Super Star Trading Houses, Star Trading Houses, Trading Houses, Export Houses, 100% Export Oriented Units/Units in Free Trade Zones, Public Sector Undertakings and Limited Companies.
(*d*) Where the value of import bill does not exceed USD 25,000 in respect of import of (*i*) books and magazines, (*ii*) life saving drugs/equipments by hospitals etc., and (*iii*) import by reputed research and other development institutions like Tata Institute of Fundamental Research, C-Dot, Indian Institute of Technology, Indian Institute of Science and Universities.
(*e*) Import bills received by all limited companies *viz.*, public limited and private limited companies.

In all other cases, at the request of importers, banks may receive bills direct from the overseas seller up to USD 25,000 provided the bank is fully satisfied about the financial standing/status and track record of the importer customer. Before extending the facility, the bank should obtain report on each individual overseas seller from the overseas banker or reputed credit agency.

Procedure

When a bill is received from the correspondent bank for collection, the bank is acting as an agent for the correspondent bank. Therefore, the instructions given by the collecting bank should be scrupulously followed.

The documents received should be verified to see that they do not contravene the exchange control regulations of India. Any such discrepancy should be immediately brought to the notice of the collecting bank and its instructions sought. All bills should have a certificate of origin as one of the documents to determine the currency of payment.

An intimation should be sent to the drawee of the bill to inspect the documents and retire them. Simultaneously an acknowledgement of receipt of documents for collection should be sent to the collecting bank.

When the bill is retired by the drawee, the amount of the bill plus bank charges payable abroad should be converted at the bill selling rate and the amount should be recovered from the customer by debit to his account or by a cheque drawn on his account with his bank. Bank charges and commission for the bank in India can be recovered from the drawee. If he declines, the same can be deducted from the proceeds to be sent to the collecting bank abroad.

Usance Bill The bill should be got stamped according to the current rates by converting the foreign currency value into rupees at the rates prescribed by Government of India from time to time and got accepted by the drawee. An intimation should be sent to the collecting bank of the fact of acceptance and the due date of the bill.

On the due date when payment is received, procedure to be followed is the same as that for sight bills.

❑ Dishonour by Importer

(i) Bill Received under Letter of Credit

If the documents received under a letter of credit are in order, the issuing bank should make payment to the negotiating bank irrespective of the fact whether the importer pays or not.

If the bill is dishonoured either by non-payment or by non-acceptance, it is in the interest of the credit issuing bank to take proper care of the goods. Each import licence issued in India bears a clause that the bank becomes a joint holder under the licence if a letter of credit is opened by it against the licence. Therefore, as a joint holder, the bank can get the goods cleared and arrange for their warehousing. To avoid payment of the import duty immediately, the goods may be stored in the bonded warehouse, wherever possible. Also insurance should be kept alive.

To do the above, the bank should keep a watch on the arrival of the ship. The shipping company may send the bank (as the consignee or notify party) the steamer arrival notice. It may get the information through trade journals or clearing agent. For clearing the goods and arranging for their storage, the bank may utilise the services of approved clearing agents.

The goods cleared by the bank, if subject to licensing, may be sold to State Trading Corporation or Government Departments or actual users for which no permission from Customs is necessary. Sale to others require prior permission of Customs.

(ii) Bill Received for Collection

The collecting bank should be kept informed of the developments. It should be informed that under exchange control regulations in India, it is not possible for the bank to clear the goods and arrange for their storage. The bill should be protested for non-payment or non-acceptance as the case may be.

29.5. IMPORT TRUST RECEIPT

The importer has other facilities with the bank like key cash credit or open cash credit. When a bill received covering import of raw materials or other items, is released by payment by the importer out of his own sources or by debit to the cash credit account. The imported goods thus stand as security for the cash credit account. If the goods are to be charged as security for key cash credit facility (i.e., pledge), it is essential that the goods are in the possession of the bank and not delivered to the importer. If the goods are delivered to the importer, the essential of pledge is lost and the bank loses its right over the goods. But unless the importer is allowed to take delivery of the goods from the port and place them in the godown pledge cannot be created.

The difficulty is obviated by taking a Trust Receipt from the importer and allowing him to take delivery of the goods and place them in the godown. In the Trust Receipt the importer specifies the goods and agrees that he is holding the goods not as their owner but as an agent for the bank. Thus the bank continues to have the rights of the pledgee.

The need for Trust Receipt facility also arises in case of letters of credit calling for usance bills. Suppose the letter of credit calls for 90 days sight bill. The exporter on shipment tenders the bill through the negotiating bank and gets it accepted by the issuing bank. Since the bill bears the bank's acceptance he is assured of payment at maturity. If he is in urgent need of funds he can discount the bill with his bank.

As far as the issuing bank is concerned, it would like to retain possession of the goods till payment is made by the importer. Importer, on the other hand, would like to take possession of the goods as soon as they arrive, use them in the manufacture and/or sell them and pay against the bill. Here again the bank may release the goods against the trust receipt of the importer. Depending upon the credit rating of the customer, the bank may-

(*a*) allow the customer to use the products as well as sell the goods;
(*b*) allow the goods to be used for manufacture only;
(*c*) insist on margin; and
(*d*) agree for release only in parts.

❑ Value of Trust Receipt

In the trust letter the importer acknowledges that goods are held by him in trust for the bank and agrees to make over the sale proceeds to the bank. He further undertakes to keep the goods and transactions arising out of these goods separate from other transactions. In the case of insolvency of the importer, the bank can repossess the goods; the official receiver cannot claim the goods. The banker can appropriate the sale proceeds, if the goods were already sold by the borrower.

However, in practice, trust receipt does not secure the position of the bank to a significant extent. The risks are that-

(*a*) the importer may repledge the goods with another bank or person;
(*b*) the importer may sell the goods without remitting the amount into the bank; and
(*c*) in case of insolvency of the importer, it would be difficult to trace the proceeds of the goods.

Therefore, release of goods against trust receipt involves additional credit risk to the bank.

❑ Clearing through Clearing Agents

As an alternative to the trust receipt facility, the goods may be got cleared through the bank's approved clearing agents. The clearing and forwarding agents specialise in facilitating the shippers in fulfilling the formalities relating to booking space in ship and complying with the formalities of the customs, port and shipping company authorities both in booking and getting release of goods. The clearing agents employed to get goods cleared and delivered at the godown of the customer secured under pledge to the bank act as agents of the bank during the transit. The goods continue to remain in effective possession of the bank and the essence of pledge is not violated.

Care is, however, required in selecting the clearing agents. In approving clearing agents, their reputation in the market and integrity are considered.

30 Non-resident Deposits and Investments

REMITTANCES from Indians living abroad have been an important source of foreign exchange for India. These have been one of the major avenues by which the balance of payments deficit has been met. Various deposit and investment schemes have been devised to encourage investment in India by non-resident Indians. As these schemes are for non-residents, we define first the terms resident and non-resident from exchange control angle. Then the deposit and investment schemes for non-residents are outlined. Recently, residents have been permitted to have been permitted to hold foreign currency accounts in India. The features of this account are given in the end.

30.1 DEFINITIONS OF RESIDENTS AND NON-RESIDENTS

☐ Residents

Under Foreign Exchanger Regulation Act, a citizen of India residing in or a foreign citizen who has came to stay in India in either case:

(a) for or on taking up employment in India, or
(b) for carrying on a business or vocation in India, or
(c) for staying with his or her spouse, such spouse being a person resident in India, or
(d) for any other purpose, in such circumstances, as would indicate his intention to stay in India for an uncertain period, was considered a 'person resident' in India.

Indian citizens who proceed aboard for business tours, medical treatment, higher studies and such other purposes which do not indicate their intention to stay outside India for an indefinite or uncertain period were considered as 'persons resident in India' during their temporary absence from India.

Definition under FEMA

The definition of residents under FERA differed from that under Income Act. Income Tax lays stress on the period of stay in India which is totally absent in the definition under FERA. The definition under FEMA has been modified to fall in line with the definition under Income Tax, at least partially. Section 2(v) of FEMA defines the term 'person resident in India' to mean:

(i) a person resident in India for more than one hundred and eighty two days during the course of the preceding financial year but does not include:
   (A) a person, who has gone out of India or who stays outside India in either case:
      (a) for or on taking up employment outside India, or
      (b) for carrying on outside India a business or vocation outside India, or
      (c) for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period.
   (B) a person who has come to or stays in India, in either case, otherwise than :
      (a) for or taking up employment in India, or
      (b) for carrying on in India a business or vocation in India, or

(c) for any other purpose in such circumstances as would indicate his intention to stay in India, for an uncertain period.

(*ii*) any person or body corporate registered or incorporated in India;

(*iii*) an office, branch or agency in India owned and controlled by a person resident outside India.

(*iv*) an office, branch or agency outside India opened or controlled by a person resident in India.

Effect of the New Definition (*i*) Section 2 (u) of FEMA defines the term 'person' to include:

(*i*) an individual,

(*ii*) a Hindu undivided family,

(*iii*) a company,

(*iv*) a firm,

(*v*) an association of persons or a body of individuals, whether incorporated or not,

(*vi*) every artificial judicial person, not falling within any of the preceding sub-clauses, and

(*vii*) any agency, office or branch owned or controlled by such person.

Sub-clause (*i*) of the definition of person resident in India, which brings the period of stay in India as a criteria applies to individuals. Others are governed by sub-clauses (*ii*) to (*iv*). Accordingly a business established in India remains a resident. An office, branch or agency established abroad by a resident in India is also a resident.

(*ii*) For persons from India going abroad, the effect is similar to the one under erstwhile FEMA. Such a person going abroad for employment or business (irrespective of period of stay) or for any other purpose with intention to stay abroad for an uncertain period becomes a non-resident immediately on departure from India. It may be noted that the requirement of stay in India for a period of 182 days is in respect of the preceding financial year and not during the current year.

(*iii*) A foreigner coming to India for employment or business or vocation or for any other purpose with intention to stay in India for indefinite period becomes a resident only when he fulfils the condition of stay in 182 days during the preceding financial year. That means, he can become a resident earliest only in the second financial year of his stay in India. If his visit to India is for purposes other than those just enumerated, he cannot become a resident irrespective of the period of his stay in India. The law seems to be more careful in guarding against a foreign citizen acquiring a residential status and thereby acquiring control over assets in India.

❑ Non-residents

Persons who are not residents in India are considered 'persons resident outside India' or 'non-residents'.

Authorised dealers are permitted to open non-resident accounts without permission from the Reserve Bank in the names of: (*a*) non-resident Indians and (*b*). overseas corporate bodies predominantly owned by non-resident Indians. Non-resident Indians (NRIs) can be either (*i*) Non-resident Indian Nationals or (*ii*) Persons of Indian origin.

By implication *non-resident of Indian nationality* is a citizen of India who has gone or stays abroad (*i*) for or on taking up employment outside India, or (*ii*) for carrying on a business or vocation outside India, or (*iii*) for any other purpose in such circumstances as would indicate his intention to stay outside India for an uncertain period.

Persons of Indian Origin A foreign citizen (other than a citizen of Pakistan or Bangladesh) will be considered a person of Indian origin if (*a*) at any time he held an Indian passport or (b) he or either of his parents or grand parents was an Indian

and a permanent resident in undivided India at any time. The spouse (not being a citizen of Pakistan or Bangladesh) of a citizen of Indian or of a person of Indian origin is also treated as of Indian origin even though she may be of non-Indian origin.

Overseas Corporate Bodies (OCBs) These include overseas companies, partnership firms, societies and other corporate bodies which are owned, to the extent of at least 60% by individuals of Indian nationality or origin resident outside India. For overseas trusts at least 60% of the beneficial interest should be held by such persons.

30.2 NON-RESIDENT DEPOSIT ACCOUNTS

Foreign Exchange Management (Deposit) Regulations, 2000 govern the non-resident deposit accounts in India. Authorised dealers are permitted under the regulations to open any of the following types of accounts for non-residents of Indian nationality or origin:

1. Rupee Accounts
   - Ordinary Non-resident Rupee Account.
   - Non-resident (external) Account.
2. Foreign Currency Accounts
   - Foreign Currency (Non-resident) Accounts (Banks) Scheme.

Two types of rupee accounts, *viz.*, Non-resident (Non-repatriable) Rupee Deposit Account introduced in June 1992 and Non-Resident (Special) Rupee Account introduced in April 1999 have been withdrawn with effect from September 2002.

The salient features of each of the above are described below.

❑ Exceptions

The Regulation does not apply to the following accounts maintained with an authorised dealer:

(*a*) Rupee deposits by foreign diplomatic missions and diplomatic personnel and their family members;

(*b*) Deposits held by diplomatic missions and diplomatic personnel in special rupee accounts namely Diplomatic Bond Stores Account to facilitate purchase of bonded stocks from firms and companies who have been granted special facilities by customs authorities for import of stores into bond;

(*c*) Foreign currency deposits held by diplomatic missions and diplomatic missions in India;

(*d*) Rupee accounts maintained by persons resident in Nepal and Bhutan;

(*e*) Deposits held by UNO and its subsidiary/affiliate bodies in India and its or their officials in India.

❑ Non-resident Ordinary Rupee Accounts

Non-resident Ordinary Rupee (NRO) accounts are intended mainly to facilitate domestic transactions of non-resident Indians. Funds in an ordinary non-resident account are not repatriable abroad without the permission of Reserve Bank. Income tax is deductible at source. The advantage of ordinary non-resident accounts is that certain local funds accruing to the account holder are allowed to be credited to the account which facility is not available for other accounts.

1. *Eligibility.*

(*a*) When a person resident in India leaves India for a country (other than Nepal or Bhutan) for taking up employment, or for carrying on business or vocation outside India or for any other purpose indicating his intention to stay outside India for an uncertain period, his existing account should be designated as a Non-Resident (Ordinary) account.

(*b*) Any person resident outside India may open NRO account with an authorised dealer or an authorised bank for the purpose of putting through *bona fide* transactions in rupees not involving any violation of the provisions of the Act.

(c) The operations on the accounts should not result in the account holder making available foreign exchange to any person resident in India against reimbursement in rupees or in any other manner.

(d) At the time of opening of the account, the account holder should furnish an undertaking to the bank that in cases of debits to the account for the purpose of investment in India and credits representing sale proceeds of investments, he will ensure that such investments/disinvestments will be in accordance with the regulations made by Reserve Bank in this regard.

2. *Joint Accounts with Residents.* The accounts may be held jointly with residents.

3. *Types of Accounts.* NRO accounts may be maintained in the form of current savings, recurring or fixed deposit accounts. The requirements laid down in the directives issued by Reserve Bank in regard to resident accounts apply to NRO accounts.

4. *Permitted Credits.*

(i) Proceeds of remittances received in any permitted currency from outside India through normal banking channels or any permitted currency tendered by the account-holder during his temporary visit to India or transfers from rupee accounts of non-resident banks.

(ii) Legitimate dues in India of the account holder.

5. *Permitted Debits.*

(i) All local payments in rupees including payments for investments subject to compliance with the relevant regulations made by the Reserve Bank.

(ii) Remittance outside India of current income in India of the account holder net of applicable taxes.

6. *Repatriation.* Balances in NRO accounts are not eligible for remittance outside India without the approval of Reserve Bank. Funds received by way of remittances from outside India in foreign exchange which have not lost their identity as remittable funds will only be considered by Reserve Bank for remittance outside India. Where an account (current/savings) is opened by a foreign tourist visiting India, with funds remitted from outside India in a specified manner or by sale of foreign exchange brought by him to India, the bank (authorised dealer) may convert the balance in the account at the time of departure of the tourist from India into foreign currency for payment to the account holder provided the account has been maintained for a period not exceeding six months and the account has not been credited with any local funds, other than interest accrued thereon.

However, with effect form July 2002, banks may permit repatriation of funds out of balances NRO Accounts, for the following purposes :

(i) Upto USD 30,000 per academic year, to meet expenses in connection with education of their children;

(ii) Upto USD 1,00,000 to meet the medical expenses abroad of the account holder or his family members; and

(iii) Upto USD 1,00,000 per year, representing sale proceeds of immovable property, held by them for a period of not less than 10 years subject to payment of applicable taxes.

7. *Loans/Overdrafts to Account holders.*

(i) Loans to non-resident account holders may be granted in rupees against the security of fixed deposits subject to usual norms as are applicable to resident accounts, for personal purposes or for carrying on business activities except for the purpose of relending or carrying on agricultural/ plantation activity or for investment in real estate business.

(ii) Overdraft in the account of the account holder may be permitted subject to bank's commercial judgement and compliance with the interest rate etc. directives.

8. *Loans/Overdrafts to third parties.* Loans/overdrafts to resident individuals/firms/companies in India may be granted against the security of deposits held in NRO accounts, subject to the following terms and conditions:

(a) The loans shall be utilised only for meeting borrower's personal requirements and/or business purpose and not for carrying on agricultural/plantation activities or real estate business, or for relending.

(b) Regulations relating to margin and rate of interest as stipulated by Reserve Bank from time to time shall be complied with.

(c) The usual norms and considerations as applicable in the case of advances to trade/industry shall be applicable for such loans/ facilities.

(d) *Return to India.* NRO accounts may be re-designated as resident rupee accounts on the return of the account holder to India for taking up employment, or for carrying on business or vocation or for any other purpose indicating his intention to stay in India for an uncertain period. Where the account holder is only on a temporary visit to India, the account should continue to be treated as non-resident during such visit.

(e) *Payment of funds to Non-resident Nominee.* The amount due/payable to non-resident nominee from the account of a deceased account holder, shall be credited to NRO account of the nominee with an authorised dealer/authorised bank in India.

(f) *Reporting of transactions.* The transaction in the account which may appear to represent reimbursement in rupees against foreign exchange made available to a person resident in India other than authorised dealer, as well as any other transaction of suspicious nature should be reported to Reserve Bank.

❑ Non-Resident (External) Accounts

Accounts opened and maintained with authorised dealers in the names of persons resident outside India in pursuance of the Non-resident (External) Rupee Account Scheme are known as 'Non-resident (External) accounts' (NRE accounts).

Advantages. NRE accounts are designed to provide some special benefits which are not available under Ordinary Non-resident Accounts. The main benefits available under NRE accounts are:

1. Interest earned on the account is exempt from Income Tax.
2. Balances held in the account are exempt from Wealth Tax.
3. The balance in the account, including interest, is repatriable abroad without reference to Reserve Bank of India.

1. *Eligibility* The Non-resident Indians (NRIs) and Overseas Corporate Bodies (OCBs) (other than those of Bangladesh or Pakistan nationality) are permitted to open and maintain these accounts with authorised dealers, and with banks (including co-operative banks) authorised by the Reserve Bank to maintain such accounts.

   The account should be opened by the non-resident account holder himself and not by the holder of the power of attorney in India.

   An account may be opened in the name of an eligible NRI during his temporary visit to India against tender of foreign currency travellers cheques or foreign currency notes and coins tendered, provided the authorised dealer is satisfied that the person has not ceased to be a non-resident.

2. *Operations by Power of Attorney.* The account can be operated by a resident power of attorney holder for local payments or for investments in India. The resident Power of Attorney holder shall not, however, be allowed to repatriate outside India funds held in the account under any circumstances

or make payment by way of gift to a resident on behalf of the account holder or transfer funds from the account to another NRE account.

3. *Joint Accounts* Joint accounts in the names of two or more non-resident individuals may be opened provided all the account holders are persons of Indian nationality or origin. When one of the joint holders becomes resident, his name may be deleted and the account allowed to continue as a NRE account or the account may be redesignated as a resident account, at the option of the account holders. Opening of these accounts by a non-resident jointly with a resident is not permissible.
4. *Types of Accounts* The accounts may be maintained in any form, e.g. savings, current, recurring or fixed deposit account etc.
5. *Permitted Credits*
   (a) Proceeds of remittances to India in any permitted currency.
   (b) Proceeds of personal cheques drawn by the account holder on his foreign currency account and of foreign travellers cheques, foreign bank drafts deposited by the account holder in person during his temporary visit to India.
   (c) Proceeds of foreign currency/bank notes tendered by account holder during his temporary visit to India.
   (d) Transfers from other NRE/FCNR accounts.
   (e) Interest accruing on the funds held in the account.
   (f) Interest on Government securities and dividend on units of mutual funds, provided the securities/units were purchased by debit to the account holder's NRE/FCNR account or out of inward remittance through normal banking channels.
   (g) Maturity/Sale proceeds of Government securities including National Plan/Savings Certificates, units of mutual funds provided the securities/units were originally purchased by debit to the account holder's NRE/FCNR account or out of remittances received from outside India in free foreign exchange.
   (h) Refund of share/debenture subscriptions to new issues of Indian companies or portion thereof, if the amount of subscription was paid from the same account or from other NRE/FCNR account of the account holder or by remittance from outside India through normal banking channels.
   (i) Refund of application/earnest money made by the house building agencies on account of non-allotment of flat/plot, together with interest, if any (net of income tax payable thereon), provided the original payment was made out of NRE/FCNR account of the account holder or remittance from outside India through normal banking channels.
   (j) Current income of the non-resident account holder like rent, dividend, pension, interest, etc provided income tax thereon has been deducted/paid/provided for, as the case may be.
   (k) Any other credit if covered under general or special permission granted by Reserve Bank.
6. *Permitted Debits*
   (a) Local disbursements.
   (b) Remittances outside India.
   (c) Transfer to NRE/FCNR accounts of the account holder or any other person eligible to maintain such account.
   (d) Investment in shares/securities /commercial paper of an Indian company or for purchase of immovable property in India provided such investment/purchase is covered by the regulations made, or the general/special permission granted, by the Reserve Bank.

(e) Any other transaction if covered under general or special permission granted by the Reserve Bank.

7. *Special Series of Cheques* For easy identification and quicker processing of cheques drawn on NRE accounts, cheque books containing a special series of cheques should be issued for NRE accounts.

8. *Rate of Interest* Rate of interest applicable to these accounts will be in accordance with the directions/instructions issued by Reserve Bank from time to time. Currently the interest rate is nil on current account, 4% on savings account and free on term deposits.

9. *Temporary overdrawings* Overdrawings in NRE savings bank accounts, up to a limit of Rs.50,000 may be allowed subject to the condition that such overdrawings together with the interest payable thereon are repaid within a period of two weeks, out of inward remittances through normal banking channels or by transfer of funds from other NRE/FCNR accounts.

10. *Loan to accountholder* Loans in India can be granted to the account holder for-

   (i) personal purposes or for carrying on business activities except for the purpose of relending or carrying on agricultural/plantation activities or for investment in real estate business. The advances should be fully secured by the fixed deposits and regulations relating to normal margin, interest rate, etc. should be complied with. Repayment shall be made either by adjustment of the deposit or by fresh inward remittances from outside India through normal banking channels. The loan can also be repaid out of local rupee resources in the NRO account of the borrower. The interest on such loans shall be in accordance with directives issued by Reserve Bank from time to time;

   (ii) the purpose of making direct investment in India on non-repatriation basis by way of contribution to the capital of Indian firms/companies subject to compliance with the provisions of the Foreign Exchange Management (Transfer of Indian security by a person resident outside India) Regulations, 2000 and Foreign Exchange Management (Investment in proprietary or a partnership firm) Regulations, 2000.

   (iii) the purpose of acquisition of flat/house in India for his own residential use subject to the provisions of the relevant Regulations made under the Act.

11. *Loan in India to third parties* Any type of fund based and/or non-fund based facilities may be granted to resident individuals/firms/ companies in India against the collateral of fixed deposits held in NRE account subject to the following conditions:

   (i) There should be no direct or indirect foreign exchange consideration for the non-resident depositor agreeing to pledge his deposits to enable the resident individual/firm/company to obtain such facilities.

   (ii) Regulations relating to margin, interest rate, purpose of loan, etc., as stipulated by Reserve Bank from time to time should be complied with.

   (iii) The loan should be utilised for personal purposes or for carrying on business activities other than agricultural/plantation activities or real estate business. The loan should not be utilised for relending.

   (iv) The usual norms and considerations as applicable in the case of advances to trade/industry shall be applicable to such credit facilities.

12. *Loans outside India* Authorised dealers may allow their branches/ correspondents outside India to grant any type of fund based and/or non-fund based facilities to or in favour of non-resident depositor or to third parties at the request of depositor for bona fide purpose against the security of funds held in the NRE accounts in India and also agree to remittance of the funds from India, if necessary, for liquidation of the outstandings.

13. *Change of resident status of the account holder* NRE accounts should be redesignated as resident accounts or the funds held in these accounts may be transferred to the RFC accounts (if the account holder is eligible for maintaining RFC account) at the option of the account holder immediately upon the return of the account holder to India for taking up employment or for carrying on business or vocation or for any other purpose indicating intention to stay in India for an uncertain period. Where the account holder is only on a short visit to India, the account may continue to be treated as NRE account even during his stay in India.
14. *Repatriation of funds to non-resident nominee* Remittance of funds lying in the NRE account of the deceased account holder to his non-resident nominee is permitted.
15. *Remittances abroad by Resident nominee* Application from a resident nominee for remittance of funds outside India for meeting the liabilities, if any, of the deceased account holder or for similar other purposes, should be forwarded to the Reserve Bank for consideration.

❑ Foreign Currency Non-Resident (Banks) Accounts

NRE accounts are opened in Indian rupees and the amount is repatriable at the rate of exchange prevailing on the date of repatriation. The amount that the depositor receives may be more or less than the amount deposited by him and the interest expected thereon. If a depositor remits USD 1,000 for opening an NRE (Fixed Deposit) account for one year, the amount is converted into Indian rupees and the account is opened for the resultant rupee value. On the due date, the rupee balance and interest thereon are converted into US dollars at the rate prevailing on the date. While the depositor expects a repayment of USD 1,100 (assuming interest at 10% p.a.) the actual amount received by him may be less or more than this amount. In other words, the exchange risk is borne by the depositor. Foreign Currency Non-resident (FCNR) Account scheme was introduced in 1975 to afford protection to the depositors against the exchange risk and assure them repayment of the expected amount in foreign currency.

The exchange risk under the scheme was being borne by Reserve Bank of India. Deposits received by banks were sold to Reserve Bank at notional rates. Repayment of deposits and periodical payment of interest was made to depositors by banks by purchasing from Reserve Bank the requisite foreign exchange at the same notional rate. Foreign Currency (Non-Resident) Accounts (Banks) Scheme (FCNR-B) was introduced in May 1993 to shift the exchange risk from Reserve Bank to commercial banks. Effective from 15th August 1994, deposits can be accepted only under the FCNR-B scheme.

FCNR account is a special scheme of NRE account and all regulations governing NRE accounts are applicable to FCNR account also. Similarly, all benefits available to NRE account holders are available to FCNR account holders also. However, FCNR accounts have certain features exclusive to it which are described below:

1. *Eligibility.* NRIs and OCBs (other than nationals of Bangladesh or Pakistan) are eligible to open and maintain these accounts.
   These accounts may be opened with funds remitted from outside India or by transfer of funds from existing NRE/FCNR accounts.
2. *Designated currencies.* Deposit of funds in the accounts may be accepted in Pound Sterling, US Dollar, Deutsche Mark, Japanese Yen and Euro. If the remittance is received in a currency other than the designated currency it should be converted into the latter currency by the authorised dealer at the risk and cost of the remitter and account should be opened/credited in only the designated currency.
   In case the depositor with any convertible currency other than designated currency desires to place a deposit in these accounts, authorised dealers

may undertake with the depositor a fully covered swap in that currency against the desired designated currency. Such a swap may also be done between two designated currencies.

3. *Type of account.* These accounts may be opened only in the form of term deposit for any of the three maturity periods, viz. one year and above but less than two years, two years and above but less than three years and three years only. Recurring deposits are not permitted under this scheme.
4. *Rate of Interest.* A bank should obtain prior approval of its Board of Directors for the interest rates will be offering on deposits of various maturities. Board of Directors of a bank may authorise the Asset Liability Management Committee to fix interest rates on deposits subject to reporting to the Board immediately thereafter.
5. *Permissible Debits/Credits.* All debits/credits permissible in respect of NRE accounts are permissible in respect of these accounts also.
6. *Rate for Conversion.*
   (*i*) Remittances received in Indian rupees for opening these accounts shall be converted by the authorised dealer into the designated foreign currency at the clean T.T. selling rate for that currency ruling on the date of conversion.
   (*ii*) For the purpose of payment in rupees, funds held in these accounts shall be converted into rupees at the authorised dealer's clean T.T. buying rate for the concerned currency ruling on the date of withdrawal.
7. *Inland Movement of Funds.* Any inland movement of funds for the purpose of opening these accounts as well as for repatriation outside India of balances held in these accounts will be free of inland exchange or commission for the non-resident depositors. The Authorised dealer receiving foreign currency remittances in these accounts will also, on request, pass on the foreign currency to another authorised dealer if the account has to be opened with the latter, at no extra cost to the remitter.
8. *Payment of Interest.* The interest on the deposits should be paid on the basis of 360 days to a year. For deposits upto one year, interest is payable without any compounding effect. In respect of deposits for more than 1 year, it is payable at intervals of 180 days. However, the depositor will have the option to receive the interest on maturity with compounding effect.
9. *Loans/overdrafts.*
   (*i*) The terms and conditions as applicable to NRE deposits in respect of loans and overdrafts in India to depositor and to third parties as also loans outside India against security of deposits, shall apply *mutatis mutandis* to FCNR (B) deposits.
   (*ii*) The margin requirement shall be notionally calculated on the rupee equivalent of the deposits.
10. *Loan in foreign currency.* Loan in India in foreign currency can be made to the account holder subject to the following conditions:
    (*i*) Loans should be against own FCNR (B) deposits. The documents should be executed by the deposit holders themselves and not by their Power of Attorney holders.
    (*ii*) The maturity of the loan shall not exceed the maturity of the deposit.
    (*iii*) The purpose should be other than investments in India.
    (*iv*) Advances shall be fully secured by the deposit and regulations, if any, relating to margin shall be complied with.
    (*v*) Repayment is to be effected by fresh remittances in foreign exchange or by adjustment of the deposit.
    (*vi*) Extension of this facility should have the approval of the Board of the bank.

11. *Change of resident status.* When an account holder becomes a person resident in India, deposits may be allowed to continue till maturity at the contracted rate of interest, if so desired by him. However, except the provisions relating to rate of interest and reserve requirements as applicable to FCNR (B) deposits, for all other purposes such deposits shall be treated as resident deposits from the date of return of the accountholder to India. Banks should convert the FCNR (B) deposits on maturity into resident rupee deposit accounts or RFC account (if the depositor is eligible to open RFC account), at the option of the accountholder and interest on the new deposit (rupee account or RFC account) shall be payable at the relevant rates applicable for such deposits.
12. *Other features.*
    (*a*) Reserve Bank will not provide exchange rate guarantee to authorised dealers for deposits of any maturity in these accounts.
    (*b*) Lending of resources mobilised by authorised dealers under these accounts are not subject to any interest rate stipulations.
    (*c*) Premature withdrawal of FCNR(B) deposits for the purpose of opening NRNR Rupee Deposit accounts with an authorised dealer other than the one with whom the account FCNR(B) is maintained will attract penalty as per the directions issued by Reserve Bank from time to time.

30.3. RESIDENT FOREIGN CURRENCY ACCOUNTS

While the previous section dealt with holding in India of accounts by non-residents, the present section deals with holding in India of foreign currency accounts by residents. The Foreign Exchange Management (Foreign Currency Accounts by a person resident in India) Regulations, 2000 provides for opening of the following three types of accounts by residents:

- Exchange Earners Foreign Currency Account
- Resident Foreign Currency Account
- Resident Foreign Currency (Domestic) Account

In addition units in SEZ are also permitted to maintain foreign currency accounts.

❑ Exchange Earners Foreign Currency Accounts

Exporters of goods and services and beneficiaries of inward remittances can retain up to 50% of such remittances in foreign currency itself in an account entitled 'Exchange Earners Foreign Currency (EEFC) Account'. Export-oriented units, professionals and status holder exporters can retain up to 100% of such remittances. Amounts received in foreign exchange by domestic units for supplies to Export-oriented units are also eligible as foreign exchange received. Similarly payment received by an exporter from an escrow account in respect of countertrade is also eligible. However, remittances received pursuant to an undertaking or those received for meeting any specific obligation are not eligible for this facility.

1. *Type of accounts.* Banks can maintain EEFC accounts in any convertible foreign currency. The account can be maintained as non-interest bearing current account.
2. Credits. As stated in Chapter 5, EEFC account is credited only after the foreign exchange is realised. In case of an export bill, at the time of purchase the exporter is paid in rupees only that portion of the value of the bill which is not required to be retained in foreign currency. On realisation of the bill the advance availed against is fully adjusted and only the balance is credited to the EEFC account in foreign currency.
3. *Utilisation of balances.* The funds held in EEFC accounts can be used by the account holder for:

(*i*) all permissible current and capital account transactions;
(*ii*) payment in foreign exchange towards purchases from export oriented units;
(*iii*) payment of customs duty;
(*iv*) trade related loans/advances not exceeding USD 3 million by an exporter to importer abroad;
(*v*) payment in foreign exchange to a resident in India for supply of goods/ services including payment of air fare and hotel expenditure.

4. *Cheque facility.* Cheque books may be issued for EEFC account holders for making payments from such accounts for eligible purposes. The cheque books should be superscribed with the words "EEFC Account". While making payment of the cheque, the bank should ensure that the transaction is permissible under current exchange control regulations.
5. *Loans.* Balance in the account is not eligible for any fund based or non-fund based loan facility.
6. *Accounts of SEZs.* Units in special economic zone are permitted to credit 100% of their foreign exchange receipts in EEFC accounts except foreign exchange acquired by way of purchase against rupees from any person in India other than another unit in a special economic zone.

❑ Resident Foreign Currency Account

Resident Foreign Currency (RFC) Account was introduced in the year 1992 to help returning Indians to retain their legitimate earnings abroad in foreign currency. The salient the Account are given below.

1. *Eligibility.* A person resident in India may open, hold and maintain with an authorised dealer in India a Foreign Currency Account, to be known as a Resident Foreign Currency (RFC) Account, out of foreign exchange:
   (*a*) received as pension or any other superannuation or other monetary benefits from his employer outside India; or
   (*b*) realised on conversion of the assets held abroad while resident abroad or inherited from a person who was resident abroad and repatriated to India; or
   (*c*) received or acquired as gift or inheritance from a person referred to in (*b*) above;
   (*d*) foreign exchange acquired or received before 8th of July 1947 or any income accruing thereon which is held outside India in pursuance of a general or special permission granted by the Reserve Bank.
2. *Utilisation.* The funds in a RFC Account is free from all restrictions regarding utilisation of foreign currency balances including any restriction on investment in any form outside India.
3. *Limit on holding.* Unless otherwise stipulated by the Reserve Bank, foreign exchange can be held in the RFC account without any limit.
4. *Types of accounts.* The account can be held in the form of current or savings or term deposit account in cases where the account holder is an individual, and in the form of current account or term deposit account in all other cases. It can be held singly or jointly in the name of person eligible to open, hold and maintain such account.
5. *Payment to nominee.* On the death of a foreign currency accountholder, the authorised dealer with whom the account is held or maintained may remit to a nominee being a person resident outside India, funds to the extent of his share or entitlement from the account of the deceased accountholder. If the nominee being a person resident in India, is desirous of remitting funds outside India out of his share for meeting the liabilities abroad of the deceased, he should apply to the Reserve Bank for such remittance.

☐ Resident Foreign Currency (Domestic) Account

Resident Foreign Currency (Domestic) Account introduced in November 2002 is seen as a move towards making rupee fully convertible on capital account. A resident individual can open and maintain this account with an authorised dealer an account in foreign currency provided that such foreign exchange in the form of currency notes, bank notes and travellers cheques was acquired by him:

(*a*) while on a visit to any place outside India by way of payment for services not arising from any business in or anything done in India; or

(*b*) from any person not resident in India and who is on a visit to India, as honorarium or gift or for services rendered or in settlement of any lawful obligation; or

(*c*) by way of honorarium or gift while on a visit to any place outside India; or

(*d*) earlier from an authorised person for travel abroad and remains unspent.

Debits to the account shall be for payment towards current/capital account transactions in accordance with the existing foreign exchange regulations. The account will be maintained in the form of current account and shall not bear any interest. Cheque facility will be available. There will be no ceiling on the balances held in the account.

The facility of opening of RFC (Domestic) Account is in addition to the existing facility of (*i*) RFC Account and (*ii*) retention of foreign exchange in cash and/or travellers cheques up to USD 2000 or its equivalent.

While opening these accounts the Authorised Dealers are to follow the same procedures, including 'Know Your Customer' guidelines as applicable for opening any other domestic account.

☐ Foreign Currency Account of a unit in a Special Economic Zone

A unit located in a Special Economic Zone may open hold and maintain a Foreign Currency Account with an authorized dealer in India provided:

- all foreign exchange funds received by the unit in the Special Economic Zone (SEZ) are credited to such account,
- no foreign exchange purchased in India against rupees shall be credited to the account without prior permission from the Reserve Bank,
- the funds held in the account shall be used for bonafide trade transactions of the unit in the SEZ with the person resident in India or otherwise,
- the balances in the accounts shall be exempt from the restrictions imposed under Rule 5, except item 3 and 4 of the Schedule III, of the Foreign Exchange Management (Current Account Transactions) Rules, 2000. (Items 3 and 4 refer to gifts and donations exceeding USD 5,000 per annum per beneficiary).

The funds held in these accounts shall not be lent or made available in any manner to any person or entity resident in India not being a unit in Special Economic Zones.

30.4. INVESTMENTS BY NON-RESIDENTS

Non-residents can make investments in India only after obtaining specific permission from the Reserve Bank of India. Investments by non-residents are subject to the policy guidelines framed by the Government of India from time to time, in line with its industrial policy. However, investments by non-residents of Indian origin or nationality are allowed more liberally in order to give them wide investment opportunities. Foreign Exchange Management (Transfer or issue of Security by a Person Resident Outside India) Regulations, 2000 currently govern investments in India by non-residents. The regulations provide for non-resident investments of the following types:

1. Investment in shares and convertible debentures:
   (*i*) Foreign Direct Investment

(ii) Portfolio Investments
(iii) Other Investments on non-repatriation basis.
(iv) Investment by Foreign Institutional Investors
2. Investments in securities other than shares and convertible debentures.

☐ Foreign Direct Investment Scheme

1. Reserve Bank's Automatic Route An Indian company which is not engaged in banking, NBFC's activities in Financial Services Sector, Civil Aviation, petroleum including exploration/refinery/marketing, housing and real estate development sector for investment from persons other than NRIs/OCBs, venture capital, investing in infrastructure and service sector, atomic energy, defence, agriculture, print media, broadcasting, and postal services is permitted to issue shares to non-resident on repatriation basis up to the extent specified below:

Table 30.1 Sectoral cap on Investments by Non-residents

Sector	Investment cap
1. Telecommunication:	
(i) In manufacturing activity	100%
(ii) In basic, cellular mobile, etc.	49%
2. Housing and Real Estate	100%
3. Coal and Lignite:	
(i) In public sector undertakings	49%
(ii) Others	50%
4. Drugs and Pharmaceuticals	74%
5. Hotel and Tourism	51%
6. Mining	
(i) Exploration and mining of diamonds and precious stones	74%
(ii) Others	100%
7. Advertising	74%
8. Films	100%
9. Any other activity (other than those restricted)	100%

This general permission is subject to the conditions that:
(a) The issuer company does not require an industrial licence;
(b) The shares are not being issued for acquiring existing shares of another Indian company;
(c) If the person resident outside India to whom the shares are being issued proposes to be a collaborator, he should have obtained Central Government's approval if he had any previous investment/collaboration/tie up in India in the same or allied field in which the Indian company issuing shares is engaged.

1. Subject to compliance with the provisions of paragraph (i) above an Indian company which proposes to undertake activities in Table 30.1 is permitted to issue shares/convertible debentures to persons resident outside India out of fresh capital issued for financing expansion programme for carrying on such activities.
2. A trading company is permitted to issue shares/convertible debentures to the extent of 51 per cent of its capital to persons resident outside India. The remittance of dividend in respect of such shares would be permissible only when the company secures registration as an Export/Trading/Star Trading House.
3. A SSI Unit may issue shares to non-residents up to 24 percent of its capital. Such a company is permitted to issue shares beyond 24 per cent subject to ceilings given in Table 30.1 if (a) it gives up SSI status

and (*b*) it is not engaged or does not propose to engage in manufacturing of items reserved for SSI sector.

4. EOUs or units in Free Trade Zones or in Software/Electronic Hardware Technology Parks are permitted to issue shares to persons resident outside India beyond 24 percent subject to compliance with ceilings indicated in the Table.
5. Issue of shares by an Indian company to a person resident outside India which are not covered by the provisions of sub-paragraph (*i*) to (*v*) above would require approval of SIA or FIPB.
6. An Indian company is permitted to issue fresh shares to the depository abroad for the purpose of raising resources through ADR or GDR mechanism subject to the conditions specified.
7. The price of shares to be issued by the Indian company to persons resident outside India should not be less than that worked out in accordance with SEBI guidelines.
8. The consideration for issue of shares to persons resident outside India under this scheme should be received either by way of inward remittance through normal banking channels or out of funds held in NRE/FCNR accounts of NRI/OCB investor.
9. The Indian company issuing shares to non-residents under this scheme should submit to Reserve Bank, reports within 30 days of receipt of consideration and within 30 days of issue of shares in the specified format.
10. Reserve Bank's permission is necessary for retention abroad of share subscription received by Indian company from non-residents.
11. It may be noted that there are no separate schemes for NRIs/OCBs for direct investment in India on repatriation basis. NRIs/OCBs are now on par with any other foreign investor and they may invest in the shares/ convertible debentures issued by an Indian company under the Foreign Direct Investment Scheme.

❑ Portfolio Investment Scheme

This scheme refers to purchase/sale of shares and/or convertible debentures by an NRI /OCB on a Stock Exchange in India on repatriation and/or non-repatriation basis.

1. A Non-resident Indian (NRI) or an Overseas Corporate Body (OCB) may purchase/sell shares and/or convertible debentures of an Indian company, through a registered broker on a recognised stock exchange, subject to the following conditions:
   (*i*) the NRI/OCB designates a branch of an authorised dealer for routing his/its transactions relating to purchase and sale of shares/ convertible debentures under this Scheme, and routes all such transactions only through the branch so designated;
   (*ii*) the paid-up value of shares of an Indian company, purchased by each NRI or OCB both on repatriation and on non-repatriation basis, does not exceed 5 percent of the paid up value of shares issued by the company concerned;
   (*iii*) the paid-up value of each series of convertible debentures purchased by each NRI or OCB both on repatriation and non-repatriation basis does not exceed 5 percent of the paid-up value of each series of convertible debentures issued by the company concerned;
   (*iv*) the aggregate paid-up value of shares of any company purchased by all NRIs and OCBs does not exceed 10 percent of the paid up capital of the company and in the case of purchase of convertible debentures the

aggregate paid-up value of each series of debentures purchased by all NRIs and OCBs does not exceed 10 percent of the paid-up value of each series of convertible debentures.
Provided that the aggregate ceiling of 10 per cent referred to in this clause may be raised to 24 per cent if a special resolution to that effect is passed by the General Body of the Indian company concerned;

(*v*) the NRI or OCB investor takes delivery of the shares purchased and gives delivery of shares sold;

(*vi*) payment for purchase of shares and/or debentures is made by inward remittance in foreign exchange through normal banking channels or out of funds held in NRE/FCNR account maintained in India if the shares are purchased on repatriation basis and by inward remittance or out of funds held in NRE/FCNR/NRO account of the NRI/OCB concerned maintained in India where the shares/debentures are purchased on non-repatriation basis;

(*vii*) the Overseas Corporate Body (OCB) informs the designated branch of the authorised dealer immediately on the holding/interest of NRIs in the OCB becoming less than 60 per cent.

2. The link office of the designated branch of an authorised dealer should furnish to the Reserve Bank a report on daily basis giving the details of (a) name of the non-resident Indian or OCB, (b) company-wise number of shares and/or debentures and paid-up value thereof purchased and/or sold by each NRI /OCB.
3. The net sale/maturity proceeds (after payment of taxes) of shares and/or debentures of an Indian company purchased by NRI or OCB under this Scheme, may be allowed:

(*a*) to be credited to his/its NRO account, where the shares and/or debentures were purchased on non-repatriation basis, or

(*b*) at the NRI or OCB investor's option, to be remitted abroad or credited to his/its NRE/FCNR/NRO account, where shares and/or debentures were purchased on repatriation basis.

❑ Investment on Non-repatriation basis

This scheme applies to purchase and sale of shares/ convertible debentures by a NRI or an OCB, on non-repatriation basis, other than under portfolio investment scheme.

1. No purchase of shares or convertible debentures of an Indian company can be made if the company concerned is a Chit Fund or a Nidhi company or is engaged in agricultural/plantation activities or real estate business or construction of farm houses or dealing in Transfer of Development Rights. For the present purpose real estate business shall not include development of township, construction of residential/ commercial premises, roads, bridges, etc.
2. A NRI or OCB may, without any limit, purchase on non-repatriation basis, shares or convertible debentures of an Indian company issued whether by public issue or private placement or right issue.
3. The amount of consideration shall be paid by way of inward remittance through normal banking channels from abroad or out of funds held in NRE/ FCNR /NRO account in India. In the case of an NRI/OCB resident in Nepal and Bhutan, the payment should be made only by way of inward remittance in foreign exchange through normal banking channels.
4. The amount invested in shares or convertible debentures under this Scheme and the capital appreciation thereon shall not be allowed to be repatriated abroad.

❑ Foreign Institutional Investors

This scheme refers to purchase/sale of shares and/or convertible debentures of an Indian company by a registered Foreign Institutional Investor under Portfolio Investment Scheme

1. A registered Foreign Institutional Investor (FII) may, through the Securities and Exchange Board of India, apply to the Reserve Bank for permission to purchase the shares and convertible debentures of an Indian company under Portfolio Investment Scheme. The permission may be granted by Reserve Bank subject to such terms and conditions as may be considered necessary.
2. The FII shall purchase the shares/convertible debentures of an Indian company through registered brokers on recognised stock exchanges in India.
3. The amount of consideration for purchase of shares / debentures shall be paid out of inward remittance from abroad through normal banking channels or out of funds held in account maintained with the designated branch of an authorised dealer in India.
4. The total holding by each FII/SEBI approved sub-account of FII shall not exceed 10% of the total paid-up equity capital or 10% of the paid-up value of each series of convertible debentures issued by an Indian company and the total holdings of all FIIs/sub-accounts of FIIs put together shall not exceed 24% of paid-up equity capital or paid up value of each series of convertible debentures. The limit of 24% may be increased to 40% by the Indian company concerned by passing a resolution by its Board of Directors followed by passing of a special resolution to that effect by its General Body. For arriving at the ceiling on holdings of FIIs, shares/ convertible debentures acquired both through primary as well as secondary market will be included. However, the ceiling will not include investment made by FII through off-shore Funds, Global Depository receipts and Euro-Convertible Bonds.
5. A registered FII may also be permitted to purchase shares/ convertible debentures of an Indian company through private placement/ arrangement, subject to the ceilings specified in paragraph 4 above.
6. The Reserve Bank may, on application, permit a registered FII to open a Foreign Currency Account and/or a Non-resident Rupee Account with a designated branch of an authorised dealer for routing the receipt of and payment for transactions relating to purchase and sale of shares / convertible debentures under this Scheme, subject to the following conditions:
   (*i*) The account shall be funded by inward remittance through normal banking channels or by credit of sale proceeds (net of taxes) of the shares / convertible debentures sold on stock exchange.
   (*ii*) The funds in the account shall be utilised for purchase of shares / convertible debentures in accordance with this Scheme or for remittance outside India.
   (*iii*) The funds from Foreign Currency Account of the registered FII may be transferred to Non-Resident Rupee account of the same FII and *vice-versa*.
7. The designated branch of an authorised dealer may allow remittance of net sale proceed (after payment of taxes) or credit the net amount of sale proceeds of shares / convertible debentures to the foreign currency account or a Non-resident Rupee Account of the FII concerned.
8. Reserve Bank may, subject to such terms and conditions as it may consider necessary permit a domestic asset management company or portfolio manager who is registered with SEBI as a foreign institutional investor for managing the funds of a sub-account, to make investment under the Scheme

on behalf of (i) a person resident outside India who is a citizen of a foreign state, or (ii) a body corporate registered outside India. The investment should be made out of funds raised or collected or brought from outside India through normal banking channel. The application should be made through SEBI. Investments permitted to be made shall not exceed 5% of the total paid-up equity capital or 5% of the paid-up value of each series of convertible debentures issued by an Indian company, and shall also not exceed the over-all ceiling paragraph (4) above.

❑ Investment in Securities Other than Shares and Debentures

This scheme provides for purchase and sale of securities other than shares or convertible debentures of an Indian company by a person resident outside India.

1. A registered Foreign Institutional Investor may purchase, on repatriation basis, dated Government securities/treasury bills, non-convertible debentures/bonds issued by an Indian company and units of domestic mutual funds either directly from the issuer of such securities or through a registered stock broker on a recognised stock exchange in India. The FII shall restrict allocation of its total investment between equity and debt instruments (including dated Government Securities and Treasury Bills in the Indian capital market) in the ratio of 70:30. If the FII desires to invest up to 100 per cent in dated Government Securities including Treasury Bills, non-convertible debentures/bonds issued by an Indian company, it shall form a 100% debt fund and get such fund registered with SEBI.
2. An NRI or OCB may, without limit, purchase on repatriation basis:
   (i) Government dated securities (other than bearer securities) or treasury bills or units of domestic mutual funds;
   (ii) bonds issued by a public sector undertaking(PSU) in India;
   (iii) shares in Public Sector Enterprises being disinvested by the Government of India, provided the purchase is in accordance with the terms and conditions stipulated in the notice inviting bids.
3. An NRI or OCB may, without limit, purchase on non-repatriation basis, dated Government securities (other than bearer securities), treasury bills, units of domestic mutual funds, units of Money Market Mutual Funds in India, or National Plan/Savings Certificates.
4. An FII who purchases securities under this scheme shall make the payment for purchase of such securities either by inward remittance through normal banking channels or out of funds held in Foreign Currency Account or Non-resident Rupee Account maintained by the Foreign Institutional Investor with a designated branch of an authorised dealer with the approval of Reserve Bank.
5. An NRI or OCB who purchases securities on repatriation basis shall make payment either by inward remittance through normal banking channels or out of funds held in his/its NRE/FCNR account.
6. An NRI or OCB who purchases securities on non-repatriation basis, shall make payment either by inward remittance through normal banking channels or out of funds held in his/its NRE/FCNR/NRO account.
7. A non-resident who has purchased securities in accordance with this scheme may:
   (a) sell such securities through a registered stock broker on a recognised stock exchange or
   (b) tender units of mutual funds to the issuer for repurchase or for payment of maturity proceeds or
   (c) tender Government securities/treasury bills to the Reserve Bank for payment of maturity proceeds.

8. In the case of a registered FII the designated branch of an authorised dealer may allow remittance of net sale/ maturity proceeds (after payment of taxes) or credit the net amount of sale/ maturity proceeds of such securities to the foreign currency account or Non-resident Rupee Account of the FII.
9. In the case of an NRI or OCB, the net sale/ maturity proceeds (after payment of taxes) of such securities, may be:
   (*a*) credited to his/its NRO account, where the payment for the purchase of the securities sold was made out of funds held in NRO account, or
   (*b*) remitted abroad credited to his/its NRE/FCNR/NRO account, where the securities were purchased on repatriation basis in accordance with sub-paragraph (1) of paragraph 2 and the payment for purchase of the securities sold was made by inward remittance through normal banking channels or out of funds held in NRE/FCNR account.

31 International Financial Markets

With liberalisation in the domestic regulations and globalisation of financial markets abroad, an increasing number of Indian companies are raising funds in international financial markets. Typically the operations are in Eurocurrency markets, which provide larger access at competitive cost. This chapter discusses the features of the Eurocurrency market and their off-shoot, off-shore financial centres.

Eurocurrency market is an international capital market which specialises in borrowing and lending of currencies outside the country of issue. Thus, deposits in dollars with a bank in London are Eurodollars. Similarly, Japanese yen held by banks in London are Euroyen; pound-sterling held by banks in Germany are Eurosterling, and so on. They are all Eurocurrencies. The main centres of Eurocurrency are London and a few other places in Europe. The growth of the market has extended beyond these limits and now it includes a few centres of Asia too, such as Singapore and Hongkong.

31.1. FACTORS FAVOURING GROWTH OF THE MARKET

The foundation of modern Eurocurrency was laid in 1949. The new Chinese Communist Government apprehended that their dollar earnings would be blocked by the USA. To overcome the threat, it began to disguise its dollar earnings by placing them with a Russia-owned bank in Paris. Following the outbreak of the Korean war in 1950, the USA blocked Peking's identifiable dollar balances in the USA. Fearing similar action against their holdings, the Russian banks in Paris and London began disguising their balances by placing them with banks in Western Europe instead of depositing them directly in New York. Thus the Western Banks had claims on dollar balances in the USA and the Communist depositors had similar claims on the Western Banks.

Another contributing factor was the decision taken by the British Government in late 1957 to impose a ban on new overseas loans, denominated in sterling to finance trade between countries outside the Sterling Area. During the same period, exchange control restrictions were relaxed throughout Western Europe, affording commercial banks the freedom to conduct foreign exchange business and to accept deposits in foreign currencies. The situation was utilised by the London banks to offer their restricted non-sterling area clients the alternative of financing in US dollars.

The real impetus for the growth of Eurodollars came from certain developments in the USA itself. Regulation Q of the Federal Reserve Act provided mandatory ceilings on interest rates that could be paid on bank deposits. Under the regulations, no interest was payable on bank deposits of less than 30 days' duration, while interest rates for longer terms were governed by strict ceilings. Thus the interest rates payable on dollar deposits in the USA was restricted, while no such restriction was there for deposits outside the USA. By offering higher rates of interest than those prevailing in the USA, banks operating outside the USA were able to attract substantial dollar deposits from non-US residents. The higher rate of interest also resulted in transfer of some of dollar balances kept by foreign investors in New York to outside the USA. Initially, these deposits were placed with banks in London, as they had a ready use of these funds in foreign exchange business and lending to non-sterling areas. Thus London gained prominence as a financial centre for Eurocurrency.

Another regulation that encouraged flow of funds from the USA to European centres was Regulation M of the Federal Reserve Act. This regulation required the banks to maintain certain percentage as reserves against deposits. Except for a brief period, this regulation was not applied to deposits of European branches of US banks. This resulted in the cost of operations lower in Europe as compared to that in the USA. A part of this economy in operations could be passed on the customers in the form of higher rates of interest on deposits at the European centres. The absence of regulations encouraged some US banks to move some of their depositor's accounts, including those of Americans, to the European market.

All the factors thus far mentioned encouraged the flow of funds into the Eurocurrency markets. Certain other factors ensured its sustenance by creating adequate demand for the funds thus generated. One such factor was the controls and restrictions on borrowing funds in the United States for reinvestment abroad, begun as a voluntary restraint programme in 1965 and made mandatory in 1968. As a result of the restrictions, the borrowers were driven to seek loans outside the US market and naturally they resorted to the Eurocurrency market.

To discourage flow of dollar from the country, USA introduced the Interest Equalisation Tax in 1963. This was a tax on US residents' earnings on foreign securities. To cover the tax, the US lenders charged higher rates of interest from foreign borrowers. Routing the funds through the Eurocurrency market helped to avoid the interest equalisation tax and thus enabled the lenders to offer funds at lesser interest rates.

31.2. SPECIAL FEATURES OF THE MARKET

The following are the special features of the Eurocurrency market:

1. Transactions in each currency take place outside the country of its issue. For example, dollars earned by a Japanese firm from exports may be deposited with a bank in London. The London bank is free to use the funds for lending to any other bank. The bank may use it for lending to a French Bank. Thus the utility of the currency is entirely outside the control of the central bank of the country issuing the currency. For this reason, Eurocurrencies are also referred to as offshore currencies.
2. Even though the currency is utilised outside the country of its origin, it has to be held only in the country of its issue. To continue our example, the Japanese firm deposits its dollar earnings with a bank in London. The London Bank will keep the funds in a New York Bank in its own name. When the London Bank lends the amount to the French Bank, it will give suitable instructions to the New York Bank. On receipt of the instructions, the New York Bank will debit the account of the London Bank and credit it to the account of the French Bank. Thus ultimately the settlement of all dollar transactions takes place in New York. Similarly, settlement of all Eurosterling transactions is made in London.
3. Though Eurocurrencies are outside the direct control of the monetary authorities of their respective countries of issue, they are subject to some form of indirect control. This is because the settlement of all transactions has to take place only in the country of issue. If the country of issue imposes any restrictions, the conversion of balances in the currency held outside the country into another currency would also be affected. As already stated conversion into another currency would involve clearing in the country of issue at some point of the transaction. This automatically subjects them to the restriction.
4. Eurocurrency market is not a foreign exchange market. It is a market for deposits with and between banks (inter-bank deposits) and for loans by banks to the non-bank public. It is a market in which foreign currencies

are lent and borrowed as distinct from the foreign exchange market, where they are bought and sold. It consists of a pool of predominantly short-term deposits which provide the biggest single source of funds that commercial banks transform into medium and occasionally long-term international loans or Eurocredits.

5. The transactions in the market involve huge amounts running into millions of dollars. The large-scale financing has led to the development of syndications of loans, where a large number of banks participate in the lending operations.
6. Eurocurrency market is a highly competitive market with free access for new institutions in the market. Consequently, the margin between the interest rates on deposits and advances has narrowed down considerably.
7. A special feature is the concept of 'floating rates of interest'. The rate of interest is linked to a base rate, usually the London Inter-Bank Offered Rate (LIBOR). The interest on the deposit or the advance would be reviewed periodically and changed in accordance with change, if any, in LIBOR.
8. US dollar remains the leading currency traded in the Eurocurrency market, even though its share is declining. Other currencies traded in the market on large scale are Deutsche mark, Japanese Yen, Pound Sterling and Swiss Franc.
9. The Eurocurrency market can broadly be divided into four segments:
   (*i*) Eurocredit markets, where international group of banks engage in lending for medium and long term;
   (*ii*) Eurobond market, where banks raise funds on behalf of international borrowers by issuing bonds; and
   (*iii*) Eurocurrency (deposits) market, where banks accept deposits, mostly for short term.
   (*iv*) Euronotes market, where corporates raise funds.

The division is not watertight and the different segments overlap each other.

31.3. INTEREST RATE IN EUROCURRENCY MARKETS

The interest rates in Eurocurrency markets are determined by a multitude of factors which affect the demand and supply conditions of the currency concerned. Some of the factors are: (*i*) volume of world trade transacted in the currency, (*ii*) domestic interest rates, (*iii*) domestic monetary policy and reserve requirements, (*iv*) domestic government regulation, and (*v*) relative strength of the currency in the foreign exchange market. In practice, domestic interest rates act as a floor to Eurocurrency rates because the funds flow into Eurocurrency market seeking higher interest. Although the Eurocurrency market operates in a number of centres around the world, interest rates for a particular currency are consistent. Any temporary variations at different markets are quickly eliminated by international arbitrage.

Interest in Eurocurrency market is generally a floating rate of interest. Periodically, the interest rate will change with reference to a benchmark rate like LIBOR. For instance, the interest on a Eurobond for five years may be fixed at 150 basis points over Libor. (One basis point is 1/100 of 1%). The Libor at the time of issue plus 1.5% will be applicable for six months. At the end of this period, Libor then prevailing will be reckoned and the interest for the next six months will be based on the Libor then prevailing. This will be repeated every six months.

LIBOR LIBOR is the 'London Inter-Bank Offered Rate' and represents the rate at which banks in London will lend a currency to other banks for a specific maturity. Since London is a major Eurocurrency market, Libor is used as the basis for most Eurocurrency transactions. Libor varies for different maturities. Thus we have 1 month Libor, 3 months Libor, 6 months Libor etc. Rates quoted by different banks may vary slightly, the bigger banks offering lower rates. In respect of a particular

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contract based on Libor, say a Eurobond issue, the rate is fixed by nominating reference banks. The reference banks may be from among those syndicating the issue. Or, to maintain neutrality, they may be banks outside the syndicate. The rates quoted by these banks at a stipulated time, often 11 AM London time, two business days before start of the due date, is taken as the basis. The average of such rates is rounded off to the nearest 1/8 per cent.

LIBID is the 'London Interbank Bid' rate. It is the rate at which banks accept Eurocurrency deposits. Bid rates are lower than offered rates usually by 1/8 to 1/4 per cent.

LIMEAN is the average of Libor and Libid.

EURO LIBOR While LIBOR is applicable for dollar transactions, Euro Libor is applicable for transactions in Euro. It is based on the rates quoted by 16 banks in London.

EURIBOR Euribor (Euro Interbank Offered Rate) is the benchmark rate of the large euro money market that has emerged since 1999. Euribor is the rate at which euro interbank term deposits are offered by one prime bank to another prime bank and is published at 11.00 a.m. It is based on rates quoted by 57 banks in the Eurozone.

Prime Rate This is the rate of interest charged by first class banks in USA on advances to their first class borrowers. For example, it may relate to an advance made to a multinational corporation with a very high credit rating. This rate is usually a couple of percentage points higher than the discount and Federal funds rate. While it follows the same trends, it is determined rate calculated from money market rates, specially from the 90 days Certificate of Deposit rate.

Every bank in the USA announces independently its prime rate, but this tends to influence the rate of other banks also. Similarly, the prime rate has influence over the Eurodollar rate and is also influenced by it. A change in the prime rate is followed by a change in the Eurocurrency rate and *vice versa*.

SIBOR This represents the Singapore Interbank Offered Rate. Similar to Libor, it is the rate at which principal banks in Singapore offer to lend Asian dollars and other currencies to other banks. Sibor forms the basis for interest rate on Asian dollar and syndicated loans.

31.4. EUROCREDITS

Most of the lending in Eurocurrency markets takes the form of Eurocredit. Eurocredits are medium and long-term loans provided by international group of banks in currencies which need not be those of the lenders or borrowers. Eurocredit belongs to wholesale sector of the international capital market and normally involves large amounts.

Security Eurocredits are provided mostly without any collateral security from the borrower. Greater emphasis is laid on the credit rating of the borrower rather than on any tangible security. Providing Eurocredits as unsecured facilities also renders the job easy by avoiding complicated procedures to take charge of the security.

Type of Facility The conditions stipulated for drawing and repayment of the facility depend upon the kind of credit provided. Eurocredits are normally provided in either of the following two forms: (*i*) revolving credit and (*ii*) term credit.

Revolving credit is similar to a cash credit facility. It is a standby facility to meet temporary but recurring financial requirements of the borrower. Interest is charged on the actual amount utilised; on the sanctioned but unutilised portion, a commitment fee may be charged. Repayment is arranged by progressively reducing the credit limit till the entire facility is thus reduced.

Term credit is similar to medium-term loans provided by banks. At the beginning itself both the lenders and borrowers agree on the schedule of drawing the facility.

The facility is utilised in full for some time and then, in accordance with the agreement already entered into, repayment begins. The repayment schedule is fixed taking into account the expected revenue flow from the investment.

The borrower is expected to give seven days' notice when he wants to avail the instalment as per the schedule of drawings. Once he has given the notice to avail of the drawing, he is irrevocably bound by it. Similarly, for forgoing the drawing, seven days' notice is required to be given to the lenders. Many loan agreements provide for pre-payment of the full amount without any penalty at 30 days or 60 days' notice. The provision helps the borrowing companies to repay the loan and avail better conditions that may prevail in the market at a later date.

Period The period of Eurocredits extends up to 15 years. But most of the credits are for periods of 5 to 8 years. On an average about 5% of the total credits are for periods ranging from 1 to 5 years and about 10% from 10 to 15 years.

Interest Interest is fixed at a certain percentage over a reference rate, generally the interbank rate for Eurocurrency deposits. For dollar loans the reference rate is the LIBOR (London Inter-Bank Offered Rate); for Euro it is EURIBOR. For similar reason, for loans in pound sterling the Paris Interbank Offered Rate is taken as the base rate.

Generally interest for dollar loans is fixed at a percentage over Libor, say 1% over Libor. The interest is revised every six months, considering the changes in Libor. Thus, technically, the credit is 'rolled over' or renewed every six months. The difference between the interest charged on the loan and the Libor is the lending margin. The lending margin is not fixed but depends upon the credit rating of the borrower and his bargaining capacity.

Currency Most of the loans raised are in dollars. Some loan agreements also provide for currency option. That is, initially the loan is raised in dollars. The borrower is given the option to roll over the loan in a different currency according to his requirement. This again is possible provided the bank can procure the required currency. The multi-currency option helps the borrower in avoiding exchange risk and also does not involve the lending bank in any risk.

❑ Syndication of Loans

Each Eurocredit runs into a huge amount of a few hundred million dollars. It is not safe or possible for a single bank to undertake the entire amount. Thus few banks form a syndicate (similar to consortium lending in domestic banking) to provide funds to the borrower. The practice is also partly due to the US laws which provide limitations on loans of any single bank to any single borrower. Bank syndicates are not permanent groupings. They are formed in each case by banks willing to participate in the credit.

In arranging the credit the major role is played by (*i*) managing bank(s) appointed by the borrower to arrange the credit; (*ii*) lead bank, providing most of the money, and (*iii*) agent bank appointed by lenders to look after their interests once the loan agreement is signed. All the functions may be rendered by a single bank.

The managing bank(s) is/are appointed by the borrower to arrange the credit. The participants in the market fall into two segments: (*i*) The wholesale large commercial banks who arrange credits, take major share and are a force to reckon with; and (*ii*) retail sector small banks taking what participation they can get.

The appointment of the managing bank is formalised with the award of mandate by the borrower. The managing bank helps the borrower in drawing up a statement of the borrower's financial condition and purpose of the credit and the loan agreement. It negotiates terms with other banks and assembles the syndicate. The manager's function comes to an end with the signing of the loan agreement by the borrower and the participating banks and the agent bank take over from there. But, in practice, the managing bank continues to keep in touch with the borrowers to help protect the interests of the lending syndicate.

For the service rendered, the managing bank is entitled to the management fee at a flat percentage of the loan. It is paid by the borrower at the time of signing of the agreement.

The participants in the syndicate are entitled to participation fee. A part of the management fee received by the managing bank is passed on to the participants as the participation fee in proportion to the share of funds provided by each. Participation fee is not payable if share of a bank is less than a prescribed minimum.

A situation may arise where the borrower has to pay facility fee in addition to the management fee. The facility fee is the commitment charge paid on undrawn portion of the credit to compensate the banks for keeping funds ready. It is payable at an annual rate.

Protection to Lending Banks One major step taken by lending banks to protect their interests is to analyse the position of the borrower and his country's economic and political environment thoroughly before committing themselves on the loan. Even though all members of the syndicate sign a common loan agreement, each lending bank is responsible for its own decision and surveillance over the borrower. But the smaller banks may lack the desired infrastructure to undertake a detailed country risk analysis. They, therefore, rely on the larger banks.

Many covenants are included in the loan agreement safeguarding the interest of the lending banks. Any misrepresentation by the borrower in the information furnished to the syndicate or failure to perform the covenants will be considered as default by the borrower. Default with any single lending bank will be regarded as default with all banks. The covenants include negative lien, maintenance of ratios between assets and liabilities, limitation on dividends and total debt service in relation to earnings, etc. But recourse to legal protection is rendered difficult because the credits fall outside the jurisdiction of any single authority. Further complication is the legal status of governments and international organisations as borrowers, although many countries have passed laws to waive sovereign immunity in commercial transactions. Therefore, in case of default, settlement by political negotiation rather than by litigation is the order of the day.

The interests of the lending banks are protected better when there is co-financing by official international organisations like IMF and World Bank. In such cases information about international financial flows and debtor countries becomes easily available. In case of default IMF may propose conditions for management of economies as a corrective measure. But co-financing by these institutions is confined to a very few cases.

In case of weaker borrowers, the lending banks try to compensate the higher risk involved by prescribing higher lending margins. Higher margins may also be a polite way of saying 'no' to the proposal.

31.5. EUROBONDS

A major source of borrowing at Euromarkets is through the issue of international bonds known as Eurobonds. Eurobonds are those sold for international borrowers in several markets simultaneously by international group of banks. They are issued on behalf of multinational corporations, international agencies and governments. In the past borrowers were largely from industrialised countries. Of late, developing countries have entered the market on a large scale. Most of their borrowings had been balance of payments-oriented, either directly or indirectly.

Eurobond should be distinguished from foreign bonds. Foreign bond is issued on behalf of a non-resident borrower as in the case of Eurobond. But a foreign bond is sold only in the domestic capital market of the issuing country by a group of banks in the market of issue. It is subject to regulations of the country of issue. For example, a foreign bond may be issued on behalf of a Japanese firm exclusively

in West Germany. As against these restrictions a Eurobond is outside the regulations of a single country. The investors are spread world-wide.

Eurobonds are unsecured securities. Therefore only borrowers of high financial standing are able to issue such bonds. When they are issued by government corporations and local bodies, they are guaranteed by the government of the country concerned. Issues by subsidiaries normally carry guarantee of the parent company.

Selling of Eurobonds is done through Syndicates. The Lead Managing Bank is responsible for advising on the best size of the issue, terms and timing and for coordinating the issue. Lead managers take the help of co-managing banks. Entire issue is underwritten by the managers and a larger group of underwriting banks. In addition there are still larger groups of selling banks.

The lead managing bank is entitled to the management fee, the underwriting banks the underwriting allowance and selling banks to the selling concession. All put together, the cost of issue may come to 2% to 2.5% of the value of the issue. Initially the lead manager holds the entire commission, allowance, etc. The borrower gets the value of the issue less commission, etc., from the lead manager. The lead manager allocates the bonds to all members of the selling group at face value less their commission/allowance. Thereafter every member is on its own. They can sell to investors at whatever prices they can obtain. Thus no two investors in the Eurobond market need pay the same price for newly issued bonds.

Features Most Eurobonds are bearer securities. Most of the bonds are denominated in US dollars, issued in denominations of USD 10,000. The average maturity of Eurobonds is about 5 to 6 years although it is normal to find issues with maturity up to 15 years.

❑ Types of Bonds

There are four main types of Eurobonds:

(*i*) Straight or Fixed-rate bonds;
(*ii*) Convertible bonds;
(*iii*) Currency option bonds; and
(*iv*) Floating Rate Notes.

(i) Straight or Fixed Rate Bonds

These are fixed interest-bearing securities, the interest normally payable at yearly intervals. Interest is payable on the basis of interest year of 360 days. Maturities range from 3 to 25 years. Maturity common is up to 15 years. But the actual life of a bond is reduced considerably by the borrower exercising the right to redemption before maturity that is included in the bond. The redemption is done by offering an agio (premium).

Provision for redemption of bond may be made either through creation of a purchase fund or a sinking fund. In a purchase fund the borrower sets aside an amount to repurchase some of his outstanding bonds in the open market up to a stipulated amount in any given year of the issue's life. But creation of purchase funds does not create any liability on the part of the borrower to redeem the bond before maturity. The borrower may exercise his discretion when the market conditions favour such a decision. Often the fund is used to support bonds in the secondary markets, for the sake of credit standing of the borrower and to help future borrowing. A sinking fund is instituted when there is legal obligation to buy back. Otherwise it is similar to purchase fund.

There are no withholding taxes on interest earned on Eurobonds. That is, there is no deduction of tax at source. But the investor is expected to declare the income to national tax authorities and pay tax. But tax avoidance and tax evasion are rampant.

Though the rate of interest is fixed, the actual yield from the investment depends upon the price paid by the investor. Bond prices are influenced by the level of short-

term interest rates and the degree of liquidity in the money market. Price fluctuations can produce capital gain or loss to the investor when he disposes of the bond in the secondary market. Price fluctuations often lead to switch between bonds in the secondary market and between bonds and other instruments.

(ii) Convertible Bonds

These are also fixed interest-bearing securities. The investor has the option to convert them into the equity share (common stock) of the borrowing compan.. The conversion will be done at a stipulated price for the shares and during a stipulated period. Thus convertible bonds are similar in nature to that of convertible debentures.

The conversion price is normally kept higher than the market price for the equity shares on the date of bond issue. Therefore the investor will exercise the option of conversion only if the market price during the option period is higher than the fixed price.

The rate of interest on convertible bonds is lower than that offered on a comparable straight bond. This is because the investor will profit from a rise in the share price. Another advantage to the borrowing company is that it will also receive cash for a phased programme of newly issued shares when the investors exercise their option of conversion.

The attraction of convertible bonds to the investors is that in addition to fixed income on their investment they stand to participate in the capital growth of the company. Further, some of the bonds are issued in a currency other than the currency in which the shares of the company are denominated. This provides an opportunity to diversify the currency risk. Such bonds are issued with a fixed exchange rate clause specifying the rate at which the conversion into shares will be accounted. The investor's decision to convert or to hold bonds as such will depend upon the relative movement in exchange rates.

Bonds with Warrants A variant of convertible bonds is issued with warrants. The warrant gives the option of conversion into shares. Warrant is part of the bond but is detachable and traded separately when the conversion takes place. The investor can keep the bond and trade the warrant for the shares.

The value of the warrant is less than the conversion price of shares. The investor has, therefore, to surrender a part of the bond or pay cash to make up the difference.

(iii) Currency Option Bonds

These are similar to straight bonds with the difference that it is issued in one currency with option to take payment of interest and principal in a second currency. Normally option bonds are issued in sterling and provide option for payment in dollar or Euro.

The rate at which the conversion of currency takes place depends upon the terms of issue. Some bonds fix the rate of conversion at the time of issue itself. But recent issues provide for floating rates for conversion. The rate of conversion in such a case is the spot rate quoted in the market three business days before each payment is due for interest and principal.

(iv) Floating Rate Notes (FRNs)

FRNs are similar to straight bonds in respect of maturity and denomination. But the speciality of the FRNs is that the interest payable is varying in accordance with the market conditions unlike the fixed rate payable on a straight bond.

Interest on FRNs is payable at a spread over the Libor which is normally 1/4%. But in individual cases the spread can vary from a low of 1/8% to a high of 1.5%. The rate of interest is adjusted every six months depending upon the ruling Libor. Many bonds also provide for a minimum interest clause in case the Libor and the spread fall below a certain level. Some bonds include a 'drop lock' clause

under which if the minimum rate happens to be paid, it is fixed for the remaining period of the bond.

The advantage of FRNs is that they provide the investors with the facility of investing for long term and also benefit from movement in short-term rates. Most issuers of FRNs have been banks. Banks also invest in FRNs.

31.6. EUROCURRENCY DEPOSITS

While Eurobonds represent the funds amassed by the banks on behalf of international borrowers, Eurocurrency deposits represent the funds accepted by the banks themselves. This sector of the Eurocurrency market consists of all deposits of currencies placed with banks outside their home currency. The deposits are accepted in Eurocurrencies or in currency cocktails (a unit representing a basket of currencies) like SDR and ECU (European Currency Unit).

Eurocurrency time deposits are by far the most important instruments in the Euromarkets surpassing by several times the outstandings under Eurobond and foreign bond issues. Deposits may be placed at call or for fixed periods as time deposits. Call deposits may be made for overnight, two-day or seven-day notice for US dollars, Canadian dollars, Sterling and Japanese yen and for a minimum notice of two days in other currencies.

Time deposits are accepted for periods of 1, 3, 6 and 12 months for all currencies. Thus it can be seen there is a close link in the functioning of the eurocurrency deposit market and foreign exchange markets. Deposits in US dollars and pound-sterling can be placed for periods up to five years.

In general the minimum size of deposit that can be placed in Eurocurrency market is USD 50,000 or its equivalent.

❑ Certificates of Deposit

A certificate of deposit resembles a time deposit with the difference that the former is negotiable while a time deposit is not. Certificates of deposits (CDs) evidence receipt of money by the bank and also carry the bank's guarantee for repayment of principal and interest.

CDs are issued payable to bearer and therefore can be traded in the secondary market. Most CDs in Eurocurrency market are in dollars and few in sterling and yen. The minimum denomination is USD 50,000. Normally they are issued for periods up to one year.

CDs provide an excellent avenue for banks who would like to keep the liquidity and earn interest at the same time. For example, if a bank feels that it can afford to invest for about six months, it can purchase CDs for this period. If need arises, CDs can be sold in the secondary market and funds recouped.

Types of CDs The most common type of CDs are straight or tap CDs. They bear a fixed rate of interest and have a fixed maturity date of 1 to 12 months. Interest is normally fixed at 1/8 per cent below Libor at the time of issue. In individual cases the interest fixed depends upon the credit standing of the issuing bank and liquidity position in the market.

Floating Rate Certificates of Deposits (FRCDs) have caught the imagination of Indian banks too, whose branches or consortia are functioning abroad. Few issues of such certificates have been made in Singapore and other eastern markets. In the Eurocurrency market, FRCDs are issued with maturities up to three years. Interest is adjusted every six months at 1/4 per cent over the prevailing Libor. FRCDs are, therefore, more beneficial to investors when compared with a straight CD for six months rolled over three years. Interest is paid semi-annually.

Tranche CDs are issued with maturities up to five years. They carry fixed rate of interest. A tranche CD is a share in a programme of CD issues by a bank up to a predetermined level, say USD 100 million or more. Each tranche CD carries the same rate of interest and matures on the same date. Usually they are placed directly

with investors rather than offered publicly to the market. In many respects, therefore, they represent short-term Eurobonds.

Discount CDs are issued at a discount and are paid at maturity for their face value, the difference representing the interest for the period. Interest calculation is similar to that for treasury bills or bankers' acceptances. Initial issues were for a period of one or two months at the option of the lender.

31.7. EURONOTES

Euronotes constitute the instruments of borrowing issued by corporates in the Eurocurrency market, with or without the underwriting support of banks. This is evolved as a process of disintermediation in the market whereby the borrowers are directly approaching the lenders without the intermediation of banks and financial institutions.

The following categories of instruments fall under Euronotes:

(*i*) Commercial Paper
(*ii*) Note Issuance Facilities
(*iii*) Medium Term Notes.

❑ Commercial Paper

Commercial Paper (CP) is promissory note of maturity less than a year issued by a corporate body. Generally the issue is not underwritten and therefore companies with high ranking issue CP. They are issued for high denominations like USD 100,000. Usually they are issued on a discount to yield basis.

Typically the period for which CP is issued varies from 90 to 180 days. They are unsecured instruments. The investors are mainly from major fund managers, insurance companies, banks and corporates.

For the borrowers CP provides a cheap source of finance as the interest rate is lesser than that paid on bank borrowings. It is flexible as the size of issue can be varied according to the requirements. First rated corporates may also back up their issues with lines of credit from banks, from which they can draw if CP is not fully subscribed. For the investors the yield is higher than that on bank deposits, they are negotiable and hence liquid, and the duration is short so that it fits into their short term financial plans.

❑ Note Issuance Facilities

Note issuance facility (NIF) is a device adopted to meet the divergent needs of the borrowers for medium term funds with the willingness of the investors to invest in short term. The reconciliation is achieved through the underwriting facility provided by banks.

NIF is a medium term commitment under which a borrower can issue short term paper in its own name, but the underwriting banks are committed either to purchase any notes which the borrower is unable to sell, or to provide standing credits.

Under this arrangement the borrowers place short term notes (Euronotes) of, say 3 months or 6 months maturity, directly to the investors. The notes are rolled over on their maturity. That is, the existing notes are redeemed and fresh notes are issued. Banks underwrite that at the time of each rollover they would take up the unsold notes or provide matching credit.

Depending upon slight variation in the methodology adopted for their issue, NIFs are variously known as Revolving Underwriting Facility (RUF), Standby Note Issuance Facility (SNIF), Note Purchase Facility (NPF), etc.

❑ Medium-Term Notes

Medium-Term Notes (MTNs) represent a long-term, non-underwritten and fixed interest rate source of raising finance, comparable with Eurobond issues. Whereas

Eurobond is underwritten, MTN is not underwritten. They were evolved to bridge the maturity gap between the short term commercial paper of less than one year and long term Eurobond of more than 5 years.

MTNs are like privately placed bonds but with great flexibility. The maturity can vary from one year to ten years. Documentation procedures are simpler as compared to bond issue. They enjoy a highly liquid market. In view of these facts, these instruments have become quite popular.

31.8. OFFSHORE BANKING

Offshore banking refers to the international banking business involving non-resident foreign currency-denominated assets and liabilities. It refers to the banking operations that cover only non-residents and do not mix with the domestic banking. An offshore banking centre is a place where deliberate attempt is made to attract international banking by offering many concessions in the form of taxes and levies being imposed at lower rates or not being charged. A more important relaxation is the exemption of the offshore banks from restrictions on operations. Offshore banking units in these centres can carry on their activities of deposit taking from and lending to international enterprises or investors without conflict with the domestic fiscal and monetary policy. In short, offshore banking is international banking kept separate from domestic banking coupled with freedom of functioning.

Offshore banking is carried out in about 20 centres throughout the world which offer the following benefits:

1. Exemption from minimum reserve requirements.
2. Freedom from control on interest rates.
3. Low or non-existent taxes and levies.
4. Entry is relatively easy, especially for large international banks, in contrast to the situation in neighbouring countries, which may strictly limit or prohibit the entry of foreign banks.
5. Licence fees are generally low.
6. Close proximity to the important loan outlets or deposit sources; *e.g.*, Bahrain is an offshore base for petro-dollars.

Offshore banking is an extension of the concept of Eurocurrency to East. They provide a link between Eurocurrency markets and the final borrowers. They are providing essential time zone links which are truly world-wide and ensure that the market operates 24 hours a day. While offshore banking is an integral part of Euromarket, what distinguishes them from the mainstream of Euromarkets is that they were especially set up by the host countries to promote international banking. The need for channelising huge international money resources that OPEC came to possess following the oil crisis resulted in setting up of a number of offshore centres. These centres exist in almost all Asian countries like Singapore, Hongkong, Korea, Philippines, Colombo and Bahamas.

Offshore banking units are branches of international banks or other subsidiaries or affiliates. They do not carry retail business, but generally provide wholesale banking services, namely, project financing, syndicated loans, issue of short-term and medium term instruments like negotiable certificates of deposits and capital notes, as well as merchant banking activities in foreign currency denominated bonds and equity shares*. The deals are mostly between banks or with large borrowers or multinational corporations. Multinational corporations prefer transacting in offshore financial centres because of certain apparent advantages: (*i*) avoidance of high tax incidence; (*ii*) freedom from exchange control; (*iii*) maintenance of secrecy of deals due to non-interference from government and regulatory authorities, and (*iv*) deferring tax by floating subsidiary units in such centres and delaying their remittance of profits to the parent company, when it would be taxed.

Participation of the Indian Banks

Offshore banking may be a measure of showing the sophistication achieved by a bank in international finance. That the response from Indian banks to offshore banking is positive reveals the development of these banks in the last few years in the field of international banking. A number of banks including State Bank of India, Indian Overseas Bank, Bank of India and Bank of Baroda have set up offshore banking units for deposit taking and final lending at places like Bahrain, Hongkong, Colombo, Cayman Islands, etc. Indian Bank, Bank of Baroda and Union Bank of India have jointly floated a deposit taking company IBU International Finance Ltd. in Hongkong to do both offshore and onshore banking.

The benefits that would be derived by the Indian banks from these ventures are:

1. They would earn sizable profits as these ventures involve relatively low operating costs.
2. With multi-currency deposit bases the banks would be able to serve better the needs of their customers who have set up joint ventures abroad in the form of foreign currency finance. In the absence of facilities with the Indian banks such business would be diverted to other international banks.
3. The banks would be strengthening the balance of payments of the country through repatriation of profits from the venture.

Offshore Banking Centre in India

A persistent plea has been made by financial experts to establish an offshore banking centre in India. Geographically, India provides distinct advantages in attracting offshore banking units, because it has a stable economic and political performance, a vast market, technical manpower which could find employment in these centres. The geographical position is such that the Indian market would open a little before the Tokyo market closes and close a little before New York opens, thus providing for international money market dealers a vital time link.

In an era where many Indian corporations are functioning abroad and many corporations are granted permission to seek overseas finance, the establishment of an offshore unit will help tap the resources easily.

The following benefits are expected from establishing an offshore banking centre in India:

1. Exporters would benefit in terms of finer margins on loans and better foreign exchange rates available via an offshore banking unit. The benefits of multi-currency operations which, to an extent, minimise currency fluctuation risk, will be an added advantage.
2. Salaries paid by offshore banks and local expenditure incurred by them contribute to the welfare of the economy. For smaller countries the benefit would be of greater significance. For a larger country like India, however, this may not form a significant portion of the total income.
3. This country may earn revenue in the form of licence fees, profit taxes imposed on the banks operating in the area. It may also get the benefit of banks' funds in the form of capital and liquidity requirements.
4. The country can gain improved access to the international capital markets.
5. The domestic financial system may become more efficient through increased competition and through exposure of the domestic banks to the practices of offshore banks.
6. The offshore banking centre will provide opportunities to train the local staff which will in turn contribute to a faster growth of the domestic economy.
7. The offshore banking units would help channelise non-resident Indian investments.

8. Setting of an offshore banking centre would trigger enforced development of more advanced communication facilities which is a must for its functioning.
9. As the exporters could get cheaper finance from this centre, the expenditure on export interest subsidy can be saved.
10. Such centre will add to the prestige of the country and establish India firmly on the world financial map.

The establishment of an offshore centre involves some cost to the host country:

1. An offshore centre requires certain infrastructure in the form of good telecommunication system, education and training facilities, etc. The host country may have to incur heavily on these if the facilities are non-existing. The cost involved may not be justified by the benefits derived.
2. The supervision and regulation of offshore banks may involve substantial costs.
3. Encouraging offshore banking may result in the diminution in autonomy of domestic monetary policy, since it is difficult to draw a line always between the offshore and onshore operations, particularly in the absence of exchange control.
4. Offshore banking provides scope for tax evasion by residents. For example, in Hongkong, it was found that residents place deposits with offshore banks and take loans of the same amount. The interest on loan would be a deductible expenditure for taxation while the income from interest on deposits is not taxed.
5. Offshore banks may prove to be deleterious competitors to the local banks and may inhibit their growth.
6. Offshore banks may increase demand for domestic resources like space (land for office and housing) and skill (professionals). Since the supply in the short run is inelastic, the increased demand may cause inconvenience to local residents.

It may be observed from the above discussion that the cost of having an offshore banking centre would be substantial to a country with limited resources and undeveloped infrastructure. For a country of the size of India, the cost involved may not be significant. There is, therefore, a strong case for India to develop an offshore banking centre or international banking centre of its own.

Bombay is a suitable centre for establishing offshore banking in India. It has all the requirements—goods infrastructure in the form of telecommunications and services, abundant and well-trained manpower and presence of many international banks, both Indian and foreign, already engaged in international banking. Besides, Bombay is having an ideal location in the eastern time zone. It is active along with Singapore and Bahrain and has marginal overlap with London and Frankfurt. The setting up of the International Banking Centre in Bombay would throw the door open for the free flow of international trade and without any strings attached. The foreign loans or aid are generally available only with certain conditions, which can be avoided by utilising the funds from the offshore bank.

Recommendations of Sodhani Committee

The Sodhani Committee on Foreign Exchange Reforms (1996) has recommended allowing Indian banks and financial institutions to set up offshore banking units as it would prove to be cost-effective for local institutions. These units can offer many services including managing funds raised by Indian corporates through GDR issues.

To attract investment in such units, the panel has recommended that, on the lines of tax-havens such as Mauritius and Cayman Islands, either nil tax or low tax be levied on income generated by the offshore banking units.

CBUs in SEZs

While introducing the Exim Policy for the years 2002-2007, the Honourable Commerce Minister announced that for the first time in India, Overseas Banking Units (OBUs) would be permitted to be set up in Special Economic Zones (SEZs). These units would be virtually foreign branches of Indian banks but located in India. These units would be exempt from CRR, SLR and would give access to SEZ units and SEZ developers to international finance at International rates. The Reserve Bank has been entrusted with the responsibility of formulating the scheme. It is reported that the scheme formulated by Reserve Bank has been approved by the Government. Detailed instructions are awaited.

❑ Tax Havens

A distinction should be made between offshore banking centres and tax havens. A tax haven is a territory where assets can be held without any local tax liability or the tax is substantially less. Therefore, the concession is available to all, domestic as well as international banks. Even where concession is confined to foreign source of income, it is restricted to banks alone. An offshore financial centre is a place whereby by deliberate attempts, domestic and international banking is separated and the international banking is free from withholding taxes and exchange controls. Tax havens offer a good choice for development as offshore financial centres.

Tax havens may be used by multinationals to conceal their income or avoiding taxes. These countries do not have tax treaties or treaties regarding information sharing with other countries. Thus, while they provide channel for legitimate tax avoidance, they may also offer a shield for unaccounted and illegal moneys flowing into them.

Tax havens of the world can be grouped into four types:

1. *Tax Havens that Have no Income or Capital Gains or Gift and Estate Tax* This includes many of the tax havens in the Caribbean, such as Bahamas, Bermuda, and the Cayman Islands. In the Cayman Islands, foreign owned companies are guaranteed against taxes for 20 years. It has no tax treaties and has moderate corporate and incorporation fees.

2. *Tax Havens with Very Low Rate of Taxes* British Virgin Islands, and Netherlands Antilles are examples of this type. Income taxes are very low, and there are special tax privileges to shipping, aviation and holding companies.

3. *Tax Havens that Tax Income from Domestic Sources, but Exempt all Income from Foreign Sources* Hong Kong and Panama fall in this type. In Hong Kong a nominal tax of 15% is imposed on Hong Kong-sourced income; foreign-source income is completely exempt. There is no tax on capital, capital gains or dividends remitted to foreign shareholders.

4. *Tax Havens with Special Tax Privileges and Suitable only for Selected Purposes* These countries are trying to promote development in certain regions or encourage industrialisation within the country. They include Republic of Ireland, Puerto Rico, Switzerland, Netherlands and Liechtenstein. Republic of Ireland exempts taxation for export earnings of corporations that set up manufacturing operations in certain regions. Tax evasion is not a criminal offence in Switzerland. The local banks will refuse requests for information even to Swiss federal tax authorities. Netherlands is a tax haven for holding companies which do not pay any tax on income and capital gains emanating from their direct participation in either domestic or foreign subsidiaries.

32 Raising Funds Abroad

There are two ways in which a corporate in India can raise funds in international markets:

(a) External Commercial Borrowings

(b) Euro Issues.

The regulations governing raising funds abroad under the above two schemes are outlined in this chapter.

32.1. DECISION TO BORROW ABROAD

The major advantages that accrue from availing a foreign currency loan are:

(a) lower interest rate;

(b) freedom from exchange risk; and

(c) non-encumbrance on assets.

In raising a foreign currency loan, the prospective borrower should keep verify that these advantages are available to him.

First, the foreign currency loan is offered in the international markets frequently against the guarantee from a bank in India. Therefore, the borrower should add the guarantee fee payable by him to his bank to the cost of raising the foreign currency loan. The interest rate, the guarantee commission and other incidental costs should aggregate to less than the cost of funds in the domestic market.

Secondly, the exchange loss on conversion can be avoided provided the purpose for which the loan is raised can be paid for in the currency of the loan and the source of repayment is also in the same currency. For instance, the loan is raised for pay in dollars for raw materials imported and export proceeds are also received in US dollar. If the sources of repayment is in a currency other than the currency of loan, the borrower will be facing exchange risk. Forward cover may be arranged, but this should be added to the cost of borrowing. Further, hedging exposures for longer periods is costly.

The *third* advantage is that since specific assets are usually not charged for funds raised abroad, the borrowing capacity in the domestic company is not affected.

The above factors should help the borrower decide whether to go for external borrowings or not. If he decides to avail the loan, the various aspects of the specific loan should be considered to make it most economical:

(i) The period of repayment should synchronise with the cash accruals of the borrower. Loans for longer periods may be preferred, but in any case, the repayment cannot exceed 10 years.

(ii) The interest should be on a floating rate basis, rather than fixed throughout the period of loans. This will give him the leverage of benefiting from fall in interest rates.

(iii) Where the currency of loan and the currency of source of repayment are different, the loan agreement may be made to include a currency option. Even otherwise, the currency option may give a chance to the borrower to take advantage of exchange rate movements.

32.2. EXTERNAL COMMERCIAL BORROWINGS

Generally the external commercial borrowings (ECB) refer to borrowings by the business community from foreign sources. The Government announces the policy of ECB for the country as a part of prudent debt management.

ECB are defined to include commercial bank loans, buyers credit, suppliers' credit, securitised instruments such as floating rate notes, and fixed rate bonds

etc., credit from official export credit agencies and commercial borrowings from the private sector window of Multilateral Financial Institutions.

❑ Features of the Policy

The following are the salient features of the policy:

1. *Approvals* For proposals falling under the USD 5 million scheme or USD 10 million scheme, approvals will be granted by RBI. Other proposals should be approved by the ECB Division, Department of Economic Affairs, Ministry of Finance.

2. *Average Maturities* The minimum average maturity period prescribed is as follows:

(*i*) Loan amount not exceeding USD 20 million - 3 years
(*ii*) Loan amount exceeding USD 20 million
  (*a*) 100% EOU units - 3 years
  (*b*) Others - 5 years

Bonds and FRNs can be raised in tranches of different maturities as long as the average maturity of the different tranches, within the same overall approval satisfies the maturity criteria.

3. *Foreign Exchange Earners* Corporates who have foreign exchange earnings are permitted to raise ECB up to thrice the average amount of annual exports during the previous three years subject to a maximum of USD 100 million without end use restrictions.

4. *Infrastructure Projects* Holding companies/promoters will be permitted to raise ECB up to USD 50 million to finance equity investment in a subsidiary/joint venture company implementing infrastructure projects.

The following sectors qualify as infrastructure sectors: (*a*) power, (*b*) telecommunication, (*c*) railways, (*d*) roads including bridges, (*e*) ports, (*f*) industrial parks, (*g*) urban infrastructure—water supply, sanitation and sewage projects.

5. *Long-term Borrowers* ECB of eight years and above of average maturity will be outside ECB ceiling, though Ministry of Finance approval would continue to be necessary.

To be eligible for this purpose, the long term debt instrument should not include any 'put' or 'call' options potentially reducing the stated maturities.

Development Financial Institutions (DFIs) can raise funds under this window in addition to their normal annual allocated covered by the cap.

Borrowing under the long term window should not be used to enhance the average maturity of borrowings under normal window. If they are combined, then the entire borrowings will fall under the cap.

Corporates may raise these borrowings either through FRN/Bond Issues/ Syndicated loans etc. as long as the maturity and interest spread are maintained as per the guidelines.

6. *On-Lending by DFIs and Other Financial Intermediaries* While DFIs are required to adhere to the average maturity criteria prescribed, they are permitted to on-lend at different maturities. They may also on-lend for project-related Rupee expenditure. However, other financial intermediaries are required to adhere to the general ECB guidelines on maturity in their on-lending programs.

All financial intermediaries, including DFIs, are required to on-lend their external commercial borrowings within 12 months of drawdown.

DFIs are permitted to on-lend such Recycled Funds (available with them on account of time mismatch between repayment obligation of their sub-borrowers vis-à-vis those of DFIs to the offshore lenders), out of original ECBs only for import of capital goods and project-related rupee expenditure.

7. *End Use Requirements* There is no restriction on end use of funds except that they cannot be used for investment in stock market or in real estate.

8. *Proceeds from Bonds, FRNs and Syndicated Loan* Corporate borrowers who have raised ECB for import of capital goods and services through Bonds/FRN/

Syndicated loans are permitted to remit funds into India. The funds can be utilised for activities as per their business judgement except investment in stock market or in real estate, for upto one year or till the actual import of capital goods and services takes place, whichever is earlier

9. ECB Entitlement For New Projects All infrastructure and greenfield projects will be permitted to avail ECB to an extent of 35% of the total project cost. However, ECB limits for telecom projects are more flexible at 50% of the project cost. Greater flexibility may also be allowed in case of power projects and other infrastructure projects based on merits. 100% EOUs will be permitted to have foreign currency exposure upto 60% of the project cost.

10. Structured Obligations In order to enable corporates to hedge exchange rate risks and raise resources domestically, Domestic Rupee Denominated Structured obligations would be permitted to be Credit enhanced by International Banks/International Financial Institutions/Joint Venture Partners subject to the following conditions:

(*a*) In the event of default, foreign banks giving guarantee will make payment of defaulted amount after bringing in the equivalent amount of foreign exchange into the country.

(*b*) FEMA clearance should be obtained from RBI in advance.

(*c*) Prior clearance for bonds /debentures issue from RBI/SEBI should be obtained.

(*d*) In the event of default, the default should be foreign currency equivalent of the outstanding calculated in rupee terms.

(*e*) The liability of the Indian company will always be rupee denominated and the debt servicing may be done in equivalent foreign exchange funds. Debt servicing in a post-default situation may be in rupees or foreign exchange as envisaged initially in the contract document.

(*f*) The guarantee fee/commission/charges and other incidental expenses to the Indian company should be in rupee terms and not exceed 3% p.a.

(*g*) In case of default, the interest rate could be coupon on the bond/or 250 bps over prevailing secondary market yield of 5 year GOI security, whichever is higher.

11. Other Terms and Conditions Apart from the maturity and end-use requirements, the financial terms and conditions of each ECB proposal are required to be reasonable and market-related. The choice of the sourcing of ECB, currency of the loan, and the interest rate basis (i.e. floating or fixed), will be left to the borrowers. In case of borrowing by public sector units, the loan agreement should not contain the covenant that the Government will continue to hold at least 51% of equity.

12. Validity of Approval Approvals are valid for a period of six months, i.e. the executed copy of the loan agreement is required to be submitted within this period. In the case of FRNs, Bonds etc., the same are required to be launched within this period. In case of power projects, the validity of the approval will be for a period of one year and 9 months in the case of telecom sector project. Bonds, Debentures, FRNs and other such instruments will have additional validity period of three months for all the ECB approvals across the board. Extension will not be granted beyond the validity period.

13. Pre-payment of ECB

(*a*) Prepayment facility would be permitted if they are met out of inflow of foreign equity or out of balances in EEFC account;

(*b*) In addition to ECB being prepaid out of foreign equity, corporates can avail either of following two options for prepayment of their ECBs:

(*i*) On permission by the Government, prepayment may be undertaken, within the permitted period, of all ECBs with residual maturity up to one year, or

(*ii*) Prepayment upto 10% of outstanding ECB to be permitted once during the life of the loan, subject to the company complying with the ECB approval terms. Those companies who had already availed prepayment facility of 20% earlier would not be eligible.

(*c*) Validity of permission under the above two options will be as under:

(*i*) Prepayment approval for ECBs other than Bonds/Debentures/FRNs will be 15 days or period up to next interest payment date, whichever is later.

(*ii*) In case of Bonds/FRNs, validity of permission will not be more than 15 days.

Prepayment will be allowed by RBI.

14. Refinancing the Existing Foreign Currency Loan Refinancing of outstanding amounts under existing loans by raising fresh loans at lower costs may also be permitted on a case-to-case basis, subject to the condition that the outstanding maturity of the original loan is maintained. Rolling over of ECB will not be permitted.

A corporate borrowing overseas for financing its Rupee-related expenditure and swapping its external commercial borrowings with another corporate, which requires foreign currency funds, will not be permitted.

15. Cost of Borrowing The all-in-ceiling for normal, infrastructure, and long term ECBs are 300, 400 and 500 basis points over six month Libor, for the respective currency in which the loan is being raised or applicable benchmark as the case may be.

❑ Procedure for Availment

The procedural aspects of availing ECBs are covered under the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000. Regulation 5 provides that:

(*a*) A resident may borrow from a bank situated outside India, for execution outside India of a turnkey project or civil construction contract or in connection with exports on deferred payment terms, provided the terms and conditions stipulated by the authority which has granted the approval to the project or contract or export.

(*b*) An importer in India may, for import of goods into India, avail of foreign currency credit for a period not exceeding six months extended by the overseas supplier of goods, provided the import is in compliance with the Export Import Policy of the Government of India in force.

Approval of RBI or Central Government

ECB is permitted under the following schemes:

(*i*) ***Short-term Loan Scheme***

(*a*) Foreign currency credit extended by the overseas supplier of goods to an importer of goods for financing import of goods into India, provided the period of maturity of credit is more than six months but less than three years.

(*b*) Foreign currency loan/credit extended to an importer in India for financing imports into India, by any bank or financial institution outside India, provided the period of maturity of loan/credit is less than three years.

(*ii*) ***Borrowing under US Dollar Five Million Scheme*** Borrowing in foreign exchange upto USD five million by an Indian entity for general corporate purposes at a simple minimum maturity of three years.

(*iii*) ***Borrowing under US Dollar Ten Million Scheme*** Borrowing in foreign exchange not exceeding USD ten million by an Indian entity for the following purposes:

(a) Borrowing for Financing of Infrastructure Projects provided that the minimum average maturity of loan is three years. In case the loan is to be raised by more than one promoter entity for a single project, the aggregate of loan by all promoters should not exceed USD 10 million.

(b) Foreign currency loan raised by an Indian entity for financing infrastructure project, provided that the minimum average maturity of loan is not less than three years.

(c) Borrowing in foreign exchange by an exporter/foreign exchange earner upto three times of the average amount of his annual foreign exchange earnings during the previous three years subject to a maximum of USD 10 million with a minimum average maturity of three years.

(d) Borrowing for general corporate purposes at the minimum average maturity of eight years.

(iv) Scheme for Raising Loans from NRIs on Repatriation Basis Borrowings not exceeding US$ 2,50,000 or its equivalent in foreign exchange by an individual resident in India from his close relatives resident outside India, subject to the conditions that -

(a) the loan is free of interest;

(b) the minimum maturity period of the loan is seven years;

(c) The amount of loan is received by inward remittance in free foreign exchange through normal banking channels or by debit to the NRE/FCNR account of the non-resident lender;

(d) The loan is utilised for the borrower's personal purposes or for carrying on his normal business activity but not for carrying on agricultural/plantation activities, purchase of immovable property or shares/debentures/bonds issued by companies in India or for re-lending.

The borrower shall not utilise the funds borrowed under any of these Schemes for investment in stock market or in real estate business.

Automatic Approval With effect from September 1, 2000 ECBs upto USD 50 million and refinancing of all existing ECBs have been placed under automatic route. Accordingly, any legal entity can enter into loan agreements for fresh ECB with average maturity of not less than 3 years for an amount upto USD 50 million and for refinancing an existing ECB provided it is in conformity with both the ECB guidelines framed by Ministry of Finance, and the regulations of RBI. There is no need to obtain prior approval from Government or RBI.

The loan should be availed from an internationally acceptable and/or recognised lender, such as export credit agencies, suppliers of equipments, foreign collaborators, foreign equity holders, international capital markets, reputed international banks and financial institutions etc. Further the loan should be organised through a reputed merchant banker registered with the regulatory authorities of the host country, *viz.*, USA, Japan, EU countries, Singapore and such other countries as may be notified from time to time by the Government of India. The lenders should be recognised and registered in the host countries for the purpose of extending international finance.

The borrower should submit through an authorised dealer three copies of the signed loan agreement to the Reserve Bank. The Reserve Bank will acknowledge receipt of the copies of the agreement and will allot a loan identification number to such an agreement. The primary responsibility to ensure that ECBs raised are in conformity with the regulations will be that of the borrower. At a later date, if any violation is found, appropriate action will be taken by the Reserve Bank under FEMA.

The borrower will also be permitted to make necessary draw-downs under the automatic route without prior permission from the Reserve Bank. A quarterly return should be submitted through the authorised dealer.

Opening of foreign currency account for parking ECB proceeds temporarily, pending utilisation, will require prior approval of Reserve Bank.

Prior Approval Borrowings, other than under automatic route, up to USD 100 million require approval of Reserve Bank. Proposals exceeding this limit require prior approval of the Central Government. The application should be made in Form ECB.

31.3. EUROISSUES

Access to Euroequity market is made through the issue of:

(*i*) Foreign Currency Convertible Bonds; and

(*ii*) Depository Receipts.

Foreign currency convertible bond (FCCB) is a Eurobond which can be converted into shares at the option of the investor. This has also been explained under 'Euro bonds'.

Depository Receipts, or the more popular among them, the Global Depository Receipts, are explained below:

❑ Global Depository Receipt

A Global Depository Receipt is a negotiable instrument denominated in US dollars, that represents shares issued in a local currency. The shares of the issuing company are issued in the name of an international bank, called the depository who is located in a foreign country. The physical possession of the shares issued are with a 'custodian' in the issuing country. The shares are issued to the depository in the local currency. Based on the shares held by it, the depository issues the GDRs in US dollars. The dividend, after withholding tax etc., is paid by the issuing company to the depositor in the local currency. The depository converts the dividend received into US dollars at the ruling exchange rate and distributes it among the GDR holders. GDRs are bearer instruments and traded freely in international markets either through stock exchange mechanism or on an 'Over The Counter' (OTC) basis. The settlements are done through international clearing systems like Euroclear (Brussels) or CEDEL (London).

GDRs offer many advantages to the issuing company. The exchange risk is borne by the investors as the payment towards dividend is made in the local currency. There is no dispersal of voting rights as right to vote is vested only with the depository and is regulated by an agreement between the company and the depository. It enables the company to broaden the capital base by tapping large foreign equity markets. But the issue is subject to country risk analysis and for companies from countries with poor credit rating, the issue may not be successful or can succeed only at higher cost. The value of GDRs depends upon the value of the shares of the company. The prospects of the company for future issues may be affected by decline in share prices in the local market which may be a market phenomenon unconnected with the performance of the company.

For the investors, it offers portfolio diversification in a freely traded instrument in a convertible currency. The investors bear exchange risk as well as risk of capital erosion.

American Depository Receipt (ADR) is similar to GDR, but issued in the USA. It is a security issued by a bank or a depository issued in the USA against underlying rupee shares of a company incorporated in India.

❑ Government Guidelines

Government of India issued in June 1996 fresh guidelines for issuing ADRs/GDRs and FCCBs. Revised guidelines were issued in January 2000, applicable only for ADRs/GDRs. Essence of the guidelines for ADR/GDR and FCCB are given below separately:

ADR/GDR

1. ADR/GDR are reckoned as part of foreign direct investment. Accordingly, such issues should conform to the existing FDI policy and only in areas where FDI is permissible.
2. Indian companies issuing ADRs/GDRs through registered exchanges are free to access the market through an automatic route without the prior approval of the Ministry of Finance. Private placement is also eligible for the automatic approval provided the issue is lead managed by an Investment banker.
3. In all cases of automatic approval, the mandatory approval under FDI policy, approvals under Companies Act and for overseas investment/business acquisition, if required, should be obtained beforehand.
4. Companies may retain the proceeds abroad or may remit funds into India in anticipation of the use of funds for approved end uses.
5. The issue related expenses shall be subject to a ceiling of 4% in the case of GDRs and 7% in the case of listing on US exchange. Issue expenses beyond the ceiling would require RBI approval.
6. The proceeds cannot be used for investments in stock markets and real estate.
7. Separate guidelines have been issued for (a) issuing GDR/ADR linked stock option for software companies and (b) overseas business acquisition by Indian software companies through ADR/GDR realisations/Stock Swap.

FCCB

1. Only companies with a consistent good track record for three years will be allowed to issue FCCBs. This requirement will be relaxed in case of issues made for investments in infrastructure industries such as power generation, telecommunication, petroleum exploration and refining, ports, airports and roads.
2. The issue will be treated as a direct foreign investment and the clearance of Foreign Investment Promotion Board (FIPB) should be obtained where necessary.
3. FCCBs can be issued for restructuring of external debt which helps to lengthen maturity and soften terms, and for use of funds which conform to the norms prescribed by the Government for External Commercial Borrowing (ECBs) from time to time. Not more than 25% of FCCB issue can be used for general corporate restructuring including working capital requirements.
4. FCCBs should have a substantial finer spread than ECBs. Accordingly, the all-in cost for FCCBs should be significantly better than the corresponding debt instrument.
5. Companies will not be permitted to issue warrants along with their FCCB issue.