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RISK MANAGEMENT AND INTER-BANK DEALINGS:

OPERATIONAL FLEXIBILITY FOR INDIAN SUBSIDIARIES OF NON-RESIDENT COMPANIES

1. BACKGROUND

Pursuant to the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000, (the "**Regulations**")[1] the Reserve Bank of India (the "**RBI**") has framed regulations to promote the orderly development and maintenance of the foreign exchange market in India.

These Regulations have over a period of time effectively governed foreign exchange contracts in India. Now, the RBI has released a circular[2] to provide flexibility to multinational entities and their Indian subsidiaries to effectively hedge the currency risk arising out of current account transactions in India (the "**Amendment Regulations**").[3]

2. REVISED SCOPE

2.1. The Amendment Regulations now permit a non-resident to enter into a foreign exchange derivate contract with an Authorized Dealer ("**AD**") bank in India to hedge an exposure to an exchange risk of and on behalf of its Indian subsidiary in respect of the said subsidiary's current account transactions.

The Amendment Regulations also lay out the operational guidelines and the terms and conditions for hedging. Amongst other conditions, it is important to note that this will be governed by a tri-partite agreement involving the Indian subsidiary, its non-resident parent (or treasury) and the AD bank.

Although parties to a derivative transaction are free to choose their documentation template, the International Swaps and Derivatives Association ("**ISDA**") from time to time comes up with drafts of various standard common documentation templates for the parties to use.

The ISDA agreement between the AD bank and the non-resident entity will be distinct from this agreement. Further, the non-resident entity should be incorporated in a country that is a member of the Financial Action Task Force ("**FATF**") or member of a FATF-Style Regional body.

Additionally, the profit or loss of such hedge transactions shall be settled in the bank account and books of account of the Indian subsidiary. The AD bank shall obtain from the Indian subsidiary an annual certificate by its statutory auditors to this effect. Further, it may be noted that all compliance accountability still remains the prerogative of the Indian subsidiary.

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[1] Foreign Exchange Management Manual, Vol. 1, 29th Edition, at page 3.237

[2] A.P. (DIR Series) circular No. 41 dated March 21, 2017

[3] Available at https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10891&Mode=0

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Prior to the Amendment Regulations, the RBI allowed non-resident entities to hedge foreign currency exposures on behalf of its Indian subsidiaries; however, such permission was limited only to capital account transactions (for example, in cases of foreign currency loans and external commercial borrowings availed by such Indian subsidiaries).

Now, pursuant to the Amendment Regulations, considering similar benefits have been extended to current account transactions, Indian subsidiaries can avail these benefits in relation to their foreign trades, short term credit facilities in its ordinary course of business, payment of interest thereon and in case of payments due as net income from investments.

This move by the RBI is likely to improve liquidity and risk appetite. Permitting overseas parent companies to enter into these derivatives contracts will allow Indian subsidiaries to hedge their foreign currency risk exposure, thereby easing transactional risks involved.

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