International Banking

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Chapter I

Introduction to International Banking

After reading this chapter, you will be conversant with:

- Brief History of International Banking
- Reasons for the Growth of International Banking
- Characteristics and Dimensions of International Banking
- Recent Trends in International Banking
- Organizational Features of International Banking
- International Interbank Business
- International Private Banking

Introduction

Banks are the key players in the financial system of a country. They perform the function of financial intermediation in an effective manner. Lately, internationalization of banks is being witnessed across the globe. With the rapid increase in the operations of international financial markets, the international banking system has shown splendid growth during the past two decades. Internationalization of banking business refers to the process of expanding banking activities abroad and replacing domestic banking business content by international content. Banks in many nations have internationalized their operations since 1970. The quantum of operations has increased in such a manner that the concept evolved into a subject in itself.

According to Aiber, 'International Banking' is defined as 'a sub-set of commercial banking transactions and activity having a cross-border and/or cross-currency elements'.

The terms 'International banking' and 'multinational banking' can be used interchangeably. Multinational banking also signifies the presence of banking facilities in more than one country.

International banking comprises a range of transactions that can be distinguished from purely domestic operations by:

i. The currency of denomination of the transaction,

ii. The residence of the bank customer, and

iii. The location of the banking office.

A deposit or a loan transacted in local currency between a bank in its home country and a resident of that same country is termed as pure domestic banking. Thus, the term international banking is used to refer to the cross-currency facets of banking business.

Eurocurrency market is an example of a typical international banking community. The eurocurrency market conventionally encompasses all deposit and loan operations of a bank transacted in a currency other than that of the nation where the office is located. Eurocurrency banking involves intermediation in foreign currencies and the relative freedom from local reserve requirements and monetary regulations.

Globalization of banking business, though used as synonymous to international banking, refers to the process in which banking services become world wide in terms of geographical coverage and universal in terms of the provision of banking services. This in turn results in harmonization of banking rules and the removal of barriers so that all banking firms can compete in all markets. Thus, international banking may be viewed as an early stage of globalization of banks.

BRIEF HISTORY OF INTERNATIONAL BANKING

The origin of international banking dates back to the second century BC when Babylonian temples under the code of Hammurabi, safeguarded the idle funds of the affluent and extended loans to merchants to finance the movement of goods. Similarly, during the period 500-300 BC, banks in Greece regularly advertised interest for deposits and routinely handled foreign money payments. Later during the Roman civilization, a variety of financial instruments like bills of exchange were legalized to encourage trade between regions. Subsequently, the Renaissance in Europe in the fourteenth century gave rise to the concept of lending to kings, which slowly emerged into international banking. During fourteenth and fifteenth centuries, the Florentine banking houses had branches, subsidiaries and offices throughout Europe to facilitate trade among nations in wool, cloth and silks. The loans extended by these banks were the first instances of international lending by the prerunners of the modern banks to the forerunners of the modern governments.

The nineteenth century witnessed many innovations in international lending, such as trade financing and investment banking. Trade financing, started as short-term commercial lending, is used to finance commodity exports and imports or to deal in foreign exchange. Investment banking consisted of the placement of long-term funds in fixed interest securities on agency or undertaking basis to enable infrastructural and industrial development. Of the two, investment banking accounted for the great bulk of the international lending, and financing companies acted as agents or underwriters for the placement of funds, and thus originated the concept of "Capital Markets".

By 1920s, American banking institutions dominated international lending, and the European nations were the major borrowers. There was perfect international banking system existing till the time of the First World War. But post-First World War period was characterized by a series of bank failures, default and violent contractions in international trade and investment. These developments shattered confidence in international lending. Banking across national borders came to a grinding halt in the early 1930s and did not resume till the Second World War.

Banking activities across national borders have exhibited several notable patterns in the post-World War II era. Near the end of the Second World War, various nations met at Bretton Woods, New Hampshire and agreed among other things to a fixed exchange rate system and currency devaluation. This agreement, which came to be known as the Bretton Woods Agreement, dominated the international banking scene till the 1970's.

The Bretton Woods System had installed a secured financial framework and revolutionized the economic life by creating a global shopping center. After this, international banking operations were started by major commercial banking institutions in the US, UK, Canada, France, Germany, Switzerland and Japan. In 1970's, two major events occurred that completely revolutionized banking business – the demise of the Bretton Woods system and the emergence of the Middle East Oil Crisis. International banking speeded up after the first oil crisis in 1973. Progress in the telecommunications sector across the world supplemented the growth of international banking.

REASONS FOR THE GROWTH OF INTERNATIONAL BANKING

There are a number of explanations or theories provided to support the growth in international banking operations. International banking theories explain the reasons behind banks' choice of a particular location for their banking facilities, maintaining a particular organizational structure, and the underlying causes of international banking. Certain theories/explanations are listed below:

a. A primary motivating factor for international expansion is to gain direct access to the host country's markets. If a bank can offer lower loan interest rates, higher deposit rates and better services than a domestic bank, then expansion into a foreign market can be profitable. When domestic banks react to the foreign bank's activities by improving their own products and services, the host country customers clearly benefit from this increased competition.

b. "Follow-the-leader" explanation suggests that banks expand across national borders to continue to serve customers by establishing branches or subsidiaries abroad. This is mostly done in the context of monopolistic competition, so that they can take advantage of the differentiation of their services package from those provided by other banks.

c. Expansion abroad has a pervasive effect on competition. Many a time banks operating under intense competition in the home markets are forced to develop low cost technologies for financial intermediation without proper incentives; therefore, they try to exploit their competitive advantage in other markets.

d. An explanation drawn from the analysis of foreign direct investment shows that banks use management technology and marketing know-how developed for domestic uses at very marginal cost abroad.

e. "Electic Theory of Production" says that, banks can take the ownership-specific and location-specific advantages while operating abroad.

f. Market imperfections due to domestic rules, regulations and taxation along with the drastic reduction in the cost of communications prompt the banks to set up operations abroad.

g. Inter country differences in the cost of capital attract banks to set up their operations in different countries.

h. Phillip Callier in his research paper "Professional Trading, Exchange Rate Risk and the Growth of International Banking" has put forth that the establishment of money market and foreign exchange operations in major trading centers throughout the world are helping the banks (operating internationally) to significantly reduce the risk of these operations or increase their return without increasing their risk.

CHARACTERISTICS AND DIMENSIONS OF INTERNATIONAL BANKING

Though the concept of international banking is quite old, it has acquired certain new characteristics and dimensions. Some of the newer characteristics of international banking are:

- The number of participants, which at the beginning of the period were mainly American banks, has considerably widened to include German, British, Japanese, French and Italian banks operating directly or through foreign branches and subsidiaries.
- The foreign component of total assets of the big international banks has grown at a rate considerably above the average so that many major banks now have more international loans outstanding than domestic ones.
- Nearly three quarters of the deficit of less developed countries are financed by commercial banks operating internationally.
- The amount of individual loans has risen considerably thus increasing the default risk from individual borrowers.
- The maturities for loans have risen considerably. Average maturities are now about ten years.
- Banks have started diversifying their sources of funds along with the assets.

Apart from the above, two novel kinds of overseas bank operations characterized international bank expansion in the late 1960s and 1970s:

i. A multinational consortium bank was created by several established parent banks; and

ii. The shell branch, which is not really a bank but a device to get around the domestic government regulation, was created.

The global network of banks has increased the volume of international banking business. Consequently, loans and other international business began to grow much more rapidly than domestic business.

RECENT TRENDS IN INTERNATIONAL BANKING

In the past two decades, people around the world have come across complex developments in the financial sector, which have evolved gradually. Significant liberalization of domestic banking and capital markets regulations, and opening up of the hitherto closed economies to an increasing range of borrowers have led to the deregulation of economies. At the same time, displacement of funds from traditional banking and savings institutions has significantly reduced the role of intermediaries and thus enhanced the process of disintermediation in the markets. The increasing domination of securities markets by financial institutions managed by professional bankers has led to the institutionalization of markets.

Proliferation of new products and new types of services has brought about innovation in the markets. Transferring assets from banks and other financial institutions to the markets has increased the securitization of assets. In the process, financial markets in different countries are thoroughly interlinked leading to the globalization and internationalization of markets.

Globalization has affected the financial markets in the world almost entirely. One common feature is that the foreign exchange market, equity and bond markets, and the markets for short-term credit have been integrated to a large extent through the banking system.

Table 1: Causes and Consequences of Globalization

Causes of Globalization	Consequences of Globalization
Deregulation abroad	Increased cross-border investment
Greater institutionalization abroad	Wider range of alternatives for clients
Success of Euromarkets	Market complexities
Integration of markets	Need for larger firms
Technology and know-how	Greater commitment to overseas capital
–	Greater risk exposure

According to the Bank for International Settlements, the international bank market has been charting an upward trajectory as a consequence of deregulation, liberalization, institutionalization, globalization and securitization. As a consequence, activity in the international banking arena has increased with blurring distinctions between the banks, securities houses and other financial institutions. The displacement of banks as the main conduit for depositing and borrowing money has led to the globalization of the financial markets; this global integration is driven by worldwide search on the part of investors and issuers for more favorable returns and lower cost of funds respectively. In the process, banks have assumed the mighty work of catering to the needs of the borrowers and lenders worldwide. Improved communications, the erosion of barriers to capital flows, the modernization of key national financial systems, and the gradual liberalization of international trade in services are facilitating the banks to effectively meet the above-mentioned objectives of catering to the needs of the borrowers and lenders worldwide. In the words of Bimal Jalan, the ex-governor of RBI 'it is also interesting to know that with the phenomenal advances in the telecommunications and synthesis of information and computer technology, capital movements have completely dwarfed the cross-border movement of goods and services and have become the new engine of global integration. These developments have fundamentally changed the structure of the banking system, its orientation and its vulnerability to risks'.

Foremost among the global trends in the world's financial industry are consolidation and convergence. These two encompass financially driven mergers within domestic markets. In order to cut costs, domestic banks are entering into strategic cross-border deals with banks and insurance companies in other countries. Owing to this, banks are under increasing and accelerated pressure to strategically reposition themselves in a market where the competitive landscape is enormous. Banks are now forced to identify new ways to increase efficiency, enter into developing markets, provide new products, shed unprofitable operations and capitalize on new opportunities.

Today the international banking arena is a continuous track race, where contestants compete and win a few laps/fall behind, recover or quit. Success belongs to those who produce a 'trajectory' of improvements and predict a 'corridor' of characteristics that users would demand.

ORGANIZATIONAL FEATURES OF INTERNATIONAL BANKING

International banks are organized in various formal and informal ways from simply holding account with each other to holding common ownership. Given below are some forms of banking organizations that exist across the world.

Correspondent Banking

This represents an informal linkage between banks and their customers in different countries. The term 'correspondent' is derived from the mail or cable communications that the banks use for setting customer accounts. The linkage is setup when banks maintain correspondent accounts with each other. A correspondent bank is a bank that provides services, typically as an agent to another bank located elsewhere. A correspondent bank is one of the most common ways of involving in international banking activities. Many a time large banks have correspondent relationships with banks in almost every country in which they do not have an office of their own. This informal linkage facilitates international payments and collections for customers. It allows banks to relieve their customers from maintaining any personnel or offices overseas. This not only helps in settling customer payments, but also extending limited credit for each other's customers for establishing contacts between local business people and the clients of the correspondent banks.

The major advantage of correspondent banks is that it reduces the cost of physically maintaining a branch in another country. Another advantage is that it is a stepping stone for more involved relations with the foreign correspondent.

The disadvantages of correspondent banking are mostly related to agency problems. The agent's priorities may not coincide with that of the principal and hence it may allow low priority to its activities. The correspondent bank also may not provide credit on a continuing basis to the principal bank and it may sometimes resort to taking away the customers of the principal bank.

Resident Representatives

Often banks open overseas business offices in order to help their customers in foreign countries. These banking offices do not accept local deposits or provide loans. The main objective of these offices is to provide information about local business practices and conditions, including the creditworthiness of potential customers and the banks' clients. The resident representatives usually keep in touch with the local correspondent banks and provide help when needed.

Physical presence allows a representative office to obtain first hand economic and political intelligence on the host country as well as the local financial market. It also enables the bank to interact with other local institutions overseas. It also makes sense to set up a representative office overseas if the business volume abroad is small, since a representative office involves relatively low overheads.

A disadvantage for setting up a representative office is the difficulty of attracting qualified personnel, especially since they are not involved in a decision making capacity.

Table 2 gives a list of the Representative offices of foreign banks operating in India.

Table 2: List of Foreign banks having Representative offices in India as on July 31, 2007

Sl.No	Name and Address of the Foreign Bank	Country of Incorporation	Representative Office in India	Date of Opening
1	Commonwealth bank	Australia	Bangalore	7.11.2005
2.	National bank Australia Ltd.	Australia	Mumbai	3.11.2006
3.	Raiffeisien Zentralbank Osterreich AG	Austria	Mumbai	1.11.1992
4.	Fortis Bank	Belgium	Mumbai	6.10.1987
5.	K.B.C.Bank NV	Belgium	Mumbai	1.02.2003
6.	Emirates Bank International	Dubai	Mumbai	16.06.2000
7.	Credit Industriel Et Commercial	France	New Delhi	1.04.1997
8.	Natixis	France	Mumbai	4.01.1999
9.	Bayerische Hypo – und vereinsbank	Germany	Mumbai	12.07.1995
10.	DZ Bank AG Deutsche Zentral Genossenscahfts Bank	Germany	Mumbai	22.02.1996
11.	Landesbank Baden – Wurttemberg	Germany	Mumbai	1.11.1999
12.	Dresdener Bank AG	Germany	Mumbai	6.09.2002
13.	Consumerz Bank	Germany	Mumbai	23.12.2002
14.	DEPFA Bank	Ireland	Mumbai	9.02.2007
15.	Bank Intesa Banca Commerciale Italiana Spa	Italy	Mumbai	1.11.1988
16.	Sanpaolo IMI Bank	Italy	Mumbai	20.1.1991
17.	Uni Credito Italiano	Italy	Mumbai	1.08.1998
18.	Bance Populare Di Verona E Novara	Italy	Mumbai	18.06.2001
19.	BPU Banca – Banche Popolari Unite Sc.rl	Italy	Mumbai	16.01.2006
20.	Banca Popolare di Vicenza	Italy	Mumbai	29.04.2006

Sl.No	Name and Address of the Foreign Bank	Country of Incorporation	Representative Office in India	Date of Opening
21.	Monte Dei Paschi Di Sienna	Italy	Mumbai	7.04.2006
22.	Bance di Roma	ITaly	Mumbai	17.01.2007
23.	Everest Bank Ltd	Nepal	New Delhi	24.03.2004
24.	Caixa Geral de Depositos	Portugal	Mumbai	8.11.1999
25.	Vnesheconombank	Russia	New Delhi	1.3.1983
26.	VTB India (Bank for foreign trade)	Russia	New Delhi	May, 2005
27.	Promsvyazbank	Russia	New Delhi	25.04.2006
28.	Bance de Sabadell SA	Spain	New Delhi	2.08.2004
29.	Banca Bilbao Vizcaya Argentaria BBVA	Spain	Mumbai	2.04.2007
30.	Hatton national bank	Sri lanka	Chennai	1.01.1999
31.	UBS AG	Switzerland	Mumbai	24.11.1994
32.	Zurcher Kantonial Bank	Switzerland	Mumbai	27.06.2006
33.	The Bank of New York	USA	Mumbai	27.10.1983
34.	Warchoria Bank NA	USA	Mumbai	1.11.1996

Source: http://rbidocs.rbi.org.in/rdocs/Content/pdfs/71207.pdf

Bank Agencies

An agency is similar to a bank except that it does not handle ordinary retail deposits. The agencies mostly deal in local currency markets, foreign exchange markets, arrange loans, clear bank drafts and cheques, and channel foreign funds into financial markets. They also arrange long-term loans for customers and act on behalf of the home office to keep it directly involved in important foreign financial markets.

Foreign Branches

These are operating banks, except that the directors and owners tend to reside elsewhere. These are subject to both local banking rules and the rules at home. The books of a foreign branch are incorporated with those of the parent bank, although the foreign branch will also maintain separate books for revealing separate performance, and for tax purposes. The existence of foreign branches provides faster service to customers in different countries by offering great advantage over the lengthy clearing process that can occur via correspondents. These branches, most of the time, offer quality services and safety that are provided by a large bank to customers in small countries.

The following table 3 lists foreign bank branches operating in India:

Table 3: List of Foreign Bank Branches Operating in India – country-wise as on July 31, 2007.

SL.No.	Name of bank	No. of Branches in India
1.	ABN AMRO Bank	28
2.	Abu Dhabi Commercial Bank Ltd.	2
3.	Arab Bangladesh Bank Ltd.	1
4.	American Express Bank Ltd.	7
5.	Antwerp Diamond Bank N.V.	1
6.	Bank International Indonesia	1
7.	Bank of America	5
8.	Bank of Bahrain & Kuwait BSC	2
9.	Bank of Nova Scotia	5
10	Bank of Tokyo-Mitsubishi Ltd.	3
11.	BNP Paribas	8
12.	Bank of Ceylon	1
13.	Barclays Bank P/c	4
14.	Calyon Bank	5
15.	Citi Bank N.A	39
16.	Shinhan Bank	2
17.	Chintrust Commercial Bank	1
18.	Deutsche Bank	11
19.	DBS Bank Ltd.	2
20.	HSBC	47
21.	JP Morgan Chase Bank N.A.	1
22.	Krung Thai Bank Public Co. Ltd.	1
23.	Mizuho corporate Bank Ltd.	2
24.	Mashreq bank PSC.	2
25.	Oman Internation Bank SADG	2
26.	Standard Charatered Bank (SCB)	81
27.	Sonali Bank	2
28.	Societe Generale	2
29.	State Bank of Mauritius	3
	Total	271

Source: http://rbidocs.rbi.org.in/rdocs/Content/pdfs/71207.pdf

Foreign Subsidiaries and Affiliates

A foreign branch is part of a parent organization, which is incorporated in a different country, whereas a foreign subsidiary is a locally incorporated bank that is owned either completely or partially by a foreign parent. Foreign subsidiaries do all types of banking, and it may be very difficult to distinguish them from ordinary locally owned banks. Foreign affiliates are similar to subsidiaries locally incorporated but they are joint ventures, and no individual foreign owner has control. For instance, if the State Bank of India (SBI) opens one of its branches in Japan, it is a foreign branch whereas if a bank located in Japan and SBI plan to work together, then, the bank in Japan is the foreign subsidiary of SBI.

Consortium Banks

They are joint ventures of large commercial banks. They often involve six or more partners from different countries. They are mainly concerned with investment, and they arrange large loans and underwrite stocks and bonds. They do not accept deposits, and they deal only with large corporations. They take equity positions and arrange takeovers and mergers.

INTERNATIONAL INTERBANK BUSINESS

Interbank market is the main component of the international banking market. Nearly sixty to seventy percent of all international banking market comes from other banks. The International Interbank Market (IIBM) was initially an informal market of short-term placements of deposits at fixed rates between banks in different countries. The large interbank market makes the market look essentially a wholesale market for banks. It enables banks to fund rapidly growing loan portfolios. The international interbank business either takes the form of a deposit or a loan. As a result of the development of a variety of derivative instruments to both manage and assume market risk in recent years, the deposit side of the IIBM has become much more of a funding market. The existence of foreign exchange market (which deals in currencies) has enhanced the operating efficiency of the interbank market. The nuances of the foreign exchange market are covered in detail in the chapter "The Foreign Exchange Market".

Functions of the Interbank Market

The chief functions of the Interbank Market are:

- **Linkages of Regions and Interest Rates:** The international interbank markets link regions together much as money markets do domestically; at the same time, they link interest rates across markets. The market performs as an intermediary in the global flow of funds by intermediating between the suppliers of funds and the end-users.
- **Liquidity and Risk Management:** The international interbank market aids liquidity and risk management in a number of ways. It enables banks to cope with the lumpishness of wholesale-sized deposits and loans and helps to plug holes in the balance sheet. Unwanted deposits are laid off to other banks. Funds needed to support lending can be bid for in the interbank market. Interbank and related funds markets give confidence that funds would be available easily in order to meet balance sheet contingencies. Therefore, banks are ready to issue standby credit lines in off balance sheet items. Trading on both sides of the interbank market prevents a bank from being a perpetual taker of funds, thus enhancing its reputation. It also enables reciprocal relationships to be formed with other banks. Most banks redeposit with other banks over 40 percent of funds obtained in the market.
- **Breaking up of Maturity Transformation:** Interbank markets break up the maturity transformation process. In retail banking, maturity transformation is normally undertaken fully by the bank, which accepts the deposit. But in the interbank market, normally when funds move from suppliers to end-users in various countries, they have to pass through several chains of banks. Therefore, the maturity transformation can take place in any one of the chains. While the bank making the end placement carries out the major chunk of the transformation, each intermediate bank is still left with some share of transformation process. In order to facilitate this process more effectively, banks in various countries take positions in the interbank market, and set up their own offices in different countries. In this process, any inherent risks arising out of non-bank businesses are also evened out automatically. Thus, the balance sheets of banks are free from mismatched non-business risks.
- **Spreading Risks among Different Institutions:** The interbank market enables the risks of lending to be spread amongst many different institutions. Loan risks are backed by both the capital of the lending bank and also by the capital of the banks, which agree to lend to it. This risk is reflected in the interest rate 'tiers' and lending limits of the participating banks. The margin levied by the lending banks is equal to the premium paid by the borrowing bank for 'insurance' against the default risk shared. Almost all the banks set overall and day limits on interbank placements of funds. Factors governing the size of limits are the size and profitability of the institution, quality of management, evidence of over-trading in the market and its access to lender of last resort funds in its national market. Lately, interbank market is adopting loan syndication as an important risk-sharing device.

With the vacuum between the borders across the world diminishing gradually, interdependence of countries on one other is increasing. In this scenario, the role of banks is becoming more specific. Thus, interbank business is of vital significance and an important source of revenue to the banks.

INTERNATIONAL PRIVATE BANKING

Today, the banking industry throughout the world is facing an unprecedented competition. The competition is forcing the banking institutions into a reappraisal of the existing clientele base and an attempt to penetrate into newer markets. The domestic home-protected (nationalized or public sector banks) banks no longer enjoy monopoly. A number of private banks have entered the fray in many countries and are continuously striving to differentiate themselves from others. These private banks are entering the international scene and are creating a lot of competition in the banking system. Thus the concept of international private banking is emerging.

Basically, the services offered by banks internationally focus either on the asset or liability side of the balance sheet or on a combination of both. Lately, international private banking is becoming an integral part of the banking system across the world to cater to the needs of high net worth people. The banks giving credit to the private sector have recently risen in a number of emerging market economies from the second half of 1990s, partly because of stronger demand for loans associated with robust growth and low interest rates, and greater supply of loans associated with improved bank balance sheets.

International private banking consists of banking services primarily provided for non-residents. It differs in the priorities given to the clients. Safety and secrecy are given the highest priority. Clients keen on maintaining and increasing their wealth in an environment safe from the potential scrutiny of third parties, added with a confidence are attracted to these banks. Investment options for the clients include:

i. Equity Portfolio Management,

ii. Fixed Income Portfolio,

iii. Balanced Portfolio,

iv. Offshore Mutual Fund, and

v. Short-term Portfolio Management.

Private banks operating internationally help in arriving at customizing services for long term assets protection. They ensure a safe haven in a stable environment, minimization of taxes, continuity from generation to generation with immense confidentiality that the customers expect.

Some of the services offered by international private banks are:

- Primarily, a bank should ensure that funds are where they are needed. In most cases, clients are not permitted to hold foreign currency under exchange control and other regulations imposed by their national authorities and any transaction involving offshore currency will take time to materialize because the transaction has to be processed abroad. International private banking reduces the transit time as well as the expenses to a large extent.
- In some cases, banks lend their international clients certain small amounts that are backed by assets for short time periods. Generally banks operating internationally do not provide unsecured loans as part of their business, but certain institutions provide trade financing and other forms of transactional or corporate lending services.
- Many a time clients have complex financial objective functions encompassing a variety of financial products in a number of currencies and across a range of portfolios. The objective of private international banks is to build a portfolio appropriate to each client's needs by managing effectively the inter-relationship among risk, return, liquidity and confidentiality. The banks provide clients with access to financial assistance.

- Private international banks also provide wide-ranging personal services for international clients on similar lines as those provided for domestic clients.
- Private international banks also provide ancillary services such as circular letters of credit, forex, bill paying, traveler's cheques, mail holding or forwarding and safe deposit boxes as per their financial requirements/needs.

Banks rendering international services require and deserve certain qualities in their private banking relationship like innovative products and sophisticated services. A bank's approach towards a service differentiates it from other banks. A commitment on the part of the banks in propagating services brings them wide-publicity as well as maximizes their assets in a changing world.

SUMMARY

- Globalization has intensified the activities in the international bank market to a very large extent.
- The competition has increased manifold and each bank is in search of means to differentiate itself from the others. Similarly domestic banks in developing countries are striving to sustain in the market.
- Banks in the international arena are playing a vital role in bringing various sectors together. They are bridging the gap between the lenders and borrowers in a more effective manner and are participating in enhancing the world's output.

Chapter II

International Banking: Regulatory Framework

After reading this chapter, you will be conversant with:

- Regulation of International Banking
- Regulatory Arbitrage: Birth of Offshore Banking
- Basel Concordat
- Capital Adequacy Ratios
- Loan Loss Provisioning
- Assessment of Country/Sovereign Risk
- Country Risk Management

Introduction

As mentioned in the first chapter, there was rapid development in the international lending activities and services offered by banks in the post World War II era. Bank lending is 'international' when it is cross-border, i.e., when the lending bank and the borrower reside in different countries. Most of the times lending can also be cross-currency, i.e., denominated in a foreign currency either to the lender and/or to the borrower. International bank lending can be classified based on three basic criteria – the residence of the bank, the residence of the borrower and the currency denomination of the loan. The residence of the bank is the country in which the bank office is physically located, or the country in which its parent bank has its headquarters. Similarly the residence of the borrower refers to the country in which he resides currency denomination is the currency in which the transaction is denominated. Today, the great bulk of the international banking is in the form of Eurocurrency loans and credits serviced in banking offices located in the major Eurocurrency centers such as London, Luxembourg and Singapore.

Since international banking activities take place between parties that are not in the same country, the international banks are exposed to regulations of the host country as well as the country in which the borrower is located. To help the banks operating internationally from dual regulations, a need to regulate the international banking system as a whole was felt. This chapter deals with the various aspects relating to the Regulatory framework of International Banks.

REGULATION OF INTERNATIONAL BANKING

The international banking system is underlined by procedures, customs, instruments and organizational settings that provide a workable multilateral payment arrangement among different countries.

The evolution of international monetary system from the Gold Standard to the Louvre Accord had a profound impact on the international banking developments. The nuances of the international monetary system are highlighted in the chapter "International Monetary System".

Need for Regulation of International Banking

There are varied reasons for regulating international banking. The following are the basic reasons:

- The volume of financial flows is much higher than the trade flows.
- In all developed markets, banking industry is heavily and systematically regulated than any other commercial or industrial sector. The prudential rationale, which is the backbone of bank regulation, is heavily dependent on the monetary rationale.
- Banks are inherently unstable owing to their intermediary function, because it implies a high gearing, or ratio of debt to equity capital. In the early stages of banking, lending and depository functions were largely separate. But subsequently, the fusion of these two functions led to the reduction in capital adequacy ratios of banks across the world. Therefore, common norms on the capital adequacy for banks worldwide became imperative.
- The widespread branch network of banks exposes them to widespread withdrawal of funds by depositors. Owing to their high financial leverage, banks can be described as 'conditionally' solvent, the condition being that depositors do not collectively exercise their contractual right of withdrawal and thereby forcing the banks into insolvency. This may result in a solvency problem, as the victim bank tries to unload essentially unmarketable assets.

- The financial condition of a bank is not readily determinable even by analysts with sophisticated techniques at their disposal because crucial risk parameters such as quality of the loan portfolio cannot be assessed on the basis of published accounts or other publicly available information. Even if the information is available, it may become redundant or outdated since banks cannot adjust their risk profile in a short span of time. Sometimes well performing banks also fall victim to ill-founded rumors. This lack of transparency may deteriorate the banks' financial condition, as they would not be able to take advantage of certain situations. So an urgent and genuine need was felt to regulate information flow among the banks that are operating internationally.

The above-mentioned reasons prompted the banks the world over to demand for a regulation common to all of them.

The Process of Regulation

The actual process of regulation started on 5th July, 1991 under the aegis of the Bank of England (BOE) with the closure of the Bank of Credit and Commerce International (BCCI) and its subsidiaries. Coordinated action was taken by the BOE to close down the activities of BCCI as well its subsidiaries in 60 different countries. The effect of the closure of this bank brought a sea change in the domestic supervisory practices of overseas banks.

The BOE recommended that the host countries should have the following rules in place:

– The central bank of the country should extend on-site supervision.

– The central bank should devote more resources to search for fraud, if any.

– A duty has to be imposed on auditors to report suspicions of fraud or malpractice of the bank.

– Overseas banks are subject to a full-scope review by reporting accountants on an annual basis.

– Minimum criteria for authorization should be strictly interpreted.

– The central bank should have the explicit power to refuse or revoke authorization on the grounds that the applicant or bank cannot be effectively supervised because of the group's structure.

– Cooperation and coordination between the banks, and other non-regulatory bodies should be enhanced.

The BOE also focused on issues like setting up supervisory standards (subject to independent monitoring), enhancing international supervisory cooperation, and devising bank secrecy provisions. These issues when implemented facilitated banks in different countries to be compared with their counterparts in other countries. However, international banking system had to take care of certain legal issues before implementing the systems in a full-fledged manner. The following paragraphs throw light on some legal issues encountered in international banking.

Legal Issues in International Banking

As said above, many legal problems crop up in international banking transactions because such transactions inevitably impose upon the laws of more than one country. Firstly, two systems of law are applicable, and in most cases even more than two are applicable. The presence of different currencies and exchange rates complicates international banking operations. In most cases a third party based in a different country may guarantee the loan. This thwarts free transactions between the parties as and when required. For instance, a syndicated loan agreement may impinge upon the laws of at least a dozen different countries, depending upon the geographical make-up of the bank syndicate. Whenever a court handles a case in a particular country that contains a foreign element, principles of private

international law or conflict of laws come into operation. The principles of private international law can be enumerated as follows:

i. To ascertain whether a court has jurisdiction to determine the case before it.

ii. To identify which system of law the court will apply to the fact of the case before it.

iii. To determine whether the court will recognize or enforce a judgment obtained in a foreign court.

In the case of domestic banking transactions, since the rights and obligations of the various parties are normally determined by the local systems of law under which they contract, the question of predictability does not arise, whereas in the case of international banking, it would be crucial to structure the transaction documentation within a legal framework. A balance can be struck by selecting both the systems, of law, which govern substantive aspects of the transaction, and the court, which has jurisdiction to resolve disputes that may arise, if any.

REGULATORY ARBITRAGE: BIRTH OF OFFSHORE BANKING

The gaps that arise either deliberately or unintentionally as a result of regulations, give rise to arbitrage opportunities in banking. Two developments have taken place under this – emergence of Eurocurrency markets and Offshore banking units.

Eurocurrency Markets

Eurocurrency markets are defined as 'the money market for borrowing and lending currencies that are held in the form of deposits in banks located outside the countries where the currencies are issued as legal tender.'

The Eurocurrency market allows for more convenient borrowing, which improves the international flow of capital for trade between countries and companies.

The concept of Eurocurrency markets came into existence in the early 1950s when the Soviet Union allegedly fearing that the United States might block its dollar reserves, decided to deposit its dollars in a Soviet-owned Paris bank, Banque Commerciale Pour. Thus evolved the concept of euro-dollars (the dollars held with a bank outside the US). Later many other reasons prompted the growth of Eurocurrency markets. Some of the reasons are:

a. Regulations in the US that limited foreign lending by US banks;

b. Regulated ceilings placed on interest rates of dollar deposits in the US that encouraged deposits to be placed in the Eurocurrency market where ceilings were nonexistent; and

c. Zero reserve requirements of dollars deposited in Eurobanks which allowed Eurobanks to offer attractive rates on deposits and on loans.

FUNCTIONS OF EUROCURRENCY MARKETS

The main function of the Eurocurrency market is to efficiently facilitate the flow of international funds from firms or governments with excess funds to those in need of funds.

The currency of denomination is separated from its country of jurisdiction. Eurocurrency banking is not subject to domestic banking regulations like deposit insurance fee, reserve requirements, interest restrictions, etc. Due to the absence of certain regulations, they are able to offer cheap and efficient services as compared to its domestic competitors. Broadly, the market comprises three segments:

i. The banks accept deposits mostly on short-term basis.

ii. Lend funds for medium and long-term loans.

iii. Raise funds on behalf of international borrowers by issuing bonds, etc.

The major participants in the market are commercial banks. They enter the market both as depositors and lenders. They accept deposits and lend to corporates who

are in need of funds. Corporations are other players in the market who raise loans. Not only the foreign corporations, but even the domestic firms with more international activities rely on the Eurocurrency loans when the credit conditions become tight and the interest rates are high. Simply put, firms engaged in international business enter the market to meet their Eurocurrency requirements.

BENEFITS OF EUROCURRENCY MARKETS

The following are some of the benefits of Eurocurrency markets:

- These are well connected and efficient so as to be used for hedging purposes. The banks can buy and sell foreign currency denominated assets and liabilities of different maturities and amounts to deal with interest rate and currency risks.
- These markets allow market forces to play sharper than the domestic banks to get more accurate readings.
- As the market involves various currencies of different countries, it is closely linked with the foreign exchange markets.
- These form a link between the domestic and the Eurocurrency interest rates since these markets offer deposit and loan alternatives to individual national domestic markets.
- These markets are convenient sources for funding a bank's domestic and international loans because these markets are well funded.

Offshore Banking Units

An Offshore Bank Unit (OBU) is a bank branch located outside the country of residence of the depositor. Offshore banking units normally comprise sub-offices of multinational banks established to freely transact in international currencies especially with non-residents. The motivating force behind such transactions is usually the high rates of interest on deposits and loans, coupled with cost effective services. Offshore banking units offer attractive rates of interest as they are generally exempted from all types of fiscal levies and monetary controls.

The main feature, of an offshore center is the physical presence of a banking unit, which undertakes the bulk of everyday transactions. They also serve as an important link for global markets thus facilitating the channeling of funds from major international financial centers to borrowers at other centers. Since, offshore centers cannot act as close substitutes to one another, it is not possible to close down an offshore banking unit even if certain concessions are withdrawn and the location center becomes less attractive.

The main pre-requisites for setting up a successful offshore banking center are political and economic stability. The other fundamental pre-requisites are:

- The existence of a major domestic financial market.
- A team of experienced, expert support specialists in the field.
- A well-defined background of statutory laws.
- The systems are free from restrictions and currency fluctuations, as far as non-resident transactions are concerned.
- An efficient, highly developed, cost-effective telecommunication network.
- The capability of leasing exclusive channels of communication for assessing international data and carrying out treasury operations.
- The presence of regulatory and fiscal incentives such as "no obligation" system for maintaining reserves with the central bank.
- The absence of withholding tax on depositors' interest income and income tax.

FUNCTIONS OF OFFSHORE BANKING UNITS

- OBUs conduct a wide range of business activities, chiefly banking, but also, insurance, securities transactions, trusts, and some non-financial activities such as shipping registries.
- Offshore banks deal mostly with other financial institutions and transact wholesale business denominated in currencies other than that of the country hosting the OBU.
- Offshore banking is carried out typically through offshore establishments, which are offshore branches or subsidiaries. Offshore branches are legally indistinguishable from parent banks on shore, which facilitates intra-branch transfers. Shell branches or booking offices are a particular case of offshore branches. They collect deposits from various markets and channel them for various uses as per dictates of their parent banks. Offshore activities may also take place through what are called parallel-owned banks which are banks established in 4 different jurisdictions that, while having the same owner(s), are not subsidiaries of one another.
- Offshore banks engage, *inter alia*, in Eurocurrency loans (including syndicated loans) and deposits, the underwriting of Eurobonds, and Over-The-Counter (OTC) trading in derivatives for risk management and speculative purposes. Eurocurrency transactions are the bulk of offshore banking operations. These include transactions between banks and the original depositors, between banks and ultimate borrowers, and between banks themselves on the inter-bank market. The underwriting of Eurobonds floated in international capital markets is also a significant part of offshore banking activities. Private banking is a major service offered to high net worth persons. Specialized services provided include asset management, estate planning, foreign exchange trading, custodian and trustee services.
- Another area which has seen major growth in recent years has been the setting up of Special Purpose Vehicles (SPVs) in the OBUs that are used by banks for asset securitization and by non-financial corporations to lower the cost of raising capital by utilization of the tax advantages[1].

ADVANTAGES OF OFFSHORE BANKING UNITS

- Offshore banks provide access to politically and economically stable jurisdictions. This may be an advantage for those residing in areas where there is a risk of political turmoil and who fear their assets may be frozen. However, developed countries with regulated banking systems offer the same advantages in terms of stability.
- Some offshore banks may operate with a lower cost base and can provide higher interest rates than the legal rate in the home country due to lower overheads and a lack of government intervention.
- Offshore banks can help developing countries investment and create growth in their economies, and can help redistribute world finance from the developed to the developing world.
- Interest is generally paid by offshore banks without tax deductions. This is an advantage to individuals who do not pay tax on worldwide income, or who do not pay tax until the tax return is agreed, or who feel that they can illegally evade tax by hiding the interest income.
- Some offshore banks offer banking services that may not be available from domestic banks such as anonymous bank accounts, higher or lower rate loans based on risk and investment opportunities not available elsewhere.
- Offshore banking is often linked to other structures, such as offshore companies, trusts or foundations, which may have specific tax advantages for some individuals.

1 Source: http://www.ficci.com

DISADVANTAGES OF OFFSHORE BANKING UNITS

- Offshore banking has been associated in the past with the underground economy and organized crime, through money laundering. Following September 11, 2001 attacks on the World Trade Center, offshore banks and tax havens, along with clearing houses, have been accused of helping various organized crime gangs, terrorist groups, and other state or non-state actors. However, offshore banking is a legitimate financial exercise undertaken by many expatriate and international workers.
- Offshore jurisdictions are often remote, so physical access and access to information can be difficult. Yet in a world with global telecommunications this is rarely a problem for customers. Accounts can be set up online, by phone or by mail.
- Offshore private banking is usually more accessible to those on higher incomes, because of the costs of establishing and maintaining offshore accounts. However, simple savings accounts can be opened by anyone and maintained with scale fees equivalent to their onshore counterparts. The tax burden in developed countries thus falls disproportionately on middle-income groups.

INDIA AND OFFSHORE BANKING

Most of the above-mentioned criteria, barring those relating to fiscal concessions and those pertaining to monetary and exchange control, are satisfied to a large extent in India. Since offshore banking is basically wholesale banking and the risks are greater than normal banking transactions, Indian banks are maintaining large amounts of resources at their disposal. Also, too many restrictions on the types of activities undertaken by offshore banking units may retard the growth of the system.

However, if India is to derive maximum benefit from such a banking center, the country should permit its own banks to operate under such a system. If India does not provide its own banks with the required freedom, flexibility, and business opportunities, it may not be able to generate enough interest among international banks. Further, it is absolutely necessary for the monetary authority to enhance its own supervisory skills to closely watch the developments of the offshore front and monitor their operations to help the system develop along sound and healthy lines.

Now, India has made a cautious beginning in offshore banking by permitting for the first time Offshore Banking Units (OBUs) to be set up in Special Economic Zones (SEZs). The SEZs have been set up with a view to providing an internationally competitive and hassle free environment for export production. SEZs will be specially delineated duty free enclaves and deemed to be foreign territories for the purpose of trade operations and duties/tariffs so as to usher in export-led growth of the economy. The OBUs virtually would be foreign branches of Indian banks located in India. These OBUs, inter alia, would be exempt from reserve requirements limited mandate. In fact, the approach appears to be facilitating the SEZ policy rather than introducing offshore banking in India. This is in line with the cautious policy stance adopted by the regulators in regard to the opening up of the financial sector. Notwithstanding the limited scope for offshore banking in the light of the relevant regulations, many Indian banks have set up OBUs in SEZs. Available feedback is encouraging[2].

2 Source: http://www.ficci.com

LABUAN MODEL OF MALAYSIA

Malaysia had introduced a model called Labuan Model for offshore banking. Under this model, offshore banks are permitted to accept foreign currency deposits from non-residents, grant foreign currency loans of any amount to any non-resident, and upto Malaysia Currency MYR (Ringgit Malaysia) 1million to any resident without permission from the controller and loans of higher amounts with permission from the controller. This model offers a very liberal tax system; a variety of exemptions are available under the Income Tax Act. India can use this model because such a system would facilitate opening up of a channel for raising comparatively low-cost resources, so far as small business and trade sectors are concerned.

BASEL CONCORDAT

The case of prudential regulation applies to banks' international activities as it does to their domestic operations. After the Herstatt crisis in 1974, formal machinery was setup to coordinate international regulatory arrangements. Let us first know about the Herstatt crisis.

Herstatt Crisis

Losses caused by unauthorized foreign exchange dealings were particularly high in the initial stages of floating exchange regime,[3] which began in 1973. The risk of default by the counter party in a spot foreign exchange transaction[4] was highlighted for the first time by the Herstatt collapse.

In the Herstatt case, German Marks were sold to Herstatt on June 24, 1974 by at least a dozen banks. Settlement was due in dollars on June 26. On that date the selling banks instructed their correspondent banks in Germany to debit their mark accounts and deposit their funds in the Lande Central Bank, the clearing house operated by the Bundesbank. The funds were then credited to Herstatt. The selling banks expected to receive dollars on the same day through London or New York clearing houses. However, Bankhaus Herstatt was officially declared bankrupt on June 26, 1974. Though the market closed in Germany, foreign exchange was still being traded in New York. In the mean time, Landes Central Bank had credited Herstatt with funds in Cologne, but the latter's doors were shut before Herstatt's dollars were credited to foreign banks. By closing Herstatt before dollar settlements for the day had taken place in New York, the Bundesbank was exposed to an interbank credit risk in spot foreign exchange transactions, of which banks were unaware of before. Subsequently, banks all over the world responded by imposing settlement limits on their foreign exchange dealings with one another.

Real Time Gross Settlement System

Normally, settlement in case of failure of individual institutions is ensured by eliminating the cash flow shortfall and allowing the losses on the underlying contracts to be dealt with separately through the courts. As an alternative, a Real Time Gross Settlement System (RTGS) is devised, which allows the funds transfer orders to be settled as soon as they have been sent, provided that the sending bank has sufficient cover in its account with the Central Bank. With this, the exposures become more transparent, and therefore the participants should be in a position to continuously monitor their risk settlement accounts and credit limits, if any. But the gains come at the cost of higher intraday liquid balances and operating outlays for participants.

3 Refer to the chapter "International Monetary System" for details.

4 Refer to the chapter "Foreign Exchange Market" for details.

Basel Committee on Banking Supervision (Peter Cooke Committee)

The disturbances that followed in the wake of Herstatt's collapse focused attention on the dependence of national banking system and led to the creation of a standing committee of bank supervisors, under the auspices of the Bank for International Settlements (BIS). The Bank for International Settlements (BIS) fulfills the need for an international organization, which fosters international monetary and financial cooperation and serves as a bank for Central Banks. The Bank for International Settlements commenced its activities from 17th May, 1930 in Basel.

The Committee on Banking Regulation and Supervisory Practices (Peter Cooke Committee) seeks not to harmonize national laws and practices but rather to inter-link disparate regulatory regimes with a view to ensure that all banks are supervised according to certain broad principles.

The initiative taken by the Cooke Committee came to be known as "Basel Concordat" and can be described as the most important milestone of international supervisory cooperation. The following key principles were embedded in the original contract:

- The supervision of foreign banking establishments is the joint responsibility of parent and host authorities.
- No foreign banking establishment should escape supervision.
- The supervision of liquidity should be the primary responsibility of the host authorities.
- The supervision of solvency is essentially a matter for the parent authority in case of foreign branches and primarily the responsibility of the host authority in case of foreign subsidiaries.
- Practical coordination should be promoted by the exchange of information between host and parent authorities and by the authorization of bank inspections by or on behalf of parent authorities on the territory of host authority.

Although the Concordat represented a significant step towards greater international supervisory cooperation, it suffered from a number of defects. For example, the Concordat failed to address the question of differing supervisory standards. The failure of the Concordat in some issues led to the Revised Basel Concordat (June 1983).

The Revised Basel Concordat replaces the 1975 Concordat and reformulates some of the provisions. It deals exclusively with the responsibilities of banking supervisory authorities for monitoring the prudential conduct and soundness of the business of banks' foreign establishments. The new Concordat is ratified by the group of ten countries, and is designed to establish minimum levels of capital for internationally active banks. It aims at an effective cooperation between host and parent authorities by ensuring that no foreign banking establishment escapes supervision. The new Concordat considers the following aspects for the supervision of banks' foreign establishments:

- ***Solvency:*** The allocation of responsibilities for the supervision of solvency of banks' foreign establishments depends upon the type of establishment. The solvency of branches is indistinguishable from that of the parent bank. For subsidiaries, the supervision of solvency is a joint responsibility of both host and parent authorities. For joint ventures, the supervision of solvency is the responsibility of the authorities in the country of incorporation.
- ***Liquidity:*** The host authority has responsibility for monitoring the liquidity of the bank's establishment in its country. The parent authority has responsibility for monitoring the liquidity of the banking group as a whole. In case of subsidiaries, primary responsibility for supervising liquidity is with the host authority.

- ***Foreign Exchange Operations and Position:*** There is a joint responsibility of parent and host authorities. Host authorities should be in a position to monitor the foreign exchange exposure of foreign establishments in their territories and should inform themselves of the nature and extent of supervision of these establishments being undertaken by parent authorities.

The committee took the following initiatives:

- **1975 Cross-Border Banking:** As said above, "Basel Concordat" establishes guidelines for the division of responsibilities for the supervision of banks' foreign establishments between 'home' and 'host' supervisors.
- **1983 Cross-Border Banking:** Revised "Basel Concordat" introduces the principle of consolidated supervision. It avoids supervisory gaps arising because of inadequately supervised financial centers.
- **1988 Basel Capital Accord:** It is an agreement aimed at securing international convergence of capital adequacy measurement and standards. It explicitly addresses credit risk and defines (i) Eligible capital elements, (ii) Variable risk weights applicable to several main categories of on and off balance sheet exposure, and (iii) The overall minimum capital ratio of 8% of risk weighted assets, with core capital.
- **1990 Relation between Supervisors:** It is an agreement on the need for the progressive removal of barriers to the exchange of prudential information between the two sets of supervisors. It explores ways of facilitating information flows.
- **1992 Cross-Border Banking:** It prescribes minimum standards for the supervision of international banking groups and their cross-border establishments. It strengthens the Basel Concordat by introducing minimum standards for some of its features, notably through conditions designed to prevent the setting up of cross-border banking establishments not subject to effective consolidated supervision or belonging to opaque conglomerate groups.
- **New Basel Accord 2004:** In June 1999, the committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord, and this has been refined in the intervening years, culminating in the release of the New Capital Framework in 2004. The new framework consists of three pillars – minimum capital requirements, which seek to develop and expand on the standardized rules set forth in the 1988 Accord; supervisory review of an institution's capital adequacy and internal assessment process; and effective use of disclosure as a lever to strengthen market discipline and encourage safe and sound banking practices.

CAPITAL ADEQUACY RATIOS

Credit management is a challenging function in a commercial bank. It calls for expert handling, assessing risk exposure at every stage and securing adequately the safety of funds exposed. Inspite of best efforts, there can be no full-proof safety standards, resulting in the unpreventable emergence of periodical sticky or overdue credit. Credit management is therefore a continuous search for more secure de-risking (effective risk-management) standards, and asset-liability management strategies. Such risk-management expertise built and implemented helps at not eliminating risk altogether, but minimizing the same.

Risk management has attracted the attention of Indian corporates. Risk management and asset-liability management strategies are gaining attention in India. The deregulation of the banking sector has brought with it a number of risks which banks have to face. The 1988 Basel Accord exclusively addresses effective handling of credit-risks. The new Basel accord covers other risks also.

Capital Adequacy Ratios – Basel Accord 1988

The growing concern of commercial banks regarding international competitiveness and capital ratios led to the Basel Capital Accord, 1988. The accord sets down the agreement among the G-10 central banks to apply common minimum capital standards to their banking industries. The standards are almost entirely addressed to credit risk, which is the major risk incurred by banks. The document consists of two main sections, which cover: (a) The definition of capital, and (b) The structure of risk weights.

Basel Capital Accord 1988 stipulated that the eligible capital should consist of shareholders' equity and retained earnings (Tier I Capital), supplementary capital (Tier II Capital) and subordinated debt (Tier III Capital).

The risk weights relate capital to the size of business. A risk-weighting system is used to arrive at the risk weights. Under the approach, five different weighting factors ranging from 0% for cash to 100% for commercial lending are used. The accord does not make any country distinctions other than to allocate a low weight to claims on the domestic government. The capital adequacy of banks can be assessed by computing the weighted risk ratio capturing different categories of asset or off balance sheet exposure, weighted according to broad categories of relative risking. In simpler words, capital adequacy ratio measures the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. The target standard ratio of capital to risk weighted assets should be set at 8%.

India and the Capital Adequacy Standards

The effect of "Credit-Risk" is being severely felt in India. Based on the Basel norms, the RBI also issued similar capital adequacy norms for the Indian banks. According to these guidelines, the banks will have to identify their Tier I and Tier II Capital and assign risk weights to their assets. Having done this, they will have to assess the Capital to Risk Weighted Assets Ratio (CRAR). The minimum CRAR is decided by the central banks independently.

TIER I CAPITAL

- Paid-up capital.
- Statutory reserves.
- Disclosed free reserves.
- Capital reserves representing surplus arising out of sale proceeds of assets.
- Equity investments in subsidiaries, intangible assets and losses in the current period and those brought forward from previous periods, will be deducted from Tier I capital.

TIER II CAPITAL

a. Undisclosed reserves and cumulative perpetual preference shares.

b. Revaluation reserves.

c. General provisions and loss reserves.

In India, the first effort for standardization of credit-assets for a better understanding of the inherent risk component was made in the eighties, when the RBI introduced categorization of bank-advances termed "Health Code" graded as per risk content in each type of advance. The object of any coding system is standardization. The RBI introduced the health code system for commercial bank

credits to bring industry level uniformity intended for better transparency. All bank advances were categorized under eight health codes. They are:

Table 1

Health Code No.1	–	Satisfactory
Health Code No.2	–	Irregular accounts
Health Code No.3	–	Sick viable (under nursing)
Health Code No.4	–	Sick non-viable (sticky)
Health Code No.5	–	Recalled
Health Code No.6	–	Suit filed
Health Code No.7	–	Decreed
Health Code No.8	–	Bad & Doubtful

Source: www.rbi.org

LOAN LOSS PROVISIONING

According to the Basel Accord, along with the capital adequacy standards, income recognition and provisioning also assume significance. In order to rescue banks from writing-off their non-performing loans, the Basel Accord recognizes the non-performing assets (an asset would be considered non-performing if interest on such assets remains due for a period not exceeding 180 days at the balance sheet date) and provides for the same.

Prudential Norms of Income Recognition and Provisioning

While the Health Code provided for the categorization of bank's credit based on risk exposure in India, it did not provide for risk-coverage on account of credit-assets turning non-productive or sticky. It is in this context that prudential norms of income recognition and provisioning for sticky accounts were introduced in 1992 when the RBI considered it essential to accept Basel Committee recommendations for capital adequacy. A brief description of measures implemented as per guidelines of the RBI is given hereunder. More information on Basel Committee Accord is furnished in the Appendix.

INCOME RECOGNITION

Interest income should not be recognized until it is realized. An NPA is one where interest is overdue for two quarters or more. In respect of NPAs, interest is not to be recognized on accrual basis, but is to be treated as income only when actually received.

ASSET CLASSIFICATION

The banks should classify their assets based on weaknesses and dependency on collateral securities into three categories:

Sub-standard Assets: A sub-standard asset is one which is classified as an NPA for a period not exceeding two years. With effect from March 31, 2001, a sub-standard asset has been classified as an asset which remained as an NPA for a period of less than or equal to 18 months. With effect from March 31, 2005, a sub-standard asset would be one which has remained as an NPA for a period equal to or not less than 12 months.

Doubtful Assets: A doubtful asset is one which remains as an NPA for a period exceeding two years. With effect from March 31, 2001 it was redefined as an asset which has remained as an NPA for a period exceeding 18 months. With effect from March 31, 2005 an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full – on the basis of currently known facts, conditions and values – highly questionable and improbable.

Loss Assets: A loss asset is one where the loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

PROVISIONING NORMS

Based on the asset classification, banks will have to make the following provisioning:

Loss Assets: The entire asset should be written-off. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding amount should be provided for.

Doubtful Assets: (i) A provisioning of 100 percent of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recourse and the realizable value is estimated on a realistic basis.

(ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20% to 50% of the secured portion depending upon the period for which the asset has remained doubtful.

Table 2: Provisioning Norms in case of Doubtful Assets

Period for which the asset has remained doubtful	Provision required (%)
Upto one year	20
One year to three years	30
More than three years	50

Sub-standard Assets: A general provision of 10 percent of the total outstanding amount should be made without making any allowance for DICGC/ECGC guarantee cover and securities available.

Standard Assets: The banks should make a general provision of a minimum of 0.25% on standard assets on global loan portfolio basis.

ASSESSMENT OF COUNTRY/SOVEREIGN RISK

The country/sovereign risk is the most important risk faced by banks. From good olden days, banks seldom ignore the country risk analysis in their cross-border operations. In many instances, creditors suffered losses due to insufficient information on the debtor's financial position or/and inability/unwillingness to pay. By doing the country risk analysis, banks analyze the credibility of the borrower, and above all the policies of the country in which he is residing. This is imperative because the government policies have a profound impact on the movement of capital across borders. Also any possibility of a change in the government or in the policies of the government can easily invalidate any previous contract and therefore the hope of receiving back the funds starts waning.

Country risk refers to the general level of political and economic uncertainty in a country affecting the value of loans or investment in that country. There are various economic factors involved in the country risk analysis. A few of them are mentioned in the following paragraphs:

Political Risk: It refers to the uncertain government action that affects the value of a firm. Most companies believe that greater political stability would mean a safer investment environment. Some developing countries lack social cohesion, political legitimacy and the institutional infrastructure. From an economic point of view, political risk refers to the uncertainty over the property rights. Political risk is said to exist if the government expropriates either legal title to property or streams of income it generates. It also exists if property owners are constrained in the way they use their property. International banks are worried about getting their funds back in such scenarios, as the firms' earnings would be affected.

Transfer Risk: This encompasses potential restrictions on the ability to remit funds across sovereign borders. These restrictions can result in a price-related decline in the value of the asset, remittance of dividends, debt service on loans, or other fees or royalties for financial products, or other services. Transfer risk also arises from hazards associated with global market conditions and debtor governments' policies and performance in three key areas – Structural Change (development strategy), Balance of Payments (aggregate demand) and External Asset-Liability Management. Managing transfer risk is a dynamic process. Since debt countries are continuously buffeted by changing global economic and financial trends, their policy makers should concurrently manage policies in each of the above-mentioned areas to ensure that in the long-run the process is made more transparent. Since these also affect the cash flows for a bank, international banks are concerned about the borrowers' exposure to these risks.

GDP of the Country Concerned: The GDP forms the lowest common denominator for many of the key factors, which are used to measure the country risk. A careful examination of the components of a country's GDP and their rate of change reveal the structure of the economy significantly and therefore, its flexibility to respond to internal and external shocks.

Inflation: A prolonged period of inflation is invariably symptomatic of economic mismanagement. Persistent inflation tends to be associated with low growth, declining investment and over-valued exchange rate. This in turn leads to loss of competitive spirit, lack of confidence, capital flight and balance of payment difficulties. International banks look into the GDP deflator (the broadest and accurate indicator of inflation), the wholesale price and consumer price indexes, and nominal wages of the borrowers' country while lending.

Real Exchange Rates: Exchange rates play a vital role in international banking activities, because various currencies are involved in the transactions undertaken by the international banks. The real exchange rate is computed from the nominal exchange rate by taking the inflation also into account. The high real exchange rates devastate domestic industries, which are either into exporting or competing against imports. The implications for credit analysis of real exchange rates are less important in the case of local firms selling domestically and facing little or no import competition. But for firms borrowing abroad, banks should consider the real exchange rate before lending.

Export-GDP Ratio: A high and rising export-GDP ratio would indicate a greater ability to repay debt. Banks operating internationally should consider other factors like export-commodity concentrations, the geographical concentration of export markets, and the prospects for export growth. Banks should analyze whether the borrowers' country is able to borrow abroad as long as the rate of growth equals the foreign exchange receipts or exceeds the average interest rate on its external debt.

Debt-service Ratio: One of the most widely used ratios in country-risk analysis is the debt-service ratio which measures the annual repayments of principal and interest as a percentage of foreign exchange receipts. The ratio is influenced by the outlook for exports structure and currency composition of debt. An amortization schedule for the existing medium and long-term debt stock can help the banks decide upon lending.

Ratio of Interest Payments to Foreign Exchange Receipts: Given the unstable nature of principal repayments, the ratio of interest payments to foreign exchange receipts is perceived as a better indicator of liquidity for banks, since interest cannot be easily rescheduled. Therefore, banks should look into the interest payments to foreign exchange reserves ratio before lending.

Fiscal Policy: The international banks should assess the fiscal policy of the borrower's country before lending. Fiscal policy refers to the government policy for dealing with the budget (especially with taxation and borrowing).

Monetary Policy: A study about the monetary policy of the central bank of the borrower's country would give the bank an insight into the money supply, and interest rates in the country and their effect on the firms' earnings.

Thus, country risk analysis is very important for international banks. Banks may have to pay heavily if they ignore this aspect.

Measurement of Country Risk

As part of the international banking regulation, a new approach is designed to measure the country risk/exposure. The measurement of country exposure is based on the reporting system for international lending information under the auspices of BIS. The measurement is done on a consolidated bank basis. The loans to each foreign country would be included irrespective of whether they are made by a bank's head office or by a branch or affiliate abroad. Each reporting bank, in a semi-annual country exposure report, provides information about its foreign claims. The claims are segregated by the type of borrower and by maturity. Loan commitments and other contingencies are also detailed.

In international lending, the location of the borrower may not coincide with the location of the ultimate country exposure. For instance, if a US bank has made a loan to a borrower in country X and another bank/institution in country Y guarantees the loan, then the ultimate country exposure is allocated to country Y. The country exposure data would enable the examiner:

i. To evaluate the amounts, location, maturities, and types of claims a bank has abroad.

ii. To evaluate the amounts of claims reallocated to country of ultimate risk.

iii. To compare the exposure levels with the bank's capital and suggest areas for further analysis.

The analysis of country exposure involves three steps:

- An evaluation of countries' conditions by research economists and country specialists. These evaluations would be made available to bank examiners for use as background for their analysis of foreign loan portfolios.
- Disaggregation by the examiner of aggregate exposure through reference to a bank's internal records. Special attention would be paid to the types of borrowers and the maturity distribution of the bank's foreign claims.
- The examiner's comments on the results of the analysis.

COUNTRY RISK MANAGEMENT

The objective of Country Risk Management (CRM) system is to enable the banks to balance their exposures in different countries and in commensurate with the evaluation of the risks. The system rests on two supportive exercises – country risk evaluation and balanced distribution of international asset and exposures amongst various countries. The two exercises converge in setting country limits within which the exposure needs to be controlled. The prudential guidelines for fixing country limits for overseas branches are highlighted in the following paragraphs:

- Country limits may be fixed with reference to the total assets of the foreign branches held in the four 'free' currencies (US dollar, Pound sterling, Japanese yen and Euro) and with regard to the risk rating of the country. For the purpose of country risk rating, a four-fold categorization of countries may be employed as: (a) Low-risk (b) Moderate-risk (c) High-risk and (d) Off-credit.
- Country limits may be fixed by each bank to two ceilings – one limiting the total credit exposure in an individual country in each risk category, and another governing the aggregate exposures in all countries in that risk category. Both funded and non-funded credit exposure should be taken into account for the purpose of measuring/monitoring country exposures.

- For the purpose of country limit measurement and monitoring, the following exposures are excluded:
  - Credit risk guaranteed by the parent organization of the borrower or a third party located in a country of lower risk category may be taken as risk shifted or transferred to the latter country.
  - Credit exposures, which are guaranteed or insured against, credit and/or transfer risks by government-owned or highly reputed private institutions issuing guarantee/insurance cover.

For the purpose of measuring and monitoring exposures in individual countries, Country Exposure Structural Analysis (CESA) is used by most of the central banks. The format used is enclosed in Annexure 1. The RBI has issued draft guidelines for Country Risk Management by banks in India.

A summary of these guidelines is given under Annexure 2 for students' reference.

SUMMARY

- The international banking system is underlined by procedures, customs, instruments and organizational settings that provide a workable multilateral payment arrangement among different countries.
- Many legal problems crop up in international banking transactions because such transactions inevitably impinge upon the laws of more than one country.
- The gaps that arise either deliberately or unintentionally as a result of regulations, give rise to arbitrage opportunities in banking. Two developments have taken place under this – Eurocurrency and Offshore banking units.
- The case of prudential regulation applies to banks' international activities as it does to their domestic operations. After the Herstatt Crisis in 1974, formal machinery was set up to coordinate international regulatory arrangements.
- The disturbances that followed in the wake of Herstatt's collapse focused attention on the dependence of national banking system and led to the creation of a standing committee of bank supervisors, under the auspices of the Bank for International Settlements (BIS).
- Credit management is the challenging functional area in a commercial bank. It calls for expert handling, assessing risk exposure at every stage and securing adequately the safety of funds exposed.
- The 1988 Basel Accord exclusively addresses effective handling of credit-risks.
- The Basel Capital Accord of 1988 stipulated that the eligible capital should consist of shareholders' equity and retained earnings (Tier I Capital), supplementary capital (Tier II Capital) and subordinated debt (Tier III Capital).
- The country/sovereign risk is the most important risk faced by the banks.
- Country risk refers to the general level of political and economic uncertainty in a country affecting the value of loans or investment in that country.

Annexure I

Country Exposure Structural Analysis (CESA)

PART A

(By nature of exposure and category of borrower)

Nature of Exposure	Banks	Public Sector	Private Sector	Total
1	2	3	4	5
A. Assets/Claims i. Syndicated loans ii. Other loans iii. Trade credits/receivables iv. Deposit placement (with banks)* v. Market investments* vi. Other monetary assets **Total Assets (i) to (vi)**				
B. a. **Commitments (irrevocable) to extend credit** vii. Letters of credit viii. Committed lines of credit b. **Under co-obligations** ix. Guarantees x. Bonds **Total Commitments (vii) to (x)**				
C. Total exposure (A + B) Total exposure (+) External funding of local assets@				
D. Country exposure (gross) Less: Assignments/transfers a. Claims covered by external guarantees b. Claims secured by liquid/tangible collateral held outside the country				
E. Country exposure (net)				

* – Interest bearing (only).

@ – Representing excess of local currency outstandings over local currency liabilities.

PART B

(By maturity of claims/assets)

Nature of Exposure	Short-Term		Long-Term	Total
	(Within one year)	(Over 1 year & within 3 years)	(Over 3 years)	(Assets)
1	2	3	4	5
A. Syndicated loans B. Other loans C. Trade related finance D. Deposit placements (with banks)* E. Market investments* F. Other monetary assets **Total Assets**				

* – Interest bearing (only)

Annexure II

Draft Guidelines on Country Risk Management by Banks in India

Policy and Procedures

1. Banks should formulate appropriate, well-documented and clearly defined 'Country Risk Management' (CRM) policies, with the approval of the respective boards. The CRM policy should address the issues of identifying, measuring, monitoring and controlling country exposure risks. The policy should specify the responsibility and accountability of the various levels for the country risk management decisions. Banks should also put in place procedures for ensuring that necessary steps are taken in accordance with the CRM policy. The CRM policy should be periodically reviewed by the board on the basis of the experience gained.
2. Banks should institute appropriate procedures for dealing with country risk problems. They should have in place contingency plans and clear exit strategies, which would be activated at times of crisis. Appropriate systems/ procedures should be laid down with the approval of the board to handle situations involving significant changes in conditions in any country or involving sharp deterioration in the rating of any country.
3. The CRM policy should stipulate rigorous application of the 'Know Your Customer' (KYC) principle in international activities which should not be compensated by demanding collateral or shortening of maturities. Country risk element should be explicitly recognized while assessing the counter-party risk.

Scope

4. Banks should reckon both funded and non-funded exposures from their domestic as well as foreign branches while identifying, measuring, monitoring and controlling country risks. The scope would be confined to the domestic branches of foreign banks operating in India.
5. Banks should take into account indirect country risk. For example, exposures to a domestic commercial borrower with a large economic dependence on a certain country may be considered as subject to indirect country risk.
6. Exposures should be computed on a net basis, i.e., gross exposure 'minus' collaterals, guarantees, etc. Netting may be permitted for collaterals in guarantees issued by countries in a lower risk category. Netting may also be permitted for bank's dues payable to the respective countries.

Ratings

7. To begin with, banks may adopt the sovereign ratings of international credit rating agencies. However, banks should eventually put in place appropriate systems to move over to internal assessment of country risk within a prescribed period.
8. Banks should evolve sound systems for measuring and monitoring country risk. The system should be able to identify the full dimensions of country risk as well as incorporating features that acknowledge the links between credit and market risk. Banks should use a variety of internal and external sources as a means to measure country risk. Banks should not rely solely on rating agencies or other external sources as their only country risk-monitoring tool. Banks should also incorporate information from the relevant country managers of their foreign branches into their country risk assessments.
9. The frequency of periodic reviews of country risk ratings should be more than once a year and depend on the importance and complexity of the bank's business.
10. IBA may be the central point for preparation/evaluation of country risk models of banks.

Risk Categories

11. Countries can be broadly classified into six risk categories – insignificant, low, moderate, high, very high and off-credit. IBA would be assigned the responsibility of developing a mechanism for assigning countries to the six risk categories specified above. Banks may be allowed to adopt a more conservative categorization of the countries.

Exposure Limits

12. Bank boards may set country exposure limits in relation to the bank's regulatory capital (Tier I + Tier II) with sub-limits, if considered necessary for products, branches, maturity, etc. The basis for setting the limits for the country/category shall be left to the discretion of the banks' boards. The country exposure limits set by the board should be reviewed periodically.
13. Exposure limit for any country should not exceed its regulatory capital, except in the case of insignificant risk category.
14. Banks may also setup regional exposure limits for country groups. They may select the basis for deciding the country groups.
15. The RBI may, if it becomes necessary, prescribe a prudential aggregate country exposure limit for the higher risk categories, which would be multiple of the bank's regulatory capital.

Monitoring Exposures

16. Banks should monitor their country exposures on a weekly basis before switching over to real-time monitoring. However, exposures to high-risk (and above) categories should be monitored on a real-time basis. Banks should switchover to real-time monitoring of country exposures (all categories) by 31st March, 2004.
17. The board should be regularly apprised of the country risk exposures.
18. Management of country risk should incorporate stress testing as one method to monitor actual and potential risks. Stress testing should include an assessment of the impact of alternative outcomes to important underlying assumptions.
19. Country risk management processes employed by banks would require adequate internal controls that include audits or other appropriate oversight mechanism's to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits.

Provisioning/Capital Requirement

20. Banks shall make provisioning on the funded net country exposures on a graded-scale ranging from 0 to 100, according to the risk categories mentioned above. To begin with, banks shall make provisions as per the following schedule:

Risk Category	Provisioning Requirement (%)
Insignificant	0.25
Low	0.25
Moderate	5.00
High	20.00
Very high	25.00
Restricted	100.00
Off-credit	100.00

21. The provision for country risk shall be in addition to the provisions required to be held according to the asset classification status of the asset. In the case of "loss assets" and "doubtful assets", provision held, including provision held for country risk, shall not exceed 100% of the outstanding.

22. Banks may not make any provision for "home country" exposures.

23. Banks may make a lower level of provisioning (say, 25% of the requirement) in respect of short-term exposures (say less than 180 days).

24. The issue of requiring banks to maintain capital to cover country risk would be considered at the time of implementation of the New Capital Accord.

25. Banks shall be allowed to treat the "provisions held for country exposures" on par with the "provisions held for standard assets" for being reckoned for Tier II capital.

Disclosures

26. Banks should disclose their respective "country risk management" policies in their annual report and also disclose, as a part of the "Notes on Accounts" to the balance sheet as on 31st March each year,

    i. The category-wise country exposures, and

    ii. The extent of aggregate provisions held there against.

27. The statutory auditors should look into and comment on the country risk exposures and the adequacy of provisions held.

Reporting

Banks should report details of their country-wise exposures to the RBI as a part of their DSB returns along with the details of the provisions held therefore.

Chapter III

International Monetary System

After reading this chapter, you will be conversant with:

- Exchange Rate Systems
  - Fixed Exchange Rate System
  - Floating Exchange Rate System
  - Hybrid Mechanism
- History of Monetary Systems
  - Gold Standard
  - Gold-Exchange Standard
  - Bretton Woods System
  - Post Bretton Woods System
  - European Monetary System

Introduction

The financial markets are getting integrated, and people and firms are entering into more and more cross-border financial deals. In order to make these transactions feasible, a system for determination of the amount and method of payment of the underlying financial flows is needed. Since the domestic currencies of the parties involved will be different, the flows will take place in some mutually acceptable currency. The parties involved will then need to convert the amount involved into their domestic currencies. The set of rules, regulations, institutions, procedures, practices and mechanisms which determine the rate at which this conversion takes place (called the exchange rate) and the movements in the exchange rate over a period is called the international monetary system. The International Monetary System (IMS) can be defined as 'The global network of government and commercial institutions within which currency exchange rates are determined.'

This system forms the backbone of all cross-border transactions because it makes the settlement of international payments possible. The settlement of transactions takes place by conversion of currencies into one another and the transfer of funds across nations, which becomes possible due to the existence of the international monetary system. These transactions may be on account of international trade in goods or services, or due to acquisition or liquidation of financial assets, or because of creation or repayment of international credit. By making all these possible, a smooth-running international monetary system contributes to a more efficient utilization of world resources.

In this lesson, we will discuss the following topics:

- The various mechanisms of exchange rate determination.
- The different monetary systems that have been prevalent over different periods of time.
- The current monetary system.
- The role of the various institutions involved in sustaining these systems and their contribution in the current scenario.
- An analysis of the various currency crises.

EXCHANGE RATE SYSTEMS

The exchange rate is formally defined as the value of one currency in terms of another. There are different ways in which the exchange rates can be determined. Exchange rates may be fixed, floating, or with limited flexibility. Different systems have different methods of correcting the disequilibrium between international payments and receipts.

Fixed Exchange Rate System

As the name suggests, under a fixed (or pegged) exchange rate system the value of a currency in terms of another is fixed. These rates are determined by governments or the Central Banks of the respective countries. The fixed exchange rates result from countries pegging their currencies to either some common commodity or to some particular currency. There is generally some provision for correction of these fixed rates in case of a fundamental disequilibrium. Examples of this system are the Gold Standard and the Bretton Woods System.

Fixed (or pegged) exchange rate systems include:

- Currency board system.
- Target zone arrangement (also called currency block).
- Monetary union.

CURRENCY BOARD SYSTEM

Under a currency board system, a country fixes the rate of its domestic currency in terms of a foreign currency, and its exchange rate in terms of other currencies depends on the exchange rates between the other currencies and the currency to which the domestic currency is pegged. Due to pegging, the monetary policies and economic variables of the country of the reference currency are reflected in the domestic economy. If the fundamentals of the domestic economy show a wide disparity with that of the reference country's, there is a pressure on the exchange rate to change accordingly. This may result in a run on the currency, thus forcing the authorities to either change, or altogether abandon the peg. To prevent such an event, the monetary policies are kept in line with that of the reference country by the central monetary authority, called the currency board. It commits to convert its domestic currency on demand into the foreign anchor currency to an unlimited extent, at the fixed exchange rate. The currency board maintains reserves of the anchor currency upto 100% or more of the domestic currency in circulation. These reserves are generally held in the form of low-risk, interest bearing assets denominated in the anchor currency. An internationally accepted, relatively stable currency is generally selected as the anchor currency.

The currency board does not have any discretionary powers over the monetary policy. The interest rates are automatically set by the market mechanism. If demand for the anchor currency rises and people start converting more and more of the domestic currency for the anchor currency, the reserves with the currency board get depleted. As the currency in circulation has to be backed by the anchor currency reserves, the depletion of reserves results in a contraction of the domestic currency's supply. This, in turn, will result in an increase in the domestic interest rates. A high domestic interest rate increases the demand for the domestic currency as more and more people become interested in investing in the economy. This increases the supply of the anchor currency and eliminates the pressure on the domestic currency. The opposite will happen in case of an increase in the supply of the anchor currency. The interest rates, thus, act as the force which brings back the forex markets to equilibrium.

Unlike a Central Bank, a currency board does not even have the power to print unlimited amounts of money. Due to the requirement of the domestic currency being backed by reserves of anchor currency, the board can print only as much currency as can be backed by its existing reserves. This prevents the board from lending to either the government, or the domestic banks. As government's deficits are not automatically monetized, it has to finance its operations by either raising taxes, or by borrowing in the market. The market determined interest rates keep the government borrowing, and hence, spending under check; and thus forces fiscal discipline. At the same time, as neither of the sources of funds (taxes and borrowings) increases the money supply, there is no inflationary pressure on the economy due to government spending.

Since the board does not lend to even the domestic banks, it cannot act as the lender of last resort. On one hand, this ensures more prudent policies on the part of banks. On the other hand, it would result in even sound banks undergoing pressure at the time of a financial panic.

The biggest advantage of a currency board system is that it offers stable exchange rates, which act as an incentive for international trade and investment. The discipline enforced on the government and the financial system also helps in improving the macroeconomic fundamentals in the long run.

Among the drawbacks, the foremost is the loss of control over interest rates. The equilibrium in the forex markets is established at the point where the domestic interest rates in the economy are in accordance with the underlying economic fundamentals of the domestic and the anchor currency economy and the fixed exchange rate. A high inflation in the domestic markets can result in low or even negative real interest rate. This may cause an asset price bubble as money is

borrowed at low interest rates and put in financial and real assets. The excess demand for these assets makes their prices go upto unrealistically high levels. When the interest rates start rising due to any endogenous or exogenous reason, these prices come crashing down due to the high selling pressure and thus cause a financial panic. Another effect of the inability of the board to set interest rates is that an important tool for controlling the level of economic activity becomes inoperative. Interest rates cannot be used to control the inflation level in the economy and hence the level of economic activity. The economy may thus become exposed to phases of painful contraction and inflation. Further, this system, in order to operate efficiently, needs flexible wages. In case of the domestic economy facing a higher degree of inflation than the anchor currency country, or in case of an exogenous shock like a fall in the export prices, a movement in the exchange rates is not possible in this system. Thus, the adjustment has to come via domestic wages. If these prove to be sticky, the domestic currency could become overvalued, and the domestic goods uncompetitive in the international markets.

A good example of a currency board is that of Hong Kong. In addition to the currency being pegged to the US dollar (at HKD 7.8/$), a currency board (established in 1983) ensures that reserves to the extent of at least 100 percent of the domestic currency are maintained. Another country following this system is Argentina. The Argentine peso is convertible into dollar since 1991.

TARGET ZONE ARRANGEMENT

A group of countries sometimes get together, and agree to maintain the exchange rates between their currencies within a certain band around fixed central exchange rates. This system is called a target zone arrangement. Convergence of economic policies of the participating countries is a prerequisite for the sustenance of this system. An example of this system is the European Monetary System (EMS) under which twelve countries came together in 1979, and attempted to maintain the exchange rates of their currencies with other member countries' currencies within a fixed band around the central exchange rate.

MONETARY UNION

Monetary union is the next logical step of target zone arrangement. Under this system, a group of countries agree to use a common currency, instead of their individual currencies. This eliminates the variability of exchange rates and the attendant inefficiencies completely. The economic variables of the member countries have to be quite proximate for the system to be viable. An independent, common Central Bank is set-up, which has the sole authority to issue currency and to determine the monetary policy of the group as a whole. The member-countries lose the power to use economic variables like interest rates to adjust their economies to the phase of economic cycle being experienced by them. As a result, the region as a whole experiences the same inflation rate. This is the most extreme form of management of exchange rates.

Floating Exchange Rate System

Under this system, the exchange rates between currencies are variable. These rates are determined by the demand and supply for the currencies in the international market. These, in turn, depend on the flow of money between the countries, which may either result due to international trade in goods or services, or due to purely financial flows. Hence, in case of a deficit or surplus in the Balance of Payments (difference between the inflation rates, interest rates and economic growth of the countries are some of the factors which result in such imbalances), the exchange rates get automatically adjusted and this leads to a correction in the imbalance.

Floating exchange rates can be of two types: (i) Free float and (ii) Managed float.

FREE FLOAT

The exchange rate is said to be freely floating when its movements are totally determined by the market. There is no intervention at all either by the government or by the Central Bank. The current and expected future demand and supply of currencies change on a day-to-day, and even a moment-to-moment basis; as the market receives, analyzes and reacts to economic, political and social news. This, in turn, changes the equilibrium in the currency market and the exchange rate is determined accordingly. As the reactions to events do not follow a set pattern, the resultant movements in the exchange rates turn out to be quite random. Hence, a lot of volatility is observed in the markets following a free float system. This system is also known as the clean float.

MANAGED FLOAT

The volatility of exchange rates associated with a clean float increases the economic uncertainty faced by players in the international markets. A sudden appreciation of the domestic currency (a currency appreciates when it becomes dearer vis-à-vis the other currency) would make the domestic goods more expensive in the international markets (as the same number of units of domestic currency, representing the good's cost, would then translate into a higher number of units of the foreign currency). This may result in making the domestic product uncompetitive, and hence reduce the exports. If any industry is totally dependent on exports, it may even get wiped out. A sudden depreciation may lead to increased prices of imported goods, thereby increasing the inflation rate in the economy. These uncertainties increase the risk associated with international trade and investments, and thus reduces the overall efficiency of the world economic system. In order to reduce these inefficiencies, Central Banks generally intervene in the currency markets to smoothen the fluctuations. Such a system is referred to as a managed float or a dirty float. This management of exchange rates can take three forms:

i. The Central Bank may occasionally enter the market in order to make smooth transition from one rate to another, while allowing the market to follow its own trend. The aim may be to avoid fluctuations which may not be in accordance with the underlying economic fundamentals, and speculative attacks on the currency.

ii. Some events are liable to have only a temporary effect on the markets. In the second variation, intervention may take place to prevent these short and medium-term effects, while letting the markets find their own equilibrium rates in the long-term, in accordance with the fundamentals.

iii. In the third variation, though officially the exchange rate may be floating, in reality the Central Bank may intervene regularly in the currency market, thus unofficially keeping it fixed.

Hybrid Mechanism

A crawling peg system is a hybrid of fixed and flexible exchange rate systems. Under this system, while the value of a currency is fixed in terms of a reference currency, the peg itself keeps changing in accordance with the underlying economic fundamentals, thus letting the market forces play a role in the determination of the exchange rate. There are several bases which could be used to determine the direction of the change in the exchange rate. One could be the actual exchange rate ruling in the market. Though the rate is officially fixed at a certain level, in the market it hovers around the fixed rate, and is allowed to move so if it is not too much in divergence with the official rate. If this market determined exchange rate continuously shows a declining trend over a period, the peg is revised downwards, and vice-versa. Another possible base could be the recent

figure for the difference between domestic inflation and the inflation rate in the anchor-currency country. The changes could even be based on the balance of trade figures or changes in the external debt of the country. The advantage of a crawling peg is that, though it gives a relatively stable exchange rate (changes in which are fairly predictable), the rate is never too much out of line with the underlying fundamentals of the economy.

The value of Indian rupee is determined by the crawling peg system. The RBI allows the rupee to float freely to a certain extent and beyond that intervenes.

HISTORY OF MONETARY SYSTEMS

Various variations and combinations of the above-mentioned exchange rate mechanisms were followed in the past. Each one of them had its own unique method of correcting disequilibrium in the international monetary system. The following monetary systems along with their correction mechanisms are being discussed below:

- Gold Standard.
- Gold-Exchange Standard.
- Bretton Woods System.
- Post-Bretton Woods System.
- European Monetary System.

Gold Standard

The gold standard was followed in its classical form from 1870 to 1914. While the United Kingdom and the United States were on the gold standard from 1821 and 1834 respectively, most of the countries had joined the system by 1870. The essential feature of this system was that governments gave an unconditional guarantee to convert their paper money or fiat money[1] into gold, at a pre-fixed rate at any point of time, on demand. The continued commitment of the governments to the guarantee, and the readiness of the people to believe it were the reasons the system could sustain for such a long time.

The exchange rate between two currencies was determined on the basis of the rates at which the respective currencies could be converted into gold, i.e., the price of gold in the two countries. For example, if in the US the price of one ounce of gold is fixed at $400 and in the UK it is £200, then the exchange rate (called the mint parity) between the $ and the £ would be $2/£ (400/200). The exchange rate would stay at this equilibrium level because of the arbitrage[2] possibility involved. Let us assume that the prevailing exchange rate was $2.5/£. So a person wanting to convert dollars into pounds would have to pay $2.5 for every pound. He could, instead, buy an ounce of gold in the US for $400 (or a fraction thereof for a proportionate price), transport it to the UK, and sell it for £200. Thereby, he would be able to get pounds at the exchange rate of $2/£. As everyone would follow this route for converting dollars into pounds, there would be no demand for pounds in the forex markets. Yet the supply would remain unaffected. This demand-supply imbalance would cause the exchange rate to come down. This would keep happening till the exchange rate reaches the equilibrium level, i.e., $2/£. An exactly opposite process would correct the exchange rate if it falls below the equilibrium level. Thus the exchange rate would be maintained at the equilibrium level. This discussion assumes that there are no transaction costs involved in buying and selling of gold and no transportation costs for shifting it from one country to another. In reality, however, there is a cost involved in all these

1 Fiat money is money which has insignificant value, but a high face value due to the decree or fiat that it can be used for the settlement of all financial obligations.

2 Arbitrage is the process of buying and selling the same product at different prices at the same time; and thus making profits due to market inefficiencies which allow the prices in two markets to diverge.

activities. Thus, the exchange rate would be able to fluctuate between bands on either side of the equilibrium exchange rate, the bands being determined by the size of these costs. The end points of the range fixed by these bands is referred to as the gold points.

There was an inbuilt mechanism in the gold standard which helped correct any imbalances in trade that any two countries would face. If France is exporting more to Germany than it is importing from it, Germany would be facing a trade deficit and France a trade surplus. This trade deficit would result in excess supply of DM (Deutsche Mark) which would drive down the DM-FFr (French Franc) exchange rate below the mint-parity level. Since at this rate, the suppliers of DM would prefer to change their holdings into FFr through the 'sell DM for gold – ship it to France – sell gold for FFr' route, there would be a transfer of gold from Germany to France. When a government commits itself to convert unlimited amounts of its paper currency into gold on demand, at all points of time it would need to have enough gold with it to make sure that it does not run out of gold in case a lot of people want to go for the conversion simultaneously. In case a country does run out of gold, its credibility would be shattered and the whole system would collapse. To avoid such a situation, a gold reserve equal to a fixed percentage (which may even be upto 100 percent) of the circulating currency is required to be maintained. With gold moving away from Germany, its gold reserves would come down and hence it would be forced to reduce the money supply. On the other hand, the gold reserves in France would go up and its money supply would increase. According to the Quantity Theory of Money, change in the price level is directly proportional to change in the money supply. With an increase in the money supply, the same amount of goods are purchased by more money, hence the prices of those goods increase; and vice-versa. As the money supply in France increases, the price of the goods produced in France also increases. At the same time, there is a reduction in the money supply in Germany, and the price of German goods decreases. This reduces the competitiveness of French goods vis-à-vis German goods and the former become less attractive to both German as well as French consumers. This results in a reduction in exports from France and an increase in imports from Germany. This process continues till trade balance between the two countries is achieved. This process of correction of imbalance in international receipts and payments is known as the price-specie-flow mechanism.

Countries continued to be on the gold standard for a long time due to its inherent advantages. Most of the advantages arose due to discipline enforced by the price stability of gold. The price of gold (its purchasing power) generally moved in line with the price of other goods and services, facing the same inflation rate. Gold being a commodity money (i.e., needing the use of other goods and services to be located, mined and minted), its cost of production also moved in line with the general inflation rate. This caused the cost of production and the purchasing power of gold to tend towards equality in the long run. The government needed to acquire additional gold before it could issue more money. As the cost of acquiring gold was equal to the value of the additional money that it could issue, the government had no incentive to finance its deficits by digging additional gold and printing more money. This enforced fiscal discipline on the government and protected the economy from inflation resulting from excessive government spending. This ensured price stability in the participating countries. The second advantage of the gold standard lay in the fact that exchange rate movements were quite predictable. In the short run, the exchange rates could move only within the gold points. In the long run, the exchange rates would change only if a country changed the price of its currency in terms of gold. A country experiencing an increase in gold reserves would be likely to lower the price of gold; while those experiencing an exodus of reserves would be likely to increase it. This predictability of

exchange rate movements reduced the risk involved in international trade and investments, and thus made the process of allocation of world resources more efficient.

The gold standard was abandoned with the advent of the First World War in 1914.

The Gold-Exchange Standard

(The Inter-War Period)

During the World War I, Britain and other countries borrowed heavily from the US in order to pay for food and arms. Britain also sold a lot of its foreign assets for the same purpose. Meanwhile, the British industry was losing its competitive edge in the international markets. After the sale of its foreign assets, the earnings from those assets which earlier used to offset a part of its trade deficit were also lost. The war ended in 1918, after which exchange rates were allowed to float for a few years. Large reparations (compensation payable by a defeated nation as damages during war) were forced upon Germany. In the US, industries which had expanded during the war were apprehensive of facing competition from foreign firms. Many countries were facing high inflation. All these factors contributed to a change in the attitude of countries towards free trade and trade barriers were imposed by many of them. The imposition of trade barriers by the US worsened the situation as its debtor countries found it difficult to earn dollars and hence repay its dollar loans.

In 1925, Britain returned to a modified version of the gold standard at the pre-war parity. Many other countries also returned to the modified standard at around the same time. International trade was being constrained by the limited gold available for backing the corresponding payments. The need was felt for creation of additional liquidity in the international markets. Hence, under the new system called the gold-exchange standard, some of the countries committed themselves to convert their currencies into the currency of some other country on the gold standard, rather than into gold. Instead of holding gold as a reserve asset, they started holding reserves of that currency. Though for most of the countries this reserve currency was the pound, due to the growing importance of France and America some countries made their currencies convertible into the FF and the dollar. This gave a special status to these countries namely Britain, France and the US. While other countries had to reduce their gold or pound reserves in order to pay for their imports, these countries could create money for the same purpose. For example, Britain could transfer pounds by creating a sterling liability owed to the other country. It thus acted as a banker to the world. Though this system provided the additional liquidity required, the methodology followed for creating the liquidity itself sowed the seeds for the failure of the system.

As mentioned earlier, Britain had returned to the modified system at the gold parity. As the economic situation had changed drastically since the abandonment of the system in 1914, the gold parity turned out to be overvalued. Another important change that had taken place since 1914, was that the costs and prices had lost the flexibility they enjoyed earlier, due to increased unionism. For the automatic correction mechanism to work properly, flexibility of these factors was an essential prerequisite. This made it difficult for Britain to maintain the exchange rate. One drawback of the system was that while the correction mechanism worked in the long run, in the short run it ended up increasing the interest rates in the economy facing the trade deficit. This used to provide a cushion by means of increased capital inflows (which would come into reap the benefit of a higher rate of interest than could be earned in other countries), which used to offset the trade deficit to some extent. In the absence of flexibility of prices and costs, the increase in interest rates became permanent. This affected the British industry badly and the country started facing deflation, which increased the unemployment levels.

Another drawback of the system was that though the prices were stable in the long run, there were alternate periods of inflation and deflation in the short run. The deflationary periods would expose the countries to increasing unemployment levels – a phase that various countries were going through during that period, and something they could ill-afford at that time. As a result, the countries found it beneficial in the short run not to let the correction mechanism work and to indulge in sterilization; thus protecting their domestic economic activity from external disturbances. Sterilization or neutralization is the policy of not letting a change in the reserves have any effect on the money supply. This may be done either by directly breaking the link between the reserves and the notes printed, or by increasing or reducing the ability of banks to create money.

The final blow came in the form of the Great Depression of the late 1920s and early 1930s, which started in the US and spread to other parts of the world. America's policy to increase its interest rates and trying to deflate its economy had a devastating effect on other countries. While the capital started flowing from Britain to America (instead of towards Britain), other economies dependent on exports to America found their incomes falling drastically due to a combined effect of the trade barriers put up by America and the reduced American demand. These countries witnessed falling employment and consumption levels. They thus got into the vicious circle of low employment, low earnings and low demand. All this was happening in a period when the unemployment levels were worrying the countries more than the worsening current-account balances.

As has been mentioned earlier, under the new system, some currencies were convertible into FFr or the dollar. But these countries did not have enough gold reserves to back their commitments. Although Britain was acting as the banker to the world, even its gold reserves were not enough to back the financial obligations it was creating for itself. In addition, unlike a normal bank, it did not have any lender of last resort. As Germany defaulted on its payment obligations in the absence of any lenders (the American markets having dried up in the wake of the depression), the confidence in the monetary system started eroding. France started converting its pound holdings into gold in order to shore up its gold reserves and prepare itself for any eventuality. As a result, Britain's gold reserves started depleting rapidly. Around the same time, a major Austrian bank by the name of Credit Anstalt collapsed. This event, together with Britain's depleting reserves, spread a financial panic around the world as Britain's ability to honor its commitment became doubtful. Soon everyone started trying to convert their pound holdings into gold. Britain being unable to fulfill its commitment, abandoned the system in 1931 in order to save its economy from disaster.

With Britain's departure from the system, the pressure shifted to the dollar, which was the only remaining currency convertible into gold. This pressure eventually resulted in the US suspending the convertibility in 1933. With this, the gold-exchange standard effectively came to an end. A few countries had already left the gold standard since the depression started in 1929. Some more followed after Britain's departure from the system. These countries floated their currencies and imposed trade and capital controls to avoid a huge depreciation in their currency's value and to insulate themselves from external factors. Even the countries that remained on the gold-exchange standard had to impose trade controls and follow deflationary policies in order not to lose gold. As most of the countries were facing an economic downturn and needed external demand to boost the domestic economy, a series of competitive devaluations (where every country tries to devalue its currency more than the other country, in order to boost its exports – also called beggar-thy-neighbor policy) started taking place. Due to the extreme volatility of exchange rates and the restrictions imposed on trade and capital flows, international trade came down to very low-levels and international capital flows almost stopped.

Bretton Woods System

The Second World War effectively stopped all international economic activity. Global economic growth was severely affected. On one hand, the warring nations suffered huge damages on account of the war, and on the other hand most of the countries were suffering from hyperinflation. The continuing war also made any cooperation on the economic front impossible. In this scenario, the need was felt for an economic system which would again make international trade and investments possible. For this, a system of stable exchange rates was required, which would also ensure that the countries do not get any incentive by following inflationary policies. Also required, was some arrangement which would help countries to tide over their short-term Balance of Payments problems and help them remain within the system without causing undue turmoil in their economies.

In 1944, representatives of 44 countries met in Bretton Woods, New Hampshire USA and, signed an agreement to establish a new monetary system which would address all these needs. This system came to be known as the Bretton Woods System.

The main terms of the agreement arrived at were as follows:

- Two new institutions were to be established, namely, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD, also called the World Bank). IMF was supposed to be more important and powerful than the World Bank. It was decided that the member countries would meet under the aegis of this institution to take a decision on any important thing which might affect world trade or the world monetary system. Hence, cooperation and mutual consultation was built into the system in order to avoid the universally harming policies being followed by most of the countries before the Second World War. The second most important function of these institutions was to provide funds to member-countries to help them tide over the temporary Balance of Payments deficit. These institutions and their functions are explained in detail later in the chapter.
- A system which came to be known as the adjustable peg system, was established which fixed the exchange rates, with the provision of changing them if the necessity arose. Under the new system, all the members of the newly set-up IMF were to fix the par value of their currency either in terms of gold, or in terms of the US dollar. The par value of the US dollar, in turn, was fixed at $35 per ounce. All these values were fixed with the approval of the IMF, and reflected the changed economic and financial scenario in each of the countries and their new positions in international trade. Further, the member countries agreed to maintain the exchange rates for their currency within a band of one percent on either side of the fixed par value. The extreme points of these bands were to be referred to as the upper and the lower support point, due to the requirement that the countries do not allow the exchange rate to go beyond these points. The monetary authorities were to stand ready to buy or sell their currencies in exchange for the US dollar at these points, and thereby support the exchange rates. For this purpose, a country which would freely buy and sell gold at the aforementioned par value for the settlement of international transactions was deemed to be maintaining its exchange rate within the 1 percent band. Thus the US, which was the only country fulfilling this condition, did not need to intervene in the forex markets.
- Currencies were required to be convertible for trade-related and other current-account transactions, though governments were given the power to regulate capital flows. This was done in the belief that capital flows destabilize economies. For the purpose of such conversion, gold reserves needed to be maintained by the US, and dollar reserves by other countries. As selling the local currency would result in an increase in the dollar reserves and buying it would result in a reduction in the reserves, the countries facing a downward

pressure (which would inevitably be the ones facing a Balance of Payments deficit, as explained later) were under more pressure than countries facing an upward pressure on its currency (the ones enjoying a Balance of Payments surplus). The additional pressure existed because the deficit country could eventually run out of reserves, and hence needed to follow more prudent economic, monetary and fiscal policies; while the surplus countries would only face an accretion of reserves. This imbalance in the responsibilities imposed on the two sets of countries eventually led to the downfall of the system.

- Since there was a possibility that such exchange rates being determined may not be compatible with a country's BoP position, the countries were allowed to revise the exchange rate upto 10% of the initially determined rate, within one year of the rates being determined. After that period, a member country could change the original par values upto five percent (on either side) without referring the matter to IMF, that too only if it's financial and economic condition made it essential. A bigger change could be brought about only with the consent of IMF's executive board, which would allow it only in case of a "fundamental disequilibrium" in its Balance of Payments. Continuous reduction in reserves was supposed to serve as an indication of a fundamental disequilibrium.
- All the member countries were required to subscribe to IMF's capital. The subscription was to be in the form of gold (one-fourth of the subscription) and its own currency (the balance). Each country's quota in IMF's capital was to be decided in accordance with its position in the world economy. This capital was needed to enable IMF to help the countries in need of Price Adjustment Mechanism.

INSTITUTIONS

As mentioned earlier, two institutions were set-up as a part of the Bretton Woods System. These institutions and their activities have to be studied in detail in order to understand the system in totality. A few more institutions came up as a part of this system. The following institutions are discussed below:

- The International Monetary Fund (IMF).
- The International Bank for Reconstruction and Development (IBRD, also called the World Bank).
- The International Development Association (IDA).
- The International Finance Corporation (IFC).

International Monetary Fund (IMF)

The International Monetary Fund was established to ensure proper working of the international monetary system. One of the important functions of IMF was to provide reserve credit to member countries facing temporary Balance of Payments problems. For this purpose, a currency pool was maintained. Each member country was required to contribute to this pool according to its quota, which was fixed on the basis of each country's importance in world trade. These contributions were to be partly in an international reserve currency and partly in the country's domestic currency. Initially, the first part of the payments was made in gold. Later it was replaced by SDRs (Special Drawing Rights, explained later). A country's quota would also determine its access to the pool and its voting powers at IMF. A country could draw from IMF in tranches for maintaining its currency's parity. A tranche represents 25% of a country's quota. Drawings of the first tranche is automatically approved by IMF. A further 100% of its quota can be borrowed in four steps. With each step, stricter conditions are imposed on the borrowing country, in order to ensure that structural corrections are carried out. In order to draw from IMF, a member country has to buy reserve assets and other currencies by paying its own currency to IMF. At the time of repayment of the loan, the borrowing country reverses the deal.

IMF's management is vested in its executive board. Out of its 22 directors, six are appointed by governments holding the largest quotas. The rest of the directors are elected by the remaining countries. The managing director, who is also the chairman of the executive board, is appointed by the executive board for five years. The board of governors, which is the highest governing body of IMF, meets once a year to take major policy decisions. Its members are generally the finance ministers or the Central Bank governors of the member countries. All the member countries are represented on this board. IMF presently has 185 countries as its members.

Objectives of IMF

The purposes of International Monetary Fund are:

i. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

ii. 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.

iii. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

iv. To assist in the establishment of a multi-lateral 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.

v. To give confidence to members by making the general resources of the fund temporarily available to them under adequate safeguards.

vi. To shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

Functions of IMF

The functions performed by IMF are mainly of three types: Surveillance, Lending and Technical assistance.

Surveillance

The International Monetary Fund is responsible for over seeing the international monetary system and for monitoring the economic and financial policies of its member countries. This process is known as surveillance. It involves tracking economic development, both globally and in individual countries, and letting policy makers know if adjustments are warranted.

The IMF has a mandate under Article IV of its Articles of Agreement to oversee (i) The international monetary system to ensure its effective operations; (ii) Each member's compliance with the obligations to direct its policies towards fostering orderly economic growth. The IMF's executive board adopted a new policy statement on surveillance. The 2007 decision on bilateral surveillance over member's policies, which replaces an earlier decision, complements Article IV, introducing a concept of external stability as an organizing principle for bilateral surveillance. Thus, the function of surveillance today covers a wide range of economic policies that are crucial to international monetary and financial stability. It includes:

a. Exchange rate, monetary and fiscal policies remain at the center of IMF surveillance. The IMF provides advice on issues ranging from the choice of exchange rate policies to ensuring consistency between the regime and fiscal and monetary policies.

b. Financial sector issues have received greater emphasis under IMF surveillance, with elevated coverage in surveillance reports building on the achievements under the Financial Sector Assessment Program (FSAP), which enables the IMF and WB to assess the strengths and weaknesses of country's financial sectors.

c. Assessment of risks and vulnerabilities stemming from large and sometimes volatile capital flows has become more central to IMF surveillance.

d. Institutions and structural issues have also gained importance in the wake of financial crisis and in the context of some countries transition from planned to market economies.

Lending

IMF lends to its member countries under various schemes. These schemes are listed below:

i. **Standby Arrangement:** This scheme was introduced in 1952. Under this scheme, countries can borrow at the first indication of its possible need. This would help the country in time as it would not have to wait for IMF's approval for the loan when the need actually arose.

ii. **Compensating Financing Facility:** This scheme was introduced in 1963 for providing financial assistance to countries facing temporary shortfall in reserves.

iii. **Buffer Stock Financing Facility:** Introduced in 1969, this scheme provides for countries receiving financial assistance from IMF in order to purchase approved primary products. This help is extended to prevent countries from suffering due to price shocks.

iv. **Extended Facility:** This scheme was introduced in 1974. It allows countries to borrow on a medium-term basis for overcoming Balance of Payments problems caused by structural imbalance.

v. **Oil Facility:** It was introduced in 1974 and was terminated in 1976. Under this scheme, help was extended to countries most affected by the oil price rise.

vi. **Trust Fund:** As gold was demonetized in 1976, IMF set-up this fund with the proceeds from the sale of gold held by it. This fund was used for providing special development loans on concessional terms to those 25 member-countries which had the lowest per capita income. It was discontinued in 1981.

vii. **Supplementary Financing Facility:** Under this scheme, established in 1977, financial assistance is provided to countries facing serious BoP problems and having high external debt.

viii. **Poverty Reduction and Growth Facility (PRGF) and Exogenous Shocks Facility (ESF):** Concessional lending arrangements to low income countries are under pinned by comprehensive country owned strategies, delineated in their Poverty Reduction Strategy Papers (PRSPs). In recent years, the largest number of IMF loans has been made through PRGF. The interest rate levied on PRGF and ESF loans are only 0.5% and loans are to be repaid over a period of $5\frac{1}{2}$ to 10 years.

ix. **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, although interest subsidies are available for PRGF eligible countries. Loans should be repaid within $3\frac{1}{4}$ to 5 years.

Technical Assistance: IMF technical assistance supports the development of the productive resources of member countries by helping them to effectively manage their economic policy and financial affairs. The IMF provides technical assistance mainly in its areas of core expertise: macro economic policy, tax policy and revenue administration, expenditure management, monetary policy, the exchange rate system, financial sector sustainability and macro economic and financial statistics.

World Bank

The World Bank was established to help countries in reconstructing their economies in the post World War II period and to help the developing countries increase their economic growth rate. The World Bank is an important source of financial and technical assistance to developing countries around the world. It is made up of two unique development institutions owned by 185 member countries. These institutions are: The International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).

Organization

The World Bank is organized like a cooperative, with its 185 members as its shareholders. The shareholders are represented by Board of Governors, who are the policy makers. The Board members meet once a year at their annual meeting. The President of the World Bank chairs the meeting and is responsible for the overall management of the bank. The President is elected by Board of Governors. His tenure is for a 5 year renewable term.

The World Banks' primary objective is to reduce global poverty and bring about sustained development. To achieve this objective, the Bank concentrates on building the climate for investment, jobs and sustainable growth in the developing countries, so that these economies will grow.

The World Bank generally makes medium and long-term loans for infrastructure projects. Lately, it has started lending to countries having BoP problems, if they are willing to adopt growth-oriented economic policies. It requires a government guarantee for making these loans. For these activities, it raises funds through subscriptions from member countries and by issuing bonds which are generally meant for private subscription.

International Bank for Reconstruction and Development

The International Bank for Reconstruction and Development (IBRD) aims to reduce poverty in middle income and credit worthy poorer countries by promoting sustainable development through loans, guarantees, risk management products and analytical and advisory services. Established in 1944 as the original institution of World Bank, the IBRD is structured like a cooperative that is owned and operated for the benefit of its 185 member countries.

Products and Services

IBRD raises most of its funds in the world's financial markets and has become one of the most established borrowers since issuing its first bond in 1947. The income that IBRD has generated over the years has allowed it to fund developmental activities and to ensure its financial strength which enables it to borrow at low cost and offer clients good borrowing terms. The IBRD has three main businesses:

i Strategy and Coordination Services;

ii. Financial Services; and

iii. Knowledge Services.

Strategy and Coordination Services

The World Bank prepares a Country Assistance Strategy (CAS) for active borrowers from the International Development Association (IDA) and the International Bank for Reconstruction and Development (IBRD). The CAS takes as its starting point the country's own vision for its development, as defined in a Poverty Reduction Strategy Paper (PRSP) or other country-owned process. Oriented toward results, the CAS is developed in consultation with country authorities, civil society organizations, development partners, and other stakeholders. The purpose of the CAS is to set out a selective program of Bank Group support linked to the country's development strategy and based on the Bank Group's comparative advantage in the context of other donor activities. CASs are designed to promote collaboration and coordination among development partners in a country.

The CAS includes a comprehensive diagnosis – drawing on analytic work by the Bank, the government, and/or other partners – of the development challenges facing the country, including the incidence, trends, and causes of poverty. The CAS identifies the key areas where the Bank Group's assistance can have the biggest impact on poverty reduction. In its diagnosis, the CAS takes into account the performance of the Bank's portfolio in the country, the country's creditworthiness, state of institutional development, implementation capacity, governance, and other sectoral and cross-cutting issues. From this assessment, the level and composition of Bank Group financial, advisory, and/or technical support to the country is determined. To track implementation of the CAS program, the CAS is increasingly result-focused. It includes a framework of clear targets and indicators to monitor Bank Group and country performance in achieving stated outcomes.

Financial Services

- *Capital Markets* – The World Bank is one of the most recognized and innovative borrowers in the capital markets and has 60 years of experience. World Bank bonds are issued by the International Bank for Reconstruction and Development (IBRD). World Bank debt products provide investors with the reassurance of a superior credit rating, a wide choice of products, and strong secondary market performance for liquid World Bank benchmark bonds. The World Bank also customizes its debt offerings to meet investors' specific asset and liability needs.
- *Asset Management Services* – The Investment Management Department manages $50-$60 billion in global fixed income liquidity portfolios for the World Bank Group and other official institutions, plus approximately $11 billion in pension fund assets for World Bank Group staff. These portfolios are invested in a broad range of fixed income, equity and special asset classes and are actively managed to enhance returns against external benchmark indices.
  For the global fixed income portfolios, strategies comprise interest rate decisions, sector rotation and arbitrage. The investment management team includes a strong quantitative and research group, which assists in the development of the strategic asset allocation decision and risk management of the portfolios
- *Treasury Operations* – The Treasury Operations Department is responsible for treasury's middle and back office functions, all systems services, and provides Cash Management and Banking Relations services for the World Bank Group as a whole. Treasury Operation's cross-functional staff provide pricing and valuation, performance measurement, transaction and securities processing and compliance support functions. The middle office provides quantitative analytics support and operational risk reporting and coordinates Treasury's control risk assessments related to internal corporate governance and risk management functions.

Knowledge Services

The IBRD brings out various reports and publications in diverse fields such as:

- Poverty Assessments.
- Social and Structural Reviews.
- Public Expenditure Reviews.
- Sector Reports.
- Country Economic Memoranda.
- Knowledge Sharing.

International Development Association (IDA)

While the above-mentioned agencies were set-up to finance profitable projects, IDA endeavors to finance those projects in developing countries which may not be financially profitable, but indirectly may have a positive effect on the concerned

economy. It was set-up in 1960 and it is part of the World Bank that helps poorest countries. The membership of World Bank is a prerequisite for membership of IDA. Hence, it is usually referred to as the soft loan window of the World Bank. It aims to reduce poverty by providing interest free loans, and grants for programs that boost economic growth, reduce inequalities and improve people's living conditions.

IDA complements the World Bank's other lending arm: the IBRD – which serves middle income countries with capital investment and advisory services. IBRD and IDA share the same staff and headquarters and evaluate projects with the same rigorous standards. IDA is one of the largest sources of assistance for the world's 80 poorest countries, 39 of which are in Africa. It is the single largest source of donor funds for basic social services in the poorest countries. IDA lends money (known as credits) on concessional terms. This means that IDA credits have no interest charge and repayments are stretched over 35-40 years including a 10-year grace period. IDA also provides grants to countries at risk of debt distress.

International Finance Corporation (IFC)

IFC was incorporated in 1956 to help the development of private enterprise in different countries. It thus supplements the activities of the World Bank. IFC helps the private sector in a number of ways. It finances their projects through loans and subscription to equity. It provides technical assistance to private enterprise. It also tries to bring private capital and private management together by creating conditions conducive to the flow of private capital. It does not insist upon government guarantee and generally takes up more risks than its counterparts.

FAILURE OF THE BRETTON WOODS SYSTEM

Though, under this system, the member countries had the option of pegging their currencies to either gold or to the dollar, the only reserve asset mentioned in the agreement establishing the system was gold. However, as the gold stocks did not increase substantially in the years following the agreement, this provision acted as an impediment to the growth of international trade. Increase in such trade required a simultaneous increase in the official reserves held by various countries, in order to facilitate the payment for these trades. To get around this problem, countries started holding dollar reserves. They generally held the reserves in the form of interest bearing securities issued by the US government. This was encouraged by the US because of the seigniorage gains involved. While the cost of printing money was almost nil, the benefits were immense as the US could pay for its increased imports just by printing additional money, without suffering a reduction in its reserves. Seigniorage gain refers to this benefit accruing from the ability to finance unlimited imports. Since other governments were ready to hold dollar reserves and not convert them into gold, the US started following a system of fractional reserves. The total number of dollars issued by the Federal Reserve (the American Central Bank) was far in excess of the value of the gold held by it. As it would not have been possible for the fed to convert all the dollars into gold, the system ran on the confidence of other countries on its ability to do so, and their non-insistence for an immediate conversion. This created a paradox in the system known as the triffin paradox or the Triffin dilemma after a Yale University professor, Robert Triffin, who first spoke about it in 1960. According to him, it was necessary for the US to run BoP deficit in order to supply the world with the additional dollar reserves needed for increased international trade. Yet, as its deficit increased and the volume of dollar reserves held by other countries grew without a simultaneous increase in US's gold reserves, its ability to honor its commitment (of converting dollars into gold) would decrease. Such a situation would result in decreased confidence in the system, and since the system was running on the member countries' confidence, it would result in the system breaking down.

Another problem with the system was that it had become too rigid, despite the aim of the members being otherwise. As the system provided for realignment of exchange rates in case of a fundamental disequilibrium, predicting exchange rate movements became very easy. This put currencies at the mercy of private speculators. If a country started facing regular BoP deficits, people would start expecting a devaluation of its currency. Attempting to profit from such a scenario, private speculators would start selling the currency for gold or some other currency which was expected to remain strong, in the hope of buying it later at a reduced price. As these capital outflows built up, the reserves of the country would go down, eventually forcing it to devalue its currency. Thus, the expectations prove self-fulfilling. These outflows could only be stopped by a firm commitment by the concerned government at the very beginning, of not devaluing its currency. After making such a commitment, though, the country would find it very difficult to go for devaluation as such an act would make it lose its credibility, and the possibility of controlling the markets next time would be very bleak. The country would also not have any other choice but to devalue, as the other adjustment mechanisms were generally not acceptable to them (which implied a contraction of the economy, thus resulting in increased unemployment); leaving them in a catch-22 situation. A country whose currency faces an upward pressure would also face a similar problem, as the inflation resulting from an attempt to stop its currency from appreciating may not be acceptable; and the only other option left would be to revalue the currency.

In the early 50s, the US was running a BoP surplus, and hence there was a shortage of dollars in the international markets. By the late 50s, however, the US BoP situation had reversed and there was an excess supply of dollars. So much so, that there was a considerable reduction in US's gold holdings and the general belief became that the dollar had become overvalued and a correction in its value was due. This situation occurred due to two reasons. One was the devaluation of other currencies vis-à-vis the dollar in the previous decade, which made American goods less competitive in the international markets and the other was the high inflation rate prevailing in the American economy. In 1960, the value of gold flared up in the London market where most of the private gold trading took place. This happened due to the speculation that the dollar was going to be devalued by increasing the price of gold. To prevent the markets from going too far off from the official price of $35 per ounce, the US arrived at a gold pool arrangement with 7 other countries, under which they sold gold in London. This helped in controlling the gold prices in the short run. At around the same time, US inflation started coming down and its BoP situation started improving. By the early 60s, the US was enjoying a current account surplus. This was being balanced by capital flows out of the US, mostly on account of US companies investing in Europe. In an attempt to reduce unemployment in the US, monetary tightening was not introduced despite the overall BoP figure remaining negative. Believing that the increasing trend in the current account balance would continue and the BoP deficit was a short-term phenomenon, the government looked at short-term arrangements for tiding over the BoP difficulties. It tried to persuade foreign governments not to convert their dollar holdings into gold, opened credit lines with foreign Central Banks, and drew small amounts from IMF. It also entered into the General Arrangements to Borrow (GAB), an agreement with 9 other major countries to form the Group of Ten (G-10). The members of this group agreed to lend their currencies to IMF in case any one of them needed to draw a huge sum from it.

Despite all these steps, the BoP position did not turn positive as capital outflows continued. The main reason was the continuing high inflation rate in the US economy. With the US needing a lot of money to finance its commitments (to provide money for the reconstruction of the various war ravaged economies) under the Marshall Plan and its own expenses due to the Vietnam War, the money supply increased drastically, thus pushing the inflation to high-levels. The US government then started imposing various restrictions on capital flows. An "interest

equalization tax" was introduced on purchase of foreign securities by US citizens and its citizens were prohibited from holding gold either within the country or outside. In 1965, American banks and companies were told to voluntarily restrict loans to foreigners, and foreign direct investments respectively. In 1968, these controls were made compulsory. By then, however, the current account had also weakened. The pressure on the dollar started building up.

Other deficit countries were also facing problems. Britain started facing a BoP deficit in the early 60s and wanted to devalue the pound. US objected as it felt that the pound-devaluation would fuel expectations of the dollar-devaluation and speculators would start taking positions against it, forcing it to be devalued. Due to the US objection, UK held on for some time, borrowing heavily from other governments and IMF to defend the pound's exchange rate. It finally gave up in 1967 and the pound was devalued. In 1968, capital started flowing out of France due to certain political disturbances there. In order to stop these disturbances, the French government had to increase wages, which resulted in making the French industry less competitive. This resulted in a pressure on the value of the French franc, especially vis-à-vis the DM. Neither France nor Germany took any action, as both of them wanted the other one to change the value of its currency with respect to the dollar. In 1969, the franc was finally devalued.

As the system started facing these problems and the pressure on the dollar increased, a new reserve asset was created by IMF in 1967. Named SDRs (Special Drawing Rights), this international currency was allocated to the IMF member countries in proportion to their quotas. The biggest benefit of SDRs was that there would be a provision for international money to be created without any country needing to run a BoP deficit or to mine gold. Its value lay not in any backing by a currency or a real asset (like gold), but in the readiness of the IMF member countries to accept it as a new form of international money. Any member country, when facing payment imbalances arising out of BoP deficits, could draw on these SDRs, as long as it maintained an average balance of 30% of its total allocations. It could then sell these SDRs to a surplus country in exchange for that country's currency, and use it for settlement of international payments. Every member country was obliged to accept upto 3 times its total allocations as a settlement of international payments. It is an interest bearing source of finance, i.e, countries holding their SDRs receive interest, and the ones drawing on them pay interest. This interest rate is determined on the basis of the average money market interest rates prevailing in France, Germany, Japan, the UK and the US. Only the member countries of IMF and specific official institutions are eligible to hold SDRs. SDR is also the unit of account for all IMF transactions.

Despite the introduction of SDRs, the crisis continued to deepen. By this time, US's gold holdings had reduced considerably (both as an absolute figure and as a proportion of its foreign liabilities). By 1971, its reserve position turned negative as the BoP deficit increased drastically. In the first three months of 1971, huge pressure built up against the dollar, especially with respect to the mark. A number of countries had to buy a lot of dollars to defend their exchange rates. Germany, not intending to increase its money supply to unmanageable proportions, once again floated its currency. In April 1971, the US suffered a trade deficit for the first time, but it could not follow contractionary policies as it was simultaneously suffering from high unemployment. The only option left to it was to devalue. Even that it could not do on its own, as increasing the price of gold in terms of the dollar would not have had the desired effect due to other currencies being pegged to the dollar directly (rather than through gold prices). Also, an unexpected devaluation of the dollar would have penalized those countries which were trying to help the US by holding on to dollars instead of converting them into gold. Most of the countries held on to dollars in the first half of 1971. In the beginning of August, France needed gold to repurchase francs from the IMF, which it had sold earlier in harder times. It fulfilled this need by converting its dollar holdings into gold. As gold reserves of the US fell and rumors spread about Britain also trying to

follow the same route as France, panic spread in the international markets about US's ability to honor its commitment to convert all dollar holdings into gold. This caused a run on its gold reserves as all countries rushed to get their dollar holdings converted when they could. This precipitated the matters so much that the US decided to stop converting dollars into gold and let its currency float on August 15, 1971. To improve its BoP position, it simultaneously imposed an additional 10% tariff on imports. Hence, the two most important pillars of the system were gone – fixing of prices of currencies in terms of gold and their convertibility into gold. As a reaction to this development, many of the countries let their currencies float.

The intention of the US behind these steps was not to shift from a pegged-exchange rate system to a floating rate system, but to seek a realignment of exchange rates. Therefore, it called for a meeting of the 10 largest IMF member countries, which was held in December 1971, at the Smithsonian Institute in Washington, and considered the issue of realignment. As a part of the agreement arrived at in that meeting, which came to be known as the Smithsonian agreement, many of the countries revalued their currencies in terms of the dollar, while the dollar was devalued by raising the price of gold from $35 to $38 per ounce. The other part of the system, i.e., the facility of conversion of dollars into gold, however, was not re-established. The band around the parity rates was increased from one percent to 2.25 percent on each side, thus providing the Central Banks more flexibility in the management of exchange rate and monetary policy. It was also agreed to liberalize trade policies and to introduce more flexibility to exchange rates.

When the demand curve for exports is relatively inelastic, a devaluation of a country's currency does not immediately lead to an improvement in its current-account balance. In the initial period, the reduction in the price of the exports is much more than the increase in the volumes and hence there is a net reduction in exports. In the long run, however, the volumes pick up and the net exports start rising. The current-account curve, thus, traces a J-shape. It first becomes worse than its position before the devaluation, and then improves. This is called the J-curve effect. The US's BoP behaved in a similar manner after the Smithsonian agreement. It was misinterpreted to mean that the devaluation of the dollar was smaller than it should have been. In mid-1972, the UK floated the pound as a response to BoP problems. This again fuelled speculation against the dollar, with dollar being abandoned in favor of mark and yen. In February 1973, the dollar came under extreme selling pressure due to these factors and the high inflation rate which continued to reign in the US. It was contemplating devaluing the dollar once again, but was pre-empted by Switzerland which floated its currency. The dollar was, nevertheless, devalued by raising the price of gold to $41.22 per ounce. In mid-March, 14 major industrial countries followed Switzerland by abandoning the system and floating their currencies. With this, the system came to an end.

Post-Bretton Woods System (The Current System)

As the Bretton Woods system was abandoned, most countries shifted to floating exchange rates. This fact was finally recognized by the IMF and the articles were amended in its agreement. The amendment was decided upon in Jamaica in 1976 and became effective on April 1, 1978. This was the second amendment to IMF's articles. Under the new articles, countries were given much more flexibility in choosing the exchange rate system they wanted to follow and in managing the resultant exchange rates. They could either float or peg their currencies. The peg could be with a currency, with a basket of currencies or with SDRs. The only restriction put was that the pegging should not be done with gold. Neither were the member countries allowed to fix an official price for gold. This was done to reduce the role of gold and to make SDRs more popular as a reserve asset. For the same reason, the value of an SDR was redefined in terms of a basket of currency (to make it more stable and hence preferable as a reserve asset), rather than in dollar terms. Also, the members were no longer required to deposit a part of their quota in gold, and IMF sold off its existing gold reserves. In order to make SDRs more

attractive as a reserve asset, they were made interest-bearing. It was also allowed to be used for different types of international transactions. The member countries were also left free to decide upon the degree of intervention required in the forex markets, and could hence make it compatible with their economic policies. Secondly, IMF was given increased responsibility for supervising the monetary system. As a part of these increased responsibilities, IMF was required to identify those countries which were causing such changes in the exchange rates through their domestic economic policies, which proved disruptive to international trade and investment. It could then suggest alternate economic policies to these countries. IMF was also responsible for identifying any country which was trying to defend an exchange rate which was inconsistent with the underlying economic fundamentals. This was to be done by a constant monitoring of the reserves position of various countries. Lastly, the new articles made it easier for countries facing short-term imbalances in their BoP accounts to access IMF's assistance.

While countries were free to determine their exchange rate policies, under Article IV of the Agreement, they were required to ensure that the economic and financial policies followed by them were such as to foster "orderly economic growth and reasonable price stability". They also had to follow principles of exchange rate management, adopted by IMF in April, 1977. According to these principles:

- A member country neither should manipulate the exchange rates in such a way as to prevent a correction in the BoP position, nor should it use the exchange rates to gain competitive advantage in the international markets.
- A member country was required to prevent short-term movements in the exchange rates which could prove disruptive to international transactions, by intervening in the exchange markets.
- While intervening in the forex markets, a member country was required to keep other countries' interest in mind, especially the country whose currency it chooses to intervene in.

These principles attempted to bring some stability in the forex markets and to prevent another bout of competitive devaluations.

Given the freedom, different countries chose different exchange rate mechanisms. While some of them kept their currencies floating, some of them pegged their currencies either to a single currency or to a basket of currencies. A peg was maintained by an intervention in the foreign exchange markets and by regulating forex transactions. Table 1 shows the exchange rate mechanisms followed by various countries.

Floating of currencies was expected to make smoother exchange rate movements. Instead a lot of volatility has since been experienced. To remove a part of this volatility, sometimes a group of nations come together to form closer economic ties by cooperating with each other in the management of their exchange rates. One such group is the European Monetary Union (EMU).

Table 1: Exchange Rate Mechanisms followed by Various Countries

Currencies Pegged to:	No. of Currencies
The US dollar	27
French franc	14
SDR	6
Non-SDR basket	34
Other currency	5
Flexibility limited vis-à-vis a single currency($)	5
Co-operation arrangements (EMS)	10
Adjusted according to a set of indicators	5
Managed float/ wide band around a peg	22
Independent float	27
	155

Source: Department of Economics, IOWA State University.

European Monetary System

The basis of the European Monetary Union (EMU) was the American desire to see a united Western Europe after the World War II. This desire started taking shape when the Europeans created the European Coal and Steel Community (ECSC), with a view to freeing trade in these two sectors. The pricing policies and commercial practices of the member nations of this community were regulated by a supranational agency. In 1957, the Treaty of Rome was signed by Belgium, France, Germany, Italy, Luxembourg and the Netherlands to form the European Economic Community (EEC), whereby they agreed to make Europe a common market. While they agreed to lift restrictions on movements of all factors of production and to harmonize domestic policies (economic, social and other policies which were likely to have an effect on the said integration), the ultimate aim was economic integration. The European countries desired to make their firms more competitive than their American counterparts by exposing them to internal competition and giving them a chance to enjoy economies of scale by enlarging the market for all of them.

The EEC achieved the status of a customs union by 1968. In the same year, it adopted a Common Agricultural Policy (CAP), under which uniform prices were set for farm products in the member countries, and levies were imposed on imports from non-member countries to protect the regional industry from lower external prices. An important roadblock in the European unification was the power given under the treaty to all the member countries, by which they could veto any decision taken by other members. This hindrance was removed when the members approved the Single European Act in 1986, making it possible for a lot of proposals to be passed by weighted majority voting. This paved the way for the unification of the markets for capital and labor, which converted the EEC into a common market on January 1, 1993. Meanwhile, a number of countries joined EEC. Denmark, Ireland and the United Kingdom joined in 1973. By 1995, Austria, Finland, Greece, Portugal, Spain and Sweden had also joined, thus bringing the membership to 15.

The structure of the EEC consists of the European Commission, a Council of Ministers and a European Parliament. The Commission's members are appointed by the member countries' governments and its decisions are subject to the approval of the Council, whereby convention, either the Finance Ministers or the heads of the Central Bank represent their respective countries. The members of the Parliament are directly elected by the voters of the member countries. In December 1991, the Treaty of Rome was revised drastically and the group was converted into the European Community by extending its realm to the areas of foreign and defense policies. The members also agreed to convert it into a monetary union by 1999.

As the Bretton Woods System was breaking down in 1973, six out of the nine members of the EEC jointly floated their currencies against the dollar. While Britain and Italy did not participate in the joint float, France joined and dropped out repeatedly. The currencies of the participating countries were allowed to fluctuate in a narrow band with respect to each other (1.125% on either side of the parity exchange rate), and the permissible joint float against other currencies was also limited (to 2.5% on either side of the parity, by the Smithsonian agreement). This gave the currency movements the look of a 'snake', with the narrow internal band forming the girth and the movements against other currencies giving the upward and downward wriggle. The external band restricting the movement of these European currencies on either side, gave the impression of a 'tunnel' thus giving rise to the term "snake in the tunnel". The idea of creating a monetarily stable zone started taking shape in 1978, which resulted in the creation of the European Monetary System (EMS) in 1979. The system was quite similar to the Bretton Woods System, with the exception that instead of the currencies being pegged to the currency of one of the participating nations, a new currency was

created for the purpose. It was named the European Currency Unit (ECU) and was defined as a weighted average of the various European currencies. Each member had to fix the value of its currency in terms of the ECU. This had the effect of pegging these currencies with each other. Since each currency could vary against the ECU and against other currencies within certain band on either side of the parity rate (2.25% for others and 6% for pound sterling, Spanish peseta and Portuguese escudo), a certain grid was formed which gave the limits within which these currencies could vary against each other. Whenever the exchange rate between two of the member currencies went beyond the permissible limit, both the countries had to intervene in the forex markets. This cooperation between the countries was expected to make the system more effective. Another important feature of this system was that the members could borrow unlimited amounts of other countries' currencies from the European Monetary Cooperation Fund (EMCF) in order to defend their exchange rates. This was expected to ward off any speculative activities against a member currency. Though the countries involved were also expected to simultaneously adjust their monetary policies, this burden was put more on the erring country. It was easier to fix the blame, as at the time of the fluctuation in the exchange rate of two members, the erring country's exchange rate would also be breaching its limits with respect to the ECU and other member currencies. When these parity rates became indefensible, they could be realigned by mutual agreement. The system was, thus, much more flexible than the Bretton Woods System.

The ECU also served as the unit of account for the EMS countries. It served another important purpose in that loans among EMS countries (including private loans) could be denominated in the ECU. The ECU's value being the weighted average of a basket of currencies, it was more stable than the individual currencies. This made it more suitable for international transactions.

A number of realignments took place in the first few years of the system. However, the 1980s saw the system becoming more rigid. The German Central Bank (GCB), the Bundesbank, was committed to a low inflation rate, and hence to a tighter monetary policy. Some other countries (especially France and Italy, who had meanwhile joined the EMS) tried to control their domestic inflation by not realigning their currency's exchange rate with the DM and instead following the same monetary policy as the Bundesbank. The UK which joined the EMS in 1990, also followed the same policy. This resulted in a high unemployment rate in such countries. This cost was acceptable to these countries, till the situation changed drastically with the effects of the 1990 German unification slowly becoming visible. As the erstwhile West Germany bore the expenses of the unification, its budget deficit started rising, increasing the German prices and wages. To keep inflation under control, the Bundesbank had to increase the interest rates to an even higher level. If the DM was allowed to appreciate at that time, the Bundesbank would not have had to increase the interest rates too much, as German prices would have reduced in response to the higher DM. But as some other member countries of the EMS refused to let the DM appreciate, they had to increase their domestic interest rates in response. This happened at a time when many of the European countries were experiencing very high unemployment rates, and Britain was going through a recession.

The situation became worse with the decision of the EC countries to go ahead with the monetary union. In 1989, the report of a Committee chaired by the president of the European Commission (EC), Jacques Delor, was published. It recommended that the members of the EC abolish all capital controls and follow one common monetary policy. This monetary policy was proposed to be formulated by a European Central Bank (ECB), and followed by the Central Banks of all the member countries, which would become a part of the European System of Central Banks (ESCB). It also recommended the irrevocable locking of the EC exchange

rates and the introduction of a common currency for the member nations. In the same year, the first stage of the process of economic integration began, and most of the recommendations of the Delor Committee (DC) report were accepted. However, it was decided that to make the integration long-lasting, member countries were to achieve a high degree of economic convergence before being allowed to merge their economies with the rest of the group.

In December 1991, as a follow upto the Delor's report, the Treaty of Rome (ToR)was revised extensively to provide for the monetary union. As these revisions were adopted in the Dutch town of Maastricht, they collectively came to be known as the Maastricht Treaty. The treaty laid down the timetable for the monetary union. According to the timetable, the union was to be completed by 1999, and the qualifying countries had to fulfill criteria regarding inflation rates, exchange rates, interest rates and budget deficits. As the markets believed these criteria to be too hard for some countries to achieve, speculative pressure against the currencies of these countries started building up. By September 1992, the pressure reached its peak. The first country to bear the brunt of the speculative attacks was Italy. Even as its government announced a set of fiscal reforms to be able to meet the convergence criteria, pressures against the lira continued. Finally, Germany and Italy entered into a deal under which Italy devalued the lira and Germany reduced its interest rates. The UK was also facing a similar attack on its currency, and had to withdraw from the EMS soon after the Italian devaluation. Despite having already devalued its currency, Italy followed Britain and pulled its currency out of the EMS. Immediately afterwards, French voters approved the Maastricht treaty. Yet, this approval could not stop an attack against the French franc. Even Bundesbank and the Banque de France (the French Central Bank) together could not postpone the inevitable for long. In July 1993, there was another attack on the franc as it became clear that the French and German interest rates would not converge. The French unemployment rates being very high and continuing to rise, it could be foreseen that a further possibility of interest rates rising there did not exist. At the same time, the German government could not be expected to reduce the interest rates as inflation was still not totally under control. It became clear that the franc had to be devalued vis-à-vis the DM, but neither of the countries was ready to adjust the parity rates of their currency. Finally, the EMS countries decided to change the band from 2.25% to 15%. Germany and the Netherlands kept the band between their currencies at 2.25%. The band for peseta and the escudo continued at 6%. Though this change in the band successfully warded off the speculative attacks against the franc, the monetary convergence got a severe setback as there was no more need for countries to converge their monetary policies. With the band becoming so wide, there was no real fixed exchange rate system left to talk about.

Despite these developments, the desire of the European countries to form a monetary union did not fade. After being ratified by all member countries, the Maastricht Treaty came into effect from November 1, 1993. Thus, the European Monetary Union (EMU) came into being. The first stage of the union continued upto the end of 1993. During this stage, capital flows and the financial sector were fully liberalized. The members were also required to keep their currencies within a 2.25% band of the parity rates. The second stage began in January 1994, with the establishment of the European Monetary Institute (EMI) in Frankfurt, which was the precursor to the ECB. Its job was to manage the EMS, coordinate national monetary policies, and to prepare for the creation of the ESCB. It's most important function was to monitor economic convergence among the member countries, a job to be shared by the EC, the Bundesbank and the Banque de France. At this stage, the governments were not allowed to borrow from their Central Banks at concessional rates and had to do so at market determined rates. They were required to systematically reduce their fiscal deficits and bring other economic indicators in line.

In December 1995, a summit was held in Madrid, where the single European currency was named as Euro, and a strict timetable for the EMU was finalized. In December 1996, the Dublin summit was held and it was decided to give full autonomy to the ECB. The rules which the ECB would have to follow for regulating monetary policy and to ensure exchange rate stability were also formulated. In May 1998, the heads of the member governments met in Brussels and were presented the reports of the various agencies responsible for monitoring the convergence of the various members. In accordance with the Maastricht Treaty, the member countries were required to fulfill the following criteria by the end of 1997:

- Fiscal deficit should be within 3% of GDP.
- Public debt should not exceed 60% of GDP.
- The inflation rate should not exceed these three countries having the lowest inflation.
- The long-term interest rates should not be exceeding the long-term interest rates of the above-mentioned 3 countries by more than 2%.
- The currency should have stayed within the ERM band for a minimum period of two years without any realignment.
- The Central Banks should be autonomous.

In line with the reports prepared by these agencies, the heads of states voted for selecting the countries which were eligible to join the EMU. 11 countries were allowed entry into the union, they being Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Britain, Denmark and Sweden opted out of choice despite being eligible and Greece was found ineligible. At the same time, the ECB was established. The day-to-day management of the ECB is the responsibility of an executive board. The board has a total of six members including a president and a vice-president. These members are appointed by consensus and enjoy an eight-year, non-renewable term. The managing body of the ECB is the governing council which consists of the executive board and the governors of the Central Banks of the EMU countries. The main functions of the ECB are to:

a. Determine the monetary policy and to implement it.
b. Support the member countries in implementing their economic policies, if that does not entail going against its main aim of maintaining price stability.
c. Help the member countries in managing their forex reserves and to conduct forex operations.
d. Ensure a smoothly operating interbank payments system.

The most significant development was the introduction of a single currency for the participants of the EMU – the euro. On January 1, 1999 the euro came into being. On this date, the exchange rates of the currencies of the participating nations with the euro were irrevocably fixed. There will be a transition period of three years during which these currencies will exist along with euro. However, from this date, all interbank payments will be in euros, there will be no interbank quotes between the dollar and local currencies, all new government debt will be denominated in euros, the ECB will conduct repo transactions only in euros, and all stock exchange quotations for equities and trades and settlements of government debt and equity will be in euro. On the retail level, the bank statements and the credit card bills will be giving the euro equivalents of the national currency figure. Above all, from the same date, the ECB started formulating a common economic policy for the participating nations. Between January 1, 1999 and December 31, 2001 all retail transactions were settled in the national currencies. Euro notes and coins were introduced on January 1, 2002.

Initially only 11 member states joined the EMU, but as on 1st September, 2007, total number of member countries was 26 (table 2).

Table 2: EU26 Member States

1.	Austria	14.	Latvia
2.	Belgium	15.	Lithuania
3.	Cyprus	16.	Luxembourg
4.	Czech Republic	17.	Malta
5.	Denmark	18.	The Netherlands
6.	Estonia	19.	Poland
7.	Finland	20.	Portugal
8.	France	21.	Romania
9.	Germany	22.	Slovakia
10.	Greece	23.	Slovenia
11.	Hungary	24.	Spain
12.	Ireland	25.	Sweden
13.	Italy	26.	United Kingdom

Source: europa.eu.int/

Out of these member countries which traded their currency in for the euro are: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, and Greece. Overseas territories of some Eurozone countries, such as French Guiana, Réunion, Saint-Pierre, etc., Miquelon, and Martinique, also use the euro. These countries together are frequently referred to as the "Eurozone", "Euroland" or more rarely as "Eurogroup". The ten newest European Union members are expected to eventually use the euro in the near future. These countries are: Cyprus, Estonia, Latvia, Lithuania, Malta, Slovenia, Slovakia, Czech Republic, Poland and Hungary. The United Kingdom and Sweden have no plans at present to adopt the euro.

After the introduction of the euro, its exchange rate against other currencies, especially the US dollar, declined heavily. At its introduction in 1999, the euro was worth USD $1.18; by late 2000 it had fallen to below $0.85. It then began what at the time was thought to be a recovery; by the beginning of 2001 it had risen to $0.95. It declined again, finally reaching a low of below $0.84 in July 2001. The currency then began to recover against the US dollar. In the wake of US corporate scandals, the two currencies reached parity on 15 July, 2002, and by the end of 2002 the euro had reached $1.04 as it climbed further.

On 23rd May, 2003, the euro surpassed its initial trading value for the first time as it again hit $1.18, and broke the $1.35 barrier (€0.74 = $1) on 24th December, 2004. On 30th December, 2004 it reached a peak of $1.3668. Currently as on October 31st , 2007 it is being traded at $ 1.44101.

RECENT DEVELOPMENTS

The most interesting development in the recent past in the field of monetary systems was the rise and fall of the south-east Asian economies. The members of the Asian block, especially Indonesia, Malaysia and Thailand built up their economies on the strength of their monetary systems. Most of the south-east Asian countries pegged their currencies to the US dollar. The fixed exchange rates helped these countries in attracting foreign capital. Their domestic interest rates and returns on other financial assets were quite high compared to the investment avenues available in the western economies. These high returns, coupled with the fixed exchange rates provided the investors a chance to earn high returns without having to bear proportionate risks. As the capital continued to flow in, the increasing trade deficit kept getting financed, putting no pressure on the exchange rates. In fact, the fixed exchange rates pulled in more foreign capital than could be profitably deployed in these economies. The result was the deployment of these

funds (which were largely short-term) into property markets and long-term ventures. Since the funds were not being used to create any real economic activity, the probability of their being serviced kept coming down. As the trend continued, the investors started getting worried about the service ability of their investments. This worry turned into a panic and investors started pulling their money quickly out of these economies, everyone desiring to be the first one to get their money back safely. Since these short-term funds were put either in asset markets or in long-term investments, this action of the investors resulted in bringing the asset markets down. At the same time, the long-term investments could not be liquidated immediately to return the investors' money. The resulting defaults made the situation worse as any possibility of the local banks or companies getting any further funds faded away. This choked even the day-to-day operations of financially sound companies. The economies suffered and the pressure on their exchange rates mounted to such an extent that the countries had to give up the peg to the dollar and float their currencies. The currencies depreciated so drastically, that the whole economies went under due to the effect. The stupendous growth rates turned negative, the trade deficits widened further and the investors had to bear a heavy loss. This once again reflects the effect pegging of exchange rates (without appropriate economic policies being followed) can have on a country's economy.

SUMMARY

- The experiments with various kinds of monetary systems have shown us that there is no perfect monetary system.
- Each system has its own benefits as well as drawbacks.
- Each system involves an adjustment mechanism, which has to be allowed to work to make the system last.
- The most important lesson that we learn from the past is that the monetary system should be allowed to evolve as a response to the changing environment, while maintaining some level of stability.
- How this balance can be achieved continues to remain an enigma, yet to be solved by countries and supranational institutions.

Chapter IV

Balance of Payments

After reading this chapter, you will be conversant with:

- Concept of Economic Transactions
- Components of the Balance of Payments Account
- Balance of Payments Compilation
- Balance of Payments Account – The Indian Perspective
- Importance of BoP Statistics

Introduction

The determination of a country's exchange rate depends upon the exchange rate system followed by it. The exchange rate of a currency is its value (or price) in terms of another currency. Like all other commodities, the price of a currency also depends on its supply and demand factors. When the exchange rates are truly flexible, the demand and supply arise only from the market forces. In the case of fixed exchange rates, in addition to the supply and demand arising from the market, the central bank/regulatory authority ensures an official demand or supply, which keeps the overall forces balanced in order to maintain the exchange rate at an equilibrium level which is considered desirable by the central bank. The various exchange rate systems were discussed in the previous chapter.

To forecast the level of exchange rate, we need to know the factors that affect the demand for and supply of a currency. Any factor increasing the supply of a currency reduces its price, i.e., causes it to depreciate and vice versa. Similarly, any factor increasing the demand for a currency, increases its price, i.e., causes it to appreciate and vice-versa. All these factors are reflected in the Balance of Payments (BoP) account. The BoP account is the summary of the flow of economic transactions between the residents of a country and the Rest of the World (RoW) during a given time period. The BoP is to a country what a statement of sources and uses of funds are to a company. It measures the flow of international payments and receipts. As it measures flows and not stocks, it records only the changes in the levels (and not the absolute level) of international assets and liabilities.

Balance of Payments (BoP) is described by the IMF in its balance of payments Manual as a statistical statement for a given period showing:

i. Transactions in goods, services and income between an economy and the rest of the world;

ii. Changes of ownership and other changes in the economy's monetary gold, Special Drawing Rights (SDRs), and claims and liabilities to the rest of the world; and

iii. Unrequited transfers and counterpart entries that are needed to balance, in the accounting sense, any entries for the foregoing transactions and changes which are not mutually offsetting.

The balance of payments manual prescribes certain principles and concepts to be followed by countries while compiling their BoP data, in order to ensure that recording of transactions is systematic and consistent. The principles refer to adoption of the double-entry bookkeeping system, distinction between entities to be treated as residents and those to be treated as non-residents, scope of economic transactions to be included in the BoP statistics, valuation of such transactions and the time when these transactions are to be recorded.

CONCEPT OF ECONOMIC TRANSACTIONS

IMF prescribes that all economic transactions between residents and non-residents are to be recorded in the BoP. For this purpose, economic transactions include all those activities whereby two entities exchange something of economic value. There are at least two parties involved in a BoP transaction, one a resident and the other a non-resident. Sometimes even if there is only one person, it may still be qualified as a BoP transaction. For example, the transfer of a non-resident's funds to the country to which he is migrating. In this case, though there is only one party involved in reality, the transfer is assumed to be from a non-resident (as the migrant is before migration) to a resident (as he is after migration). Thus, by implication, there are two entities involved and hence the transaction appears in the BoP account.

Generally, transactions which take place between a resident and a non-resident are recorded. Yet, a few transactions are recorded even if they take place between two residents or two non-residents. Let us look at an example. The BoP account records various transactions like exports/imports of goods and services, payment of dividend/interest, investments in assets, etc. These transactions are broadly classified into current account and capital account. Suppose Mr. X has a FCNR deposit in US$ with SBI which he now proposes to transfer to Bank of India. Then the amount of FCNR will be paid by SBI to Bank of India. While this does not affect the BoP as a whole, the transactions will be recorded in the BoP. Similarly, a transaction like deemed exports (where supplies are made by a resident to another resident but such sale is treated as if it is an export) are also recorded in the BoP even though the BoP position itself may not change. Thus, certain transactions which do not affect the BoP position may also be recorded.

Another exception to the general principle is the recording of those transactions where the transfer of a thing having economic value is only one-sided, i.e., the transferor does not receive anything of economic value in return. These are called transfer payments. Examples of such payments are aids, grants, taxes and gifts, etc. Since there is no corresponding payment to make the double entry possible, the offsetting entry is put under the head "Transfer Payments".

Concept of Resident

According to the IMF manual, an entity is said to be a resident of that economy to whose territory it has closer links with, than any other economy. For this purpose, territory is defined as including the areas falling within the political boundaries of a country, or its territorial seas, or those parts of international waters over which it has exclusive jurisdiction. All entities other than those which qualify as residents in accordance with the above-mentioned definition are considered non-residents. The IMF manual classifies resident entities into four categories: (i) General government institutions, (ii) Individuals, (iii) Private non-profit bodies, (iv) Enterprises.

GENERAL GOVERNMENT INSTITUTIONS

All the departments, establishments and bodies of the central, state and local governments that are located in the territory of a particular economy, are considered its residents. The embassies, consulates and other entities representing an economy's government are also considered the residents of that particular economy, although they are located abroad.

INDIVIDUALS

According to the manual, "all persons who may be expected to consume goods and services, participate in production, or engage in other economic activities in the territory of a given economy on other than a temporary basis, and whose center of interest lies in that economy" are to be considered the residents of that economy. The criteria for recognizing permanence is a stay in that economy for a minimum period of one year.

As an exception to the above rule, an economy's government, consular representatives and other representatives are considered that economy's residents, irrespective of the length of their stay abroad. This is so because their country is expected to continue to be their "center of interest".

PRIVATE NON-PROFIT BODIES

This category includes those bodies which provide services to the society either free of cost or at subsidized rates. They are considered the residents of that economy in which they are located and provide their services.

ENTERPRISES

This category includes those entities which produce and sell goods or services on a commercial basis. These are considered to be the residents of that economy on whose territory they conduct their operations. According to this definition, the foreign branches of a resident enterprise are viewed as the residents of that economy in which they are operating instead of residents of their domestic economy, despite the fact that the enterprise and its branches would be a single legal entity (having been incorporated in the domestic economy). A company's foreign subsidiary would also be considered a resident of that foreign economy in which it is incorporated and operating.

Principles for Valuation of Transactions

Every year, a large number of transactions enter the BoP account of each country. To make the data comparable across countries and over a period of time, it is essential that a uniform system be adopted for valuing these transactions. The IMF manual recommends the following principles to be followed for valuation of transactions entering the BoP account:

i. The transactions should be valued at market prices. For this purpose, the manual describes market price as "the amount of money that a willing buyer pays to acquire something from a willing seller, when such an exchange is between independent parties into which nothing but commercial considerations enter." Thus, according to this strict definition, market price refers only to the price for one specific exchange under the stated conditions. A second exchange of an identical unit, even under circumstances that are almost exactly the same could result in a different market price. In situations where market price cannot be determined, proxies or substitute measures are advocated for the determination of market prices.

ii. Both imports and exports should be valued at F.O.B basis (i.e., Free on Board basis). This means that the price paid for the insurance and shipment of goods should not be included as a part of the value of goods either by the importer or the exporter, but should be recorded separately as a payment for services (wherever paid to a foreign agency).

iii. Any transaction denominated in a foreign currency should be converted into the domestic currency at the exchange rates prevailing in the market at the time of the transaction.

iv. Transactions between affiliated enterprises integrated under the same management cannot necessarily be considered market transactions because of the lack of independence among the parties to the exchange. In such cases, transfer pricing can be used for pricing of goods and services acquired from affiliates.

v. All assets and liabilities stocks comprising a country's international investment position should be measured at market values.

Principles of BoP Accounting

Balance of Payments data record of the flow of goods, services and finance between an economy and the rest of the world. As one of the primary functions of the IMF is to prevent financial crises and assist countries in balance of payment difficulties, the collection of standardized, comparable BoP data is seen as a core task.

The BoP statement is a statistical statement that summarizes, for a specific period, the economic transactions of an economy with the rest of the world. It covers:

- All the goods, services, factor income and current transfers an economy receives from or provides to the rest of the world.
- Capital transfers and changes in an economy's external financial claims and liabilities.

Transactions are generally between residents and non-residents. The exceptions are the exchange of transferable foreign financial assets between residents and transferable foreign financial liabilities between non-residents. For the purposes of BoP, residency relates to the economic territory of a country, not nationality. An international unit is resident unit when it has a centre of economic interest in the economic territory of a country.

The foremost principle of BoP accounting is the use of the double-entry book keeping system, i.e., every transaction has two aspects and hence enters the BoP account twice, once as a credit and once as a debit. Since for every credit there is a corresponding debit, the Balance of Payments account always balances. The logic underlying every transaction being entered twice is that whenever there is a transaction, whether purchase or sale, there would be a corresponding payment – either immediate or deferred, giving rise to two entries. Since there is no compensation involved in the case of transfer payments, they are treated as trade in goodwill to satisfy the principle of double-entry. An outflow on account of transfer payment is regarded as a purchase of goodwill, while an inflow is regarded as a sale.

There is a clear rule for determining the side of a BoP account on which a particular transaction should be entered. The rule is that any transaction which creates demand for the domestic currency in the forex markets enters the BoP account on the credit side, and any transaction increasing its supply enters the debit side. Another way of understanding the rule is through sources and uses of foreign currency. Any transaction which is a source of foreign currency is a credit entry, and any transaction which is a use is a debit entry. In accordance with these definitions, credit transactions are recorded with a plus sign, and debit transactions with a minus sign.

Let us consider a few examples. As a country exports goods to another country, the demand for the domestic currency goes up as the foreign importer would need to buy the domestic currency to pay for the imports. This would appear as a credit item in the BoP account as it is a source of foreign currency. On the other hand, imports increase the supply of the domestic currency, as foreign currency would need to be bought in exchange for the domestic currency in order to pay for the imports. Since it is a use of the foreign currency, it would appear as a debit item.

Yet another simplified way of understanding the debit or credit in a BoP transaction is that a BoP credit always denotes either a reduction in assets or an increase in liabilities while a debit in a BoP statement denotes an increase in assets or a reduction in liabilities. The following table provides examples of transactions which fall under debit or credit:

Table 1: Balance of Payments Credit and Debit

Credit	Debit
Exports of goods and services	Imports of goods and services
Income receivable from abroad	Income payable abroad
Transfers from abroad	Transfers to abroad
Increases in external liabilities	Decreases in external liabilities
Decreases in external assets	Increases in external assets

COMPONENTS OF THE BALANCE OF PAYMENTS ACCOUNT

The BoP account has the following main components:

- Current Account.
- Capital Account.
- Financial Account.
- Official Reserves.
- Errors and Omissions.

Current Account

The current account records all the income-related flows. These flows could arise on account of trade in goods and services and transfer payments among countries. Trade in goods consists of exports and imports. It is also referred to as merchandise trade. As explained earlier, a country's exports, i.e., sales of goods to residents of another country, are a source of reserves. Similarly, a country's imports, i.e., purchases of goods from another country are a use of reserves. Thus, they enter on the credit and the debit side of the BoP account respectively. Trade in services consists of payments and receipts on account of interest, dividend, professional services, income on assets like patents and copyrights, tourism, transport, insurance, income from other physical property, banking and other financial services, consultancy services and other factor services involving residents of two countries. As a country receives any of these services and pays for them, it results in the use of reserves and hence appears on the debit side of the BoP account. If it extends these services and receives payment for the same, it results in a source of reserves and gets recorded as a credit entry in that country's BoP account. Transfer payments include all unilateral transfers, i.e., transfers without any corresponding exchange of goods and services. Items which fall in this category include remittances and gifts to friends and relatives, private donations, scholarships, inter-governmental aids and grants (including those made to and by supranational bodies), and pension (being compensation for past work). Compensation for current work would be covered under the heading 'services'. An inflow on this account would be recorded as a credit entry, and an outflow as a debit entry.

By definition, the BoP account always balances. Yet, the individual components may or may not balance. This in reality gives rise to the widely discussed deficits or surplus arising in the BoP account. A net inflow on account of merchandise trade results in a trade surplus, while a net outflow results in a trade deficit. In the same way, a net inflow after taking all entries in the current account into consideration is referred to as the current account surplus, and a net outflow as current account deficit.

Capital Account

The capital account records movements on account of international purchase or sale of assets. Assets include any form in which wealth may be held: money held as cash or in the form of bank deposits, shares, debentures, other debt instruments, real estate, land, factories, antiques, etc. Any purchase of a foreign asset by a resident is entered as a debit item in that country's BoP account, while any purchase by a foreign resident of a domestic asset is recorded as a credit item. The excess of the credits over debits in this account over a particular period is referred to as the capital account surplus. The excess of debits over credits is known as capital account deficit. The capital account transactions can be broadly segregated into two major categories:

i. **Capital Transfers:** A capital transfer is a transfer which consists of (i) the transfer of ownership of a fixed asset or (ii) the forgiveness of a liability by a creditor when no counterpart is received in return. A capital transfer should result in a commensurate change in the stocks of assets of one or both the parties to the transaction. A capital transfer may be in cash or in kind. For example, if a creditor entity in one economy formally agrees via a contractual arrangement with a debtor entity in another to forgive (extinguish) all or a part of the obligations of the debtor entity to that creditor, the amount forgiven is treated as a capital transfer from the creditor to a debtor. The balance of payments reflects a reduction of the liability offset by the transfer.

ii. **Acquisition and Disposal of Non produced, Non-financial Assets:** It comprises transactions associated with tangible assets that may be used or necessary for production of goods and services but are not actually produced and transactions associated with non produced intangible assets. The transactions are recorded at actual transaction value of assets acquired less assets disposed of. Changes in financial assets and liabilities that stem from transactions between two parties are valued to reflect the market values of the assets underlying the acquisition or disposition.

Financial Account

The financial account covers all transactions associated with changes of ownership in the foreign financial assets and liabilities of an economy. Such changes include the creation and liquidation of claims on, or by, the rest of the world. All valuation changes and all other changes that do not reflect transactions in foreign assets and liabilities are excluded from the capital and financial account but are reflected in the international investment position.

Official Reserves

Official reserves include gold, reserves of convertible foreign currencies, SDRs and balances with the IMF, which are the means of international payment. Foreign currencies may be held in the form of balances with foreign central banks, or as foreign government securities. The official reserves account reflects the amount of these "means of international payment" acquired or lost during the period for which the BoP account is constructed. If there is a net surplus in the current account and the capital account taken together (generally referred to as the overall BoP surplus or simply as the BoP surplus), there will be an increase in the official reserves as the inflows will exceed the outflows. This will appear as a debit entry in the BoP account. This happens because of the double-entry system. As each credit entry requires a corresponding debit entry, every inflow and outflow of reserves gets accounted in the current or capital account (depending on the nature of transaction), as well as in the official reserves account. Due to the double entry system, any transaction appearing as a credit entry in the current or the capital account, also appears as a debit entry on account of its effect on the official reserves. The net effect is of a BoP surplus getting reflected as a debit entry as an increase in the official reserves. Similarly, a BoP deficit will appear as a credit entry due to its effect on the official reserves. The same conclusion can also be arrived at in a different way. An increase in the official reserves can be taken as a use of funds, thus appearing on the debit side of the BoP account. Similarly, a reduction in the official reserves can be taken as a source of funds, thus appearing on the credit side of the BoP account. The change in the official reserves compensates the Balance of Payments deficit/surplus, i.e., the two are exactly equal in size and opposite in sign (ignoring the errors and omissions which may inadvertently creep in). Thus, all transactions appearing under the head "official reserves" are referred to as compensatory or accommodating transactions. An accommodating transaction is a transaction undertaken to finance or settle a deficit/surplus arising out of other transactions. An autonomous transaction (the transactions covered under the heads "current account" and "capital account"), on the other hand, refers to a transaction undertaken on its own accord for financial reasons, without being affected by any other transaction in the BoP. Thus, a BoP deficit/surplus means an imbalance in the autonomous transactions as a group.

Errors and Omissions

The BoP as a whole is supposed to balance due to the double-entry system. In reality, it may not always balance. The reason is that the data about the various aspects of international transactions are collected from different sources. These different sources may differ in coverage, accuracy and timing while recording these transactions. Hence an imbalance may creep into the BoP account, which is removed by adding the heading "Errors and Omissions" to it. This account shows the net figure of the imbalance with the opposite sign, thus

balancing the BoP. This figure does not reflect the total errors and omissions as some of them get canceled by other errors, and hence do not show up as an imbalance in the BoP statement.

A sample list of the components of a BoP statement are given under Annexure 1 at the end of the chapter.

Principles for Timing the Recording of Transactions

Every transaction is recorded by the two countries involved. To avoid discrepancies, it is necessary that both the countries record it in the same period in their BoP accounts. Also, as the two aspects of a transaction are generally recorded using different sources, it is essential that both the sources record the transaction in the same time period to balance the BoP statement balance. For the above mentioned reasons, the IMF manual prescribes some rules as to when a transaction should be recorded in the BoP account. The rules are as follows:

- **Current Account:** Merchandise trade should be recorded when there is an ownership change. This is said to happen when the corresponding payment is made. Trade in services is to be recorded when the services are actually rendered. Interest, dividends and other like payments are to be recorded when they are due for payment. The rule for transfer payments is that they should be recorded when the ownership of the underlying assets changes.
- **Capital Account:** Capital account transactions are also recorded with a change in ownership. For these transactions, the change in ownership is assumed to have taken place when the transaction goes through the banking channels. International loan drawings are recorded at the time of the actual disbursement of the loan and not when the lender commits to lend or sanctions the loan.

Factors Affecting the Components of BoP Account

EXPORTS OF GOODS AND SERVICES

Exports of goods and services are affected by the following factors:

Prevailing Exchange Rate of the Domestic Currency: A lower value of the domestic currency results in the domestic price getting translated into a lower international price. This increases the demand for domestic goods and services and hence their export. This is likely to result in a higher demand for the domestic currency. A higher exchange rate would have an exactly opposite effect.

Inflation Rate: The inflation rate in an economy vis-à-vis other economies affects the international competitiveness of the domestic goods and hence their demand. The higher the inflation, the lower the competitiveness and lower the demand for domestic goods. Yet, a lower demand for domestic goods and services need not necessarily mean a lower demand for the domestic currency. If the demand for domestic goods is relatively inelastic, then the fall in demand may not offset the rise in price completely, resulting in an increase in the value of exports. This would end up increasing the demand for the local currency. For example, suppose India exports 100 quintals of wheat to the US at a price of Rs.500 per quintal. Further, assume that due to domestic inflation, the price increases to Rs.530 per quintal and there is a resultant fall in the quantity demanded to 96 quintals. The exports, instead of falling would increase from Rs.50,000 to Rs.52,800.

World Prices of a Commodity: If the price of a commodity increases in the world market, the value of exports for that particular product shows a corresponding increase. This would result in an increase in the demand for the domestic currency. A fall in the demand for domestic currency would be experienced in case of a reduction in the international price of a commodity. This impact is different from the previous one. The previous example considered an increase in the domestic prices of all goods produced in an economy simultaneously, while this one considers a change in the international price of a single commodity due to some exogenous reasons.

Incomes of Foreigners: There is a positive correlation between the incomes of the residents of an economy to which the domestic goods are exported, and exports. Hence, other things remaining the same, an increase in the standard of living (and hence, an increase in the incomes of the residents) of such an economy will result in an increase in the exports of the domestic economy. Once again, this would increase the demand for the local currency.

Trade Barriers: The Higher the trade barriers erected by other economies against the exports from a country, the lower will be the demand for its exports and hence, for its currency.

Imports of Goods and Services: Imports of goods and services are affected by the same factors that affect their exports. While some factors have the same effect on imports as on exports, some of them have an exactly opposite effect. Let us analyze these factors and their effects.

Value of the Domestic Currency: An appreciation of the domestic currency results in making imported goods and services cheaper in terms of the domestic currency, hence increasing their demand. The increased demand for imports results in an increase in the supply of the domestic currency. A depreciation of the domestic currency has an opposite effect.

Level of Domestic Income: An increase in the level of domestic income increases the demand for all goods and services, including imports. This again results in an increase in the supply of the domestic currency.

International Prices: The international demand and supply positions determine the international price of a commodity. A higher international price would get translated into a higher domestic price. If the demand for imported goods is inelastic, this would result in a higher domestic currency value of imports, increasing the supply of the domestic currency. In case of the demand being elastic, the effect on the supply of the domestic currency would depend on the effect on the domestic currency value of imports.

Inflation Rate: A domestic inflation rate that is higher than the inflation rate of other economies, would result in imported goods and services becoming relatively cheaper than domestically produced goods and services. This would increase the demand for the former, and hence, the supply of the domestic currency.

Trade Barriers: Trade barriers have the same effect on imports as on exports – the higher the barriers, the lower the imports, and hence, lower the supply of the domestic currency.

INCOME ON INVESTMENTS

Both payments and receipts on account of interest, dividends, profits, etc., depend on the level of past investments and the current rates of return that can be earned in an economy. For payments, it is the level of past foreign investments and the current domestic rates of return; while for the receipts it is the past domestic investments in foreign economies and the current foreign rates of return which are relevant.

TRANSFER PAYMENTS

Transfer payments are broadly affected by two factors. One is the number of migrants to or from a country, who may receive money from or send money to relatives. The second is the desire of a country to generate goodwill by granting aids to other countries along with the economic capability to do so, or its need to take aids and grants from other countries to tide over difficulties.

CAPITAL ACCOUNT TRANSACTIONS

Four major factors affect international capital transactions. The foremost is the rate of return which can be earned on the investments as compared to the returns that can be earned on domestic investments. The higher the differential returns offered by a country, the higher will be the capital inflows. Another factor is the additional risk that accompanies these returns. The More the risk, the lower the capital inflows. Diversification across countries may offer some extra benefit in addition to the returns offered by a particular investment. This benefit arises from the fact that different economies may be at different stages of economic cycle at a given time, thus making their performance unrelated. The Higher the diversification benefits, the higher the inflows. One more factor which has a very significant affect on these transactions is the expected movement in the exchange rates. If the exchange rates are quite stable, or the movement is expected to be in the investors' favor, the capital inflows will be higher.

BALANCE OF PAYMENTS COMPILATION

The BoP account is compiled using various sources of information. The most important source is the R-Returns which the authorized dealers are required to submit to the RBI every fortnight. These R-Returns provide the details of all foreign exchange transactions entered into by the authorized dealers, including the transactions passing through the rupee accounts of non-resident banks. Other sources of information are the Government of India (GoI) (the Department of Economic Affairs under the Ministry of Finance, and other government agencies located abroad) and surveys conducted specifically to facilitate BoP compilation, etc.

Theoretically, each of these transactions recorded through the various sources have an impact on the BoP account of the country. In practice, however, these transactions are not recorded individually in the BoP account. The transactions falling under different headings and sub-headings of the BoP account are aggregated, and then the BoP account is prepared on the basis of these net figures. Yet, it is important to understand the impact of these individual transactions on the BoP account. Here are a few illustrations which explain this impact.

Illustration 1

An Indian resident exports goods to an American resident and his payment is settled by a bill of exchange denominated in US dollars, having a maturity of 90 days. From India's point of view, two things have happened – export of goods has taken place and a foreign asset has been acquired (a short-term claim on a foreign resident). Show the impact of this transaction on India's BoP:

Solution

Holdings of foreign asset (Bill of exchange)	Dr.	
Merchandise export		Cr.

While the first term will form a part of the capital account, the second will come under the current account.

Illustration 2

The bill of exchange mentioned in illustration 1 is presented for payment by the Indian exporter on maturity. He gets paid in US dollars which he retains in an account in a US bank. On one hand, this reduces the holdings of foreign assets

(in the form of the bill of exchange), and on the other hand it increases the same (in the form of the deposit). The impact will be:

Solution

Holdings of foreign assets (Deposit) Dr.

Holdings of foreign assets Cr.

(Bill of exchange)

The net effect on the BoP would be nil.

Illustration 3

The exporter then converts the dollars into rupees by selling the dollars to his local clearing bank. The effect of this transaction would be to reduce the exporter's holding of foreign assets and increase that of the clearing bank to the same extent. Since the foreign asset holdings of Indian residents in totality remain the same, there will be no effect on the BoP account.

Illustration 4

The clearing bank then sells the dollars to the central bank for the domestic currency. This results in the holdings of foreign assets going down and the official reserves going up (because a foreign currency held by a central bank is classified as a reserve asset rather than holding of a foreign asset). Show its impact on the BoP.

Solution

Official reserves Dr.

Holdings of foreign assets Cr.

If the clearing bank sells the foreign currency to another bank, there will be no impact.

Illustration 5

An Indian resident imports goods from Germany and signs a usance bill of exchange denominated in German marks for the amount due. It will result in an increase in imports and an increase in liabilities to foreign residents (from the point of view of the Indian BoP). Show the impact on the BoP.

Solution

The impact will be:

Merchandise imports Dr

Liabilities to foreign residents Cr

On maturity of the bill, the Indian importer would buy German marks from a bank and settle the payment. This will reduce the liabilities to foreign residents, as also the holdings of foreign assets (in the form of German marks – a foreign currency – held by the bank. The impact would be:

Liabilities to foreign residents Dr

Holdings of foreign assets Cr

When the bank purchases German marks from the central bank to offset its earlier deal with the importer, the result will be an increase in the holdings of German marks by the bank (a foreign asset) and a reduction in the official reserves. It will have the following effect on the BoP:

Holdings of foreign assets (German marks) Dr.

Official reserves Cr.

Illustration 6

An Indian resident takes medical treatment in America and pays for it in US dollars. This is a purchase of service. For making the payment, the resident would need to buy dollars from a bank. Show the effect on the BoP.

Solution

The effect will be:

Trade in services	Dr.	
	Holdings of foreign assets (bank's holdings of dollars)	Cr.

If the bank buys dollars from the Central Bank to cover the sale, it will again have the following effect:

Holdings of foreign assets (bank's holdings of dollars)	Dr.	
	Official reserves	Cr.

Illustration 7

Mr. X, an NRI, decides to come back to India. He sells off all his assets and converts the resultant dollars into rupees. He would do this by selling the dollars to some bank. Show the effect on the BoP.

Solution

The effect would be:

Holdings of foreign assets (dollars)	Dr.	
	Transfer payments	Cr.

In accordance with the principles of BoP accounting, even that part of X's property which does not accompany him has to be accounted for. The impact will be similar to the one mentioned above. The debit would be on account of the increase in the holdings of foreign assets (which X would now hold as a resident) and the credit as an offsetting entry.

Illustration 8

An Indian company issues ECBs denominated in French francs. This involves buying of an Indian asset (in the form of debt instruments) by foreign residents. There would be a simultaneous increase in the foreign asset holding of the bank to which the Indian company sells the francs. Show the effect on the BoP.

Solution

The impact would be:

Holdings of foreign assets	Dr.	
	Liabilities to foreigners	Cr.

Illustration 9

IMF allocates SDRs to member countries from time to time. The allocation results in an increase in the official reserves of the country receiving the SDRs. The effect is:

Solution

Official reserves	Dr.	
	Allocation of SDRs	Cr.

Till now, there has been no incident of cancellation of SDRs. Cancellation would have a reverse effect on the BoP.

Illustration 10

Suppose that some non-residents hold a part of the equity of a resident enterprise. The part of their share of earnings of the company which is paid out as dividends would be recorded in the BoP as an import of services. According to the BoP accounting principles, even that part of their share in the earnings which is retained in the company has to be recorded in the BoP account. Such retained earnings are considered income paid out and reinvested by the non-residents.

Solution

The effect is.

Trade in services	Dr.	
Holdings of foreign assets		Cr.

(for the notional payment of earnings in foreign currency)

Holdings of foreign assets	Dr.	
Liability to foreigners		Cr.

(for the notional reinvestment of earnings and the resultant increase in the amount of foreign currency held).

BALANCE OF PAYMENTS ACCOUNT – THE INDIAN PERSPECTIVE

The Indian BoP broadly follows the principles laid down by the IMF manual for preparation of the statement. The concepts of 'economic transaction' and 'resident', as well as the principle of 'double-entry system' are adopted totally in accordance with the recommendations of the manual. The Income Tax Act and the Foreign Exchange Regulation Act give different definitions of the term 'resident'. However, for BoP purposes, the definition given in the IMF manual is followed.

There is a little deviation from the manual's suggestions on valuation of transactions. In India's BoP statement, the principle of recording transactions at market price is not always applied because of the practical difficulties involved. For example, if a company pays for some machinery or for technical know-how by allotting shares to the seller, ascertaining the market value of the transaction becomes difficult. Similarly, if a company buys from or sells to its subsidiary operating in another country, it becomes difficult to find out whether the price at which the transfer has taken place, reflects the market value or not. All transactions other than merchandise trade are recorded in the Indian BoP at the actual price paid through the banking channel. In these circumstances, transactions might not get recorded at their actual market value. The second significant deviation from the principles of valuation is that while exports are recorded at their f.o.b. value, imports are recorded in the Indian BoP statement at the c.i.f. value (i.e., cost, insurance and freight value). When the insurance and shipment costs are borne by the Indian importer, they are included in the cost of goods imported. Also, the transactions denominated in foreign currencies are converted into Indian rupees on the basis of the average exchange rate for that month, instead of the exchange rate applicable to the specific transactions.

The recommendations of the IMF manual regarding timing of the transactions being recorded are followed totally for capital account transactions, transportation and insurance services, transfer payments and for undistributed income. For other transactions, the conventions differ. Exports are recorded when the customs authorities clear them for shipment and imports are recorded when they are paid for. Due to this method of recording imports, they fail to get fully reflected in the period in which they occur, for which the Indian importer obtains trade credit from the foreign supplier. Services other than transport and insurance are recorded when the payment takes place. Similarly, interest and dividends are recorded when they are actually paid, not when they are due.

Table 2 below shows the BoP statement of India for the years 2004-05 to 2006-07.

Table 2: India's Overall Balance of Payments

Item	Rupees Crore			US $ Million		
	2004-05	2005-06 PR	2006-07 P	2004-05	2005-06 PR	2006-07 P
1	2	3	4	5	6	7
A. **Current Account**						
1. Exports, f.o.b.	3,81,785	4,65,705	5,74,917	85,206	1,05,152	1,27,090
2. Imports, c.i.f.	5,33,550	6,95,131	8,68,675	1,18,908	1,56,993	1,91,995
3. Trade Balance	–1,51,765	–2,29,426	–2,93,758	–33,702	–51,841	–64,905
4. Invisibles, Net	1,39,591	1,88,704	2,49,435	31,232	42,655	55,296
a. Non-Factor Services of which:	68,831	1,05,619	1,47,804	15,426	23,881	32,727
Software Services	75,825	98,678	1,30,090	16,900	22,262	28,798
b. Income	–22,375	–24,588	–21,991	–4,979	–5,510	–4,846
c. Private Transfers	91,971	1,06,860	1,22,635	20,525	24,102	27,195
d. Official Transfers	1,164	813	987	260	182	220
5. Current Account Balance	–12,174	–40,722	–44,323	–2,470	–9,186	–9,609
B. **Capital Account**						
1. Foreign Investment, Net (a + b)	58,057	76,319	70,083	13,000	17,224	15,499
a. Direct Investment of which:	16,745	20,962	38,193	3,713	4,730	8,437
i. In India	26,947	33,967	87,725	5,987	7,661	19,442
Equity	16,741	25,549	72,077	3,714	5,759	15,976
Reinvested Earnings	8,555	7,420	13,284	1,904	1,676	2,936
Other Capital	1,651	998	2,364	369	226	530
ii. Abroad	–10,202	–13,005	–49,532	–2,274	–2,931	–11,005
Equity	–7,359	–8,169	–42,259	–1,637	–1,841	–9,398
Reinvested Earnings	–1,114	–1,612	–3,331	–248	–364	–736
Other Capital	–1,729	–3,224	–3,942	–389	–726	–871
b. Portfolio Investment	41,312	55,357	31,890	9,287	12,494	7,062
In India	41,419	55,357	31,630	9,311	12,494	7,004
Abroad	–107	0	260	–24	0	58
2. External Assistance, Net	8,525	7,505	7,951	1,923	1,682	1,770
Disbursements	16,988	16,116	16,805	3,809	3,627	3,728
Amortization	8,463	8,611	8,854	1,886	1,945	1,958
3. Commercial Borrowings, Net	23,113	11,462	72,207	5,194	2,723	16,084
Disbursements	40,679	64,387	95,675	9,084	14,547	21,291
Amortization	17,566	52,925	23,468	3,890	11,824	5,207

	4. Short term Credit, Net	16,957	7,591	14,835	3,792	1,708	3,275
	5. Banking Capital						
	of which:	17,040	5,795	9,193	3,874	1,373	2,087
	NRI Deposits, Net	–4,439	12,457	17,641	–964	2,789	3,895
	6. Rupee Debt Service	–1,858	–2,557	–725	–417	–572	–162
	7. Other Capital, Net @	3,533	–3,146	28,691	656	–738	6,391
	8. Total Capital Account	1,25,367	1,02,969	2,02,235	28,022	23,400	44,944
C.	Errors & Omissions	2,714	3,649	5,722	607	838	1,271
D.	Overall Balance (A(5)+B(8)+C)	1,15,907	65,896	1,63,634	26,159	15,052	36,606
E.	Monetary Movements (F + G)	–1,15,907	–65,896	–1,63,634	–26,159	–15,052	–36,606
F.	I.M.F., Net	0	0	0	0	0	0
G.	Reserves and Monetary Gold (Increase – /Decrease +)	–1,15,907	–65,896	–1,63,634	–26,159	–15,052	–36,606

PR : Partially Revised.

P : Provisional.

@ : Includes delayed export receipts, advance payments against imports.

Note: 1. Gold and silver brought by returning Indians have been included under imports, with a contra entry in private transfer receipts.

2. Data on exports and imports differ from those given by DGCI & S on account of differences in coverage, valuation and timing.

In India, foreign exchange transactions are regulated by the provisions of the Foreign Exchange Regulation Act (FERA). According to this Act, only authorized dealers are permitted to deal in foreign exchange and no one is permitted to buy or sell any currency except through the authorized dealers.

Box: BoP comfortable, FII data shows bullish trend this year

The country's balance of payments position has remained comfortable during 2007-08, the Reserve Bank of India (RBI), in its document, "Macroeconomic and Monetary Developments: Mid-Term Review 2007-08", said on Monday. The current account deficit was financed by capital flows, which have remained large during 2007-08 so far.

Gross fiscal deficit, as proportion of the budget estimates, was placed higher than a year ago. Revenue deficit, after adjusting the profit on sale of RBI's stake in SBI, was 122.9% of the full year budget estimates.

Tax revenue remained buoyant, rising by 22% over that during April-August 2006. Non-tax revenue (net of profit on RBI stake in SBI) registered a growth of 21.2% during the same period. During 2007-08, upto October 19, 2007, net inflows by Foreign Institutional Investors (FIIs) amounted to $21.2 billion as compared to outflows of $933 million in the corresponding period of 2006-07. Foreign Direct Investments (FDI) inflows were $6.6 billion during April-July 2007 as against $3.7 billion, a year ago. On the other hand, non-resident Indian deposits registered net outflows amounting to $148 million during April-July 2007 as against net inflows of $1.6 billion during April-July 2006.

However, merchandise trade deficit, on balance of payments basis, increased from $16.9 billion in April-June 2006 to $21.6 billion in April-June 2007. Net surplus on the invisibles account exhibited buoyancy during the first quarter of 2007-08, led by exports of software, business services and private remittances, and continued to finance 78.2% of the merchandise trade deficit.

Despite large merchandise trade deficit, higher net invisible surplus contained the current account deficit ($4.7 billion) during the first quarter of 2007-08 at broadly the same level ($4.6 billion) as in the first quarter of 2006-07.

During 2007-08 so far (April-August), growth of merchandise exports moderated, while imports posted a high growth rate. Non-oil imports registered a high growth due to robust growth in capital goods. Oil imports registered a sharp deceleration from the strong growth recorded during the corresponding period of the previous year.

Source: The Indian Express, October 30, 2007.

Limitations of Balance of Payments

Though BoP statistics are very helpful in predicting movements in the exchange rates, they are more useful for estimating general trends rather than the specific levels at which the exchange rates would stabilize. Besides, care has to be taken while interpreting BoP data. All the different balances (current account balance, capital account balance and overall balance) should be considered, along with the actual and expected trends in these balances and the expected developments in the international scene. The BoP data for one country can only give an idea as to whether that country's currency is likely to increase or decline in value. It would not help in predicting the currency's movement with respect to a particular currency. That movement can be estimated only if the BoP data for both the countries are studied together.

SUMMARY

- The BoP account records various transactions like exports/imports of goods and services, payment of dividend/interest, investments in assets, etc. These transactions are broadly classified into current account and capital account.
- The BoP account is compiled using various sources of information. The most important source is the R-Returns which the authorized dealers are required to submit to the RBI every fortnight.
- The BoP data helps in analyzing whether a particular course of action is likely to be helpful or not in eliminating or reducing a current account deficit. At the same time, BoP data cannot be considered in isolation for predicting a movement in the exchange rates.
- The BoP data for one country can only give an idea as to whether that country's currency is likely to increase or decline in value. It would not help in predicting the currency's movement with respect to a particular currency.

Annexure I

Balance of Payments: Standard Components

	Credit	Debit
1. Current Account		
A. Goods and services		
a. Goods		
1. General merchandise		
2. Goods for processing		
3. Repairs on goods		
4. Goods procured in ports by carriers		
5. Non-monetary gold		
5.1 Held as a store of value		
5.2 Other		
b. Services		
1. Transportation		
1.1 Sea transport		
1.1.1 Passenger		
1.1.2 Freight		
1.1.3 Other		
1.2 Air transport		
1.2.1 Passenger		
1.2.2 Freight		
1.2.3 Other		
1.3 Other transport		
1.3.1 Passenger		
1.3.2 Freight		
1.3.3 Other		
2. Travel		
2.1 Business		
2.2 Personal*		
3. Communication services		
4. Construction services		
5. Insurance services**		
6. Financial services		
7. Computer and information services		
8. Royalties and license fees		
9. Other business services		
9.1 Merchanting and other trade-related services		
9.2 Operational leasing services		
9.3 Miscellaneous business, professional, and technical services*		

* See Selected Supplementary Information table on page 50 for components.

** Memorandum items: 5.1 Gross premiums
5.2 Gross claims

10. Personal, cultural, and recreational services
    10.1 Audiovisual and related services
    10.2 Other personal, cultural, and recreational services
11. Government services n.i.e.

B. Income
1. Compensation of employees
2. Investment income
    2.1 Direct investment
        2.1.1 Income on equity
            2.1.1.1 Dividends and distributed branch profits***
            2.1.1.2 Reinvested earnings and undistributed branch profits***
        2.1.2 Income on debt (interest)
    2.2 Portfolio investment
        2.2.1 Income on equity (dividends)
        2.2.2 Income on debt (interest)
            2.2.2.1 Bonds and notes
            2.2.2.2 Money market instruments and financial derivatives
    2.3 Other investment

C. Current transfers
1. General government
2. Other sectors
    2.1 Workers' remittances
    2.2 Other transfers

2. Capital and Financial Account
A. Capital account
1. Capital transfers
    1.1 General government
        1.1.1 Debt forgiveness
        1.1.2 Other
    1.2 Other sectors
        1.2.1 Migrants' transfers
        1.2.2 Debt forgiveness
        1.2.3 Other
2. Acquisition/disposal of nonproduced, nonfinancial assets

B. Financial account
1. Direct investment

*** If distributed branch profits are not identified, all branch profits are considered to be distributed.
*** If distributed branch profits are not identified, all branch profits are considered to be distributed.

- 1.1 Abroad
  - 1.1.1 Equity capital
    - 1.1.1.1 Claims on affiliated enterprises
    - 1.1.1.2 Liabilities to affiliated enterprises
  - 1.1.2 Reinvested earnings
  - 1.1.3 Other capital
    - 1.1.3.1 Claims on affiliated enterprises
    - 1.1.3.2 Liabilities to affiliated enterprises
- 1.2 In reporting economy
  - 1.2.1 Equity capital
    - 1.2.1.1 Claims on direct investors
    - 1.2.1.2 Liabilities to direct investors
  - 1.2.2 Reinvested earnings
  - 1.2.3 Other capital
    - 1.2.3.1 Claims on direct investors
    - 1.2.3.2 Liabilities to direct investors

2. Portfolio investment
   - 2.1 Assets
     - 2.1.1 Equity securities
       - 2.1.1.1 Monetary authorities
       - 2.1.1.2 General government
       - 2.1.1.3 Banks
       - 2.1.1.4 Other sectors
     - 2.1.2 Debt securities
       - 2.1.2.1 Bonds and notes
         - 2.1.2.1.1 Monetary authorities
         - 2.1.2.1.2 General government
         - 2.1.2.1.3 Banks
         - 2.1.2.1.4 Other sectors
       - 2.1.2.2 Money market instruments
         - 2.1.2.2.1 Monetary authorities
         - 2.1.2.2.2 General government
         - 2.1.2.2.3 Banks
         - 2.1.2.2.4 Other sectors
       - 2.1.2.3 Financial derivatives
         - 2.1.2.3.1 Monetary authorities
         - 2.1.2.3.2 General government
         - 2.1.2.3.3 Banks
         - 2.1.2.3.4 Other sectors
   - 2.2 Liabilities
     - 2.2.1 Equity securities
       - 2.2.1.1 Banks
       - 2.2.1.2 Other sectors

2.2.2 Debt securities
2.2.2.1 Bonds and notes
2.2.2.1.1 Monetary authorities
2.2.2.1.2 General government
2.2.2.1.3 Banks
2.2.2.1.4 Other sectors
2.2.2.2 Money market instruments
2.2.2.2.1 Monetary authorities
2.2.2.2.2 General government
2.2.2.2.3 Banks
2.2.2.2.4 Other sectors
2.2.2.3 Financial derivatives
2.2.2.3.1 Banks
2.2.2.3.2 Other sectors

3. Other investment
3.1 Assets
3.1.1 Trade credits
3.1.1.1 General government
3.1.1.1.1 Long-term
3.1.1.1.2 Short-term
3.1.1.2 Other sectors
3.1.1.2.1 Long-term
3.1.1.2.2 Short-term
3.1.2 Loans
3.1.2.1 Monetary authorities
3.1.2.1.1 Long-term
3.1.2.1.2 Short-term
3.1.2.2 General government
3.1.2.2.1 Long-term
3.1.2.2.2 Short-term
3.1.2.3 Banks
3.1.2.3.1 Long-term
3.1.2.3.2 Short -term
3.1.2.4 Other sectors
3.1.2.4.1 Long-term
3.1.2.4.2 Short-term
3.1.3 Currency and deposits
3.1.3.1 Monetary authorities
3.1.3.2 General government
3.1.3.3 Banks
3.1.3.4 Other sectors
3.1.4 Other assets
3.1.4.1 Monetary authorities

3.1.4.1.1 Long-term
3.1.4.1.2 Short-term
3.1.4.2 General government
3.1.4.2.1 Long-term
3.1.4.2.2 Short-term
3.1.4.3 Banks
3.1.4.3.1 Long-term
3.1.4.3.2 Short-term
3.1.4.4 Other sectors
3.1.4.4.1 Long-term
3.1.4.4.2 Short-term

3.2 Liabilities
3.2.1 Trade credits
3.2.1.1 General government
3.2.1.1.1 Long-term
3.2.1.1.2 Short-term
3.2.1.2 Other sectors
3.2.1.2.1 Long-term
3.2.1.2.2 Short-term
3.2.2 Loans
3.2.2.1 Monetary authorities
3.2.2.1.1 Use of Fund credit and loans from the Fund
3.2.2.1.2 Other long-term
3.2.2.1.3 Short-term
3.2.2.2 General government
3.2.2.2.1 Long-term
3.2.2.2.2 Short-term
3.2.2.3 Banks
3.2.2.3.1 Long-term
3.2.2.3.2 Short-term
3.2.2.4 Other sectors
3.2.2.4.1 Long-term
3.2.2.4.2 Short-term
3.2.3 Currency and deposits
3.2.3.1 Monetary authorities
3.2.3.2 Banks
3.2.4 Other liabilities
3.2.4.1 Monetary authorities
3.2.4.1.1 Long-term
3.2.4.1.2 Short-term
3.2.4.2 General government
3.2.4.2.1 Long-term

3.2.4.2.2 Short-term
3.2.4.3 Banks
3.2.4.3.1 Long-term
3.2.4.3.2 Short-term
3.2.4.4 Other sectors
3.2.4.4.1 Long-term
3.2.4.4.2 Short-term

4. Reserve assets
   - 4.1 Monetary gold
   - 4.2 Special drawing rights
   - 4.3 Reserve position in the Fund
   - 4.4 Foreign exchange
     - 4.4.1 Currency and deposits
       - 4.4.1.1 With monetary authorities
       - 4.4.1.2 With banks
     - 4.4.2 Securities
       - 4.4.2.1 Equities
       - 4.4.2.2 Bonds and notes
       - 4.4.2.3 Money market instruments and financial derivatives
   - 4.5 Other claims

Chapter V

The Foreign Exchange Market

After reading this chapter, you will be conversant with:

- Structure of Forex Market
- Exchange Rate Quotations
- Types of Foreign Exchange Transactions
- Settlement Dates
- Quotes for various Kinds of Merchant Transactions
- Indian Forex Markets
- Convertibility
- FERA Vs. FEMA
- FEDAI Rules Regarding Interbank Dealings
- Forex Dealing Room Operations
- Trading Mechanism

The existence of a number of currencies gives rise to the need to transact in these currencies for settling international payments. As we know, in international transactions, at least one of the parties would be dealing in a foreign currency. For example, if an Indian exporter sells some goods to an American resident and the price of the goods is denominated in dollars, the exporter would be dealing in US Dollars. Similarly, if an Italian resident makes an investment in the German money market, he would need to deal in the German mark (now Euro) which would be a foreign currency to him. Sometimes, the currency in which the transaction is denominated may be a foreign currency to both the parties involved. For example, if a resident of Australia buys a car from a resident of Spain and the transaction is denominated in US dollars, both the parties will be dealing in a foreign currency. As it happens for other commodities, it would be difficult for buyers and sellers of currencies to find each other. This resulted in the development of a market which deals specifically in currencies, called the foreign exchange market. This is an OTC (Over-The-Counter) market, i.e., there is no physical marketplace where the deals are made. Instead, it is a network of banks, brokers and dealers spread across the various financial centers of the world. These players trade in different currencies through (and are linked to each other by) telephones, faxes, computers and other electronic networks like the SWIFT system (Society for Worldwide Interbank Financial Telecommunications). These traders generally operate through a trading room. The deals are mostly done on an oral basis, with written confirmations following later. In this chapter, the settlement of these payments will be discussed.

STRUCTURE OF FOREX MARKET

The main players in the foreign exchange market are large commercial banks, forex brokers, large corporations and the central banks. Central banks normally enter the market to smoothen out fluctuations in the exchange rate (as under dirty float) or to maintain fixed exchange rates.

Large commercial banks deal in the market both for executing their clients' (both corporates and individuals) orders and on their own account. They act as the market makers in the forex markets, i.e, they stand ready to buy or sell various currencies at specific prices at all points of time. The commercial banks give, on demand, a quote for a particular currency against another currency; i.e., the rate at which they are ready to buy or sell the former against the latter. At these rates, they stand ready to take any side of the transaction (buy or sell) that the customer chooses. The maximum and the minimum amount of the currencies acceptable to the bank at these rates, though not specified at the time of making the quote, are generally understood according to the conventions of the market. These rates may not necessarily be applicable to amounts smaller or larger than those acceptable according to the existing conventions. In the forex markets, there are numerous market makers, and all of them would be giving different quotes for the same pair of currencies simultaneously, at any point of time. It would be very difficult for a player to keep track of all the quotes available in the market, and hence choose the one which is considered the most favorable. As a result, a number of trades may be taking place simultaneously at different exchange rates. The market-making activity of the commercial banks, along with speculation, makes markets extremely liquid, especially for the major currencies of the world.

The foreign exchange brokers do not actually buy or sell any currency. They do the work of bringing buyers and sellers together. Though they deal in most of the major currencies, generally they specialize in a pair of currencies and hold exhaustive information about it. Other players in the market, specially the commercial banks, approach the brokers for information about the quotes of other commercial banks. The brokers serve three important purposes in the forex markets. First is, that instead of hunting around in the market for quotes, one can approach a broker and find out these prices. Second is, that brokers help the prospective buyer or seller keep his identity secret till the deal is struck. This

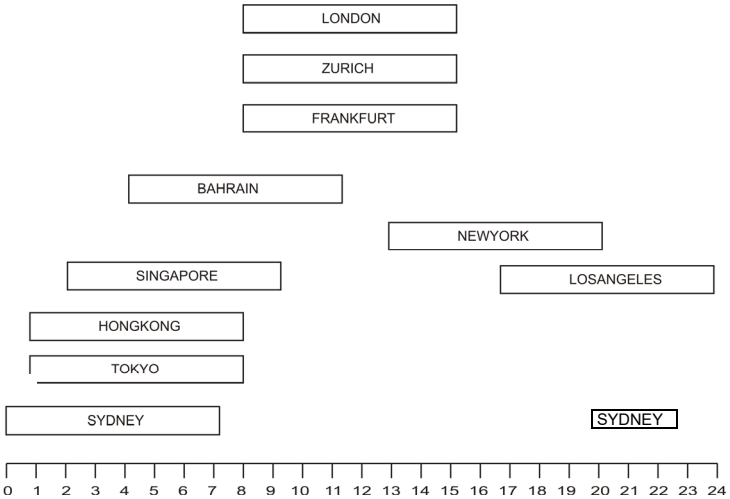
prevents the quote from being affected by the inquirer's position, i.e., whether he needs to buy or to sell. Lastly, even when there is no buying or selling requirement, commercial banks can keep their quotes from going too far away from the quotes being given by other banks, by inquiring about the market quotes from the brokers.

While small corporations generally approach the commercial banks for their needs, larger corporations sometimes operate in the market on their own. They generally deal in the market to satisfy their needs arising out of their normal business operations. Yet, some big multinational companies also operate in the market to bet on the movement of the exchange rates, in an attempt to make profits out of their expertise in dealing in the market.

The market in which the commercial banks deal with their customers (both individuals and corporates) is called the retail market, while that in which the banks deal with each other is called the wholesale or the interbank market. The size of the deals in the retail market is much smaller than those in the interbank market.

The world-wide forex market is a 24-hour market, i.e., it is open virtually all of the 24-hours of a day, in at least one of the financial markets of the world. When the New York market closes at 3 p.m., the Los Angeles market remains open as the corresponding time there is 12 p.m. When the Los Angeles market closes, it is opening time at Sydney and Tokyo. When Tokyo closes, the HongKong market is still open as it would be only 2 p.m. there. At the time of the HongKong market closing, the Singapore market can be accessed, it being only 1 p.m. there. Before the closing of the Singapore market, the Bahrain market opens. The closing time of the Bahrain market finds both Frankfurt and Zurich markets open, it being only 12 p.m. there. London being one hour behind these two, it remains open even after these two markets close down. Again, before the London market closes down, it is opening time at New York. Out of these markets, London, New York and Tokyo markets are the biggest ones. The effect of the market being open 24 hours a day, is that the impact of any relevant event is immediately reflected on the exchange rates. Besides, it provides the facility of buying or selling a currency at any time of the day, even if the local market has closed down for the day. Figure 1 depicts the opening and closing times of these markets with respect to the G.M.T.

Figure 1: Working Hours of the Various Financial Markets with respect to the GTM



Source: Icfai Research Team.

In these markets, there are a few services which report the quotes given by various players on an on-line basis. Reuters, Knightrider and the Telerate are a few of such services. Some of these services now even offer screen-based trading, i.e., the quotes are automatically matched by the system and the order executed. In 1981, Reuters launched the first conversational dealing system, Reuters Monitor Dealing Service

(RMDS). A conversational dealing system allows dealers to communicate trading requirements and simultaneously send messages on screen to a number of other dealers. In 1988, it launched Triarch 2000, a digital financial trading room system. RMDS was replaced by Reuters with an upgraded version called Dealing 2000-01 in 1989. This version allows conversations with up to four banks at the same time, instead of just one, and the response time is also quicker than that of RMDS. 2000-01 also displays the details of a concluded trade by means of an on-screen 'trading ticket'. Telerate and Quotron have also launched such conversational dealing systems. In April 1992, Reuters launched the first electronic broking system called Dealing 2000-02. Quotron and Telerate also developed similar systems called Electronic Broking System (EBS) and Minex System respectively.

The settlement of trades is completed by transfer of deposits denominated in relevant currencies between the parties involved. In the interbank market, it is normally done electronically. For example, if the Deutsche Bank sells dollars to the ICICI Bank in exchange for French Francs, the nostro account of the Deutsche Bank with a bank in the US will be debited and that of ICICI Bank will be credited with the amount of the US dollars. At the same time, the nostro account of ICICI Bank with a bank in France will be debited and that of Deutsche Bank will be credited with the amount of the French Francs. (Nostro account is the overseas account held by a domestic bank with a foreign bank or with its own foreign branch, in that foreign country's currency. The same account is called a vostro account from the holding bank's point of view. For example, a dollar account held by the State Bank of India with the Bank of America in New York will be SBI's nostro account and a vostro account from the Bank of America's point of view.) A currency's settlement always takes place in the country of origin of the currency. For example, in the US, the Clearing House Interbank Payments System (CHIPS) is used for the settlement of dollar transactions.

Though the exchange rate between any two currencies is determined by the overall equilibrium between their demand and supply, it is also true that there is no single equilibrium market price for a currency. Each trader tries to keep his quote at that level where his own position would be in equilibrium. A trader normally keeps a margin between the price at which he buys a currency and that at which he sells it. Thus, if the trader is able to match a purchase of a currency with a corresponding sale, he would be able to make a profit. In reality, however, it is very difficult to find matching orders of sufficient volumes for the trader to realize a substantial profit. At any point of time, the trader may find that he is selling more of a currency than he is buying, or vice-versa. This would result in the trader having a position in a currency, which exposes him to currency risk (risk of future prices moving against him). To avoid such net positions, the trader would have to frequently change his quote (in order to attract desired orders) so that his exposure would be minimized. In forex trading, minimizing the net positions alone is not enough. Since a trader's margins are very thin, volumes of trade become very important. A trader may find that though he is able to balance the buy and sell positions, the volume of trade coming his way is very low due to competitive prices quoted by other traders. A very low volume would result in miniscule profits. Hence, the trader has to make sure that his quote always remains competitive.

The world over, about 85% of forex trading arises as a result of transactions between market makers and speculative transactions, with only 15% of the transactions being trade or commerce related. This results in the expectations and the actions of these two groups having an overwhelming impact on the values of various currencies, at least in the short-term. On the other hand, the presence of the activities of these two groups is essential for liquidity in the market. Competition between various market makers also ensures that the divergence in the market makers' quotes is not too large. Speculation in the forex markets is essentially a zero-sum game if it is considered an activity only among speculators. The gain of one speculator must be the loss of another. Therefore, at least theoretically market makers taken together cannot make profits or incur losses. In reality, however, the presence of hedgers and the interventions resorted to by the central banks of various countries result in net speculative gains or losses.

In India, all dealings in foreign exchange are regulated by the Foreign Exchange Management Act, 1999 (FEMA). Reserve Bank of India is the regulatory authority for the Act. According to FEMA, only those entities can deal in foreign exchange, which are authorized to do so by RBI. The Act provides for entities to be authorized either as authorized dealers or as money changers. Authorized dealers are generally commercial banks and form a large part of the interbank market in India. Money changers can be either full-fledged money changers or restricted money changers. While the former are authorized to both buy and sell foreign currency from their customers, the latter can only buy the same. Money changers are allowed to deal only in notes, coins and travelers' cheques. The authorized dealers, on the other hand, are allowed to deal in all the items classified as foreign exchange by FERA. Thus, they are permitted to deal with all documents relating to exports and imports. The authorized dealers have to operate within the rules, regulations and guidelines issued by the Foreign Exchange Dealers' Association of India (FEDAI) from time to time. The offices/branches of Authorized Dealers (ADs) are classified into three categories. These categories are:

Category A: These are the offices/branches which keep independent foreign currency accounts with overseas correspondent banks/branches in their own names.

Category B: These are the branches which do not maintain independent foreign currency accounts, but have powers to operate the accounts maintained abroad by their head office or the branches categorized as 'A'.

Category C: The branches which fall in neither of the above categories and yet handle forex business through a Category A or B branch, fall under Category C.

The Indian foreign exchange market consists of three tiers. The first tier consists of all the transactions between the authorized dealers and the RBI. The second tier is the interbank market referred to earlier, i.e., the market in which the authorized dealers deal with one another. Money changers are required to offset their positions created by dealing with their customers, in this interbank market. The third tier is the retail segment, where authorized dealers and money changers deal with their customers.

Foreign Exchange

Foreign exchange is defined in terms of Sec. 2 of FEMA, 1999 as foreign currency including:

i. All deposits, credits, balances payable in any foreign currency.

ii. Any drafts, travelers' cheques, letters of credit and bills of exchange expressed or drawn in Indian currency and payable in foreign currency.

iii. Any instrument giving anyone the option of making it payable either partly or fully in a foreign currency.

Here, the term currency in 'foreign currency' includes coins, bank notes, postal notes, postal orders and money orders.

In other words, foreign exchange includes all kinds of claims of the residents of a country to foreign currency payable abroad.

EXCHANGE RATE QUOTATIONS

An exchange rate quotation is the price of a currency stated in terms of another. It is similar to the expression of the price of a commodity. Yet, there is a peculiarity attached to exchange rate quotes. In case of a commodity, there is only one way to express its price – as number of units of money needed to buy one unit of the commodity. For example, it is always Rs.10 per kg. of potatoes, never 100gm. of potatoes per rupee. In case of an exchange rate quotation, both the items involved are a form of money, i.e., both are currencies. So, the price of any one of them can be quoted in terms of one unit of the other. Due to this, there exist a number of

ways to express the exchange rate between a pair of currencies. The various reporting agencies use the following quotes:

Table 1: Cross Currency Rates

Country	INR	USD	AUD	GBP	CAD	JPY	SGD	CHF	AED	EUR
India	-	0.0253	2.846	0.0122	0.0251	2.7981	0.0365	0.0283	-	0.0171
US	39.61	-	1.1265	0.484	0.9952	110.755	1.4457	1.1204	3.6556	0.6773
Australia	35.1372	0.08877	-	0.4296	0.8834	98.3128	1.2832	0.9944	3.2451	0.6012
Britain	81.7794	2.0659	2.3277	-	2.0561	228.836	2.9866	2.3147	7.5527	1.3993
Canada	39.7774	1.0049	1.132	0.4863	-	111.291	1.4526	1.1259	-	6806
Japan	0.3574	0.9029	1.0171	0.437	0.8985	-	1.3051	1.0116	3.3005	0.6115
Singapore	27.3851	0.6919	0.7793	0.3348	0.6884	76.6293	-	0.775	-	0.4685
Switzerland	35.3289	0.8925	1.0056	0.432	0.8882	98.854	1.2902	-	3.2626	0.6046
UAE	10.8278	0.2735	0.3082	-	-	30.2987	0.3954	-	-	0.1853
Euro	58.4396	1.4764	1.6633	0.7146	1.4693	163.53	N/A	1.6542	5.3975	-

Source: The Economic Times, 01/12/2007.

It can be noticed that various methods of expressing exchange rates have been used. Throughout this book (unless otherwise specified), exchange rates will be mentioned in terms of A/B, where currency B is being bought or sold, with its value being expressed in terms of currency A. In such a quote, currency B is referred to as the base currency.

Various kinds of quotes are described in the following sections:

American vs. European Quote

A quote can be classified as European or American only if one of the currencies is the dollar. An American quote is the number of dollars expressed per unit of any other currency, while a European quote is the number of units of any other currency expressed per dollar. For example, Rs.48.28/$ is a European quote, while $1.6698/£ is an American quote. In almost all the countries, most of the exchange rates are quoted in European terms. The British pound, the Irish pound and the South African rand are a few examples of currencies quoted in American terms.

Box 1: Direct vs. Indirect Quote

A direct quote is the quote where the exchange rate is expressed in terms of number of units of the domestic currency per unit of foreign currency. An indirect quote is where the exchange rate is expressed in terms of number of units of the foreign currency for a fixed number of units of the domestic currency. An example of an indirect quote would be:

$/100 Rs.: 2.1978/98

Here, the bank would be buying dollars @ $2.1998/Rs.100 and selling dollars @ $2.1978/Rs.100.

The corresponding direct quote would be:

Rs./$: 45.4586/45.5000

Here, the bank would be buying dollars @ Rs.45.4586/$ and selling dollars @ Rs.45.5000/$.

Before August 2, 1993, the indirect methods of quoting exchange rates used to be followed in India. Since that date, however, the direct quote is being used.

In other countries, the concepts of American and European quotes are more popular in comparison to direct and indirect quotes.

Source: Icfai Research Team.

BID AND ASK RATE

In the quotes given above, there was one single rate at which the currencies were being bought and sold. For example, the rupee-dollar exchange rate was given as Rs./$ 45.50. In reality, the rate at which a bank is ready to buy a currency will be different from the rate at which it stands ready to sell that currency. These rates are called the bid and the ask rates respectively. The difference in these rates represents the cost the bank incurs in these transactions, a small return on the

capital employed, and the compensation for the risk it takes. This risk arises on account of the possibility of the exchange rate moving in an unfavorable direction before the bank is able to offset the transaction. The single rate mentioned above is generally the mid-rate, i.e., the arithmetic mean of the bid and the ask rates. The difference between the bid rate and the ask rate is called the bid-ask spread, or simply the spread. This spread is seen to be higher in the retail market than in the interbank market. This is because of the higher volumes and greater liquidity in the interbank market (lower the liquidity, higher the risk of the transaction being set off at a disadvantageous rate, and hence, higher the spread). An additional reason is that the counter-party risk (the risk of the other party not fulfilling its commitment) is lower in the interbank market since most of the players are large commercial banks. As this bid-ask spread arises due to the presence of transaction costs, the absence of these costs would result in a single rate being quoted by banks for both buying and selling the currency.

Before we go into the explanations for the bid and the ask rates, it will be useful to look at some important conventions regarding these quotes. These are:

a. The bid rate always precedes the ask rate. Hence, in the quote Rs./$: 39.435/39.51, 39.435 is the bid rate while 39.51 is the ask rate.

b. The bid and the ask rate are separated by either a slash (/) or a dash sign (–).

c. The quote is always from the banker's point of view. That is, the banker is ready to buy dollars at Rs.39.435 per dollar and sell at Rs.39.51 per dollar. A banker's buy rate is the rate at which the customer can sell a currency and vice-versa. So, if a customer wishes to sell dollars, it will have to sell them at the bank's buying rate of Rs.39.435 per dollar.

Let us understand these rates with the help of an example. Let the exchange rate of the Indian rupee with the US dollar be:

Rs./$: 39.435/39.51

Here the US dollar (currency B) is being bought and sold, with its price quoted in terms of the Indian rupee (currency A). In this quote, bid rate is the rate at which the bank is ready to buy one dollar, which is the first term from the left, i.e., Rs.39.435. In other words, it is the number of rupees that a bank is ready to pay in exchange for one dollar. The bank is bidding for the dollar at this rate. The ask rate is the rate at which the bank stands ready to sell one dollar in exchange for rupees. It is the number of rupees, the bank is ready to accept for, or is asking for selling a dollar. This rate is Rs.39.51. The bid rate is always lower than the ask rate. This is because the bank will be ready to pay less for a unit of currency than it receives, in order to make a profit.

Interbank Quote vs. Merchant Quote

Merchant quote is the quote given by a bank to its retail customers. On the other hand, a quote given by one bank to another (or to any other customer in the interbank market) is called an interbank quote. It has been mentioned that a quote is invariably the banker's quote. The question that arises is that since both the parties involved in the interbank market are banks, whose quote will it be taken as. The convention is that the bank requesting the quote is the customer and the quote will be taken as that of the bank giving the quote, i.e., the one which is acting as the market-maker.

MARKET MECHANISM AND CONVENTIONS

Let us now see how deals are struck in the interbank market. Suppose a bank requires £1,000,000. The dealer of the bank approaches another bank and asks for a quote in the sterling, without mentioning whether he wants to buy or sell. The market-making bank gives him a two-way quote (i.e., both the bid and ask rates for sterling). If the ask rate for the pound is acceptable to the banker, he says – "One mine" – implying that he has bought £1,000,000. The trade will enter the books of both the banks and written confirmations of the trade would be sent later. The

settlement of the trade will take place through any of the available electronic money transfer systems (like CHIPS). Suppose the bank wanted to sell pounds and found the quoting bank's bid rate acceptable, it would instead have said – "One yours" – implying that it has sold £1,000,000 to the market-making bank.

While giving a two-way quote, the bank keeps the bid rate and ask rate at such levels which both buyers and sellers of the relevant currency are likely to find attractive, and hence the bank expects to receive both buy and sell orders from the market. If the bank is getting orders for only one side of the transaction, it would mean either of two things – either the rates quoted by the bank are out of alignment with the rates being quoted by other players in the market, or there is too much buying or selling pressure in the market for that particular currency. In either of the cases, the bank would have to adjust its quote. Let us take the scenario where the bank is ending up getting only buy orders for a particular currency (i.e., the bank is only buying the currency), without being able to sell. It would mean that the market is getting a competitive rate for selling the currency to the bank, but the bank's selling rate is too high to attract buyers. On the other hand, it could also mean that there are too many sellers in the market. In both the cases, the bank will have to reduce its rates on both the buy and sell side. The lower bid rate will attract a fewer number of sellers, while the lower ask rate would encourage customers to buy from the bank. In case the bank is getting too many orders to sell currency to customers, it would have to increase both the bid and the ask rates, in order to attract more customers interested in selling the currency and fewer interested in buying it.

The quotes are generally given in the market as : Rs./$: 39.435/30.510

It is also a practice to state the same quote as : Rs./$: 30.435/510

With 510 representing the last three digits of the ask rate, the rest of the digits being common with the bid rate.

Since the dealers in currencies would anyway be aware of the going rate, the big figures are not specified. In the interbank market, the quote is generally further shortened to:

Rs./$: 435/510

There are a few currencies which are quoted in 100s rather than 1s or 2s. The reason is that their value is too small to be quoted otherwise. An example is the Japanese yen. Its quote generally looks like:

¥/$: 117.21/23

When the quote is given with such currencies as the base currency, the quote is for 100 units of the currency rather than one unit. For example, the corresponding $/¥ quote will be:

$/100¥: 0.8536/38

The last after-decimal digit of a quote is known as a point and the last two as a $/¥.

The quotes given by different banks for the same pair of currencies may not necessarily be the same, but they have to be within certain limits to prevent arbitrage. Let us see an example to understand these limits. Suppose there are two banks A and B. Their quotes for the Euro/$ rates are:

A – Euro/$: 1.4118/1.4121

B – Euro/$: 1.4113/1.4114

As A's bid rate is greater than B's ask rate, there is a risk-free arbitrage opportunity available. (Arbitrage is the process of buying and selling the same asset at the same time, to profit from price discrepancies within a market or across different markets. When it does not involve any commitment of capital or the taking on of risk, it is referred to as risk-free arbitrage). Dollars can be bought from B at Euro 1.4114/$ and sold to A at Euro 1.4118/$, thus making a gain of Euro 0.0004 per dollar. Thus, any bank's bid rate has to be lower than other banks'

ask rate, and its ask rate greater than other banks' bid rate. Sometimes, banks deliberately maintain their rates out of alignment with the rest of the market, because they require only one type of transactions to come to them. For example, a bank may have an overbought position in marks (i.e., it may have bought more marks than it sold). In such a case, it may like to keep its ask rate lower so as to attract customers who want to buy marks.

Note: According to FEDAI rules, exchange rates in the merchant as well as the interbank markets are to be quoted up to 4 decimals, with the last two digits being in multiples of 25 (for example, Rs./$: 39.40/65). The card rates of banks (the reference rates given by the dealing room to the 'B category' branches at the beginning of the day) should be either quoted in two decimals, or quoted in 4 decimals with the last two figures being 0 (for example, Rs./$: 39.4000 or 39.40). Also, all merchant transactions are to be settled after rounding off the final rupee amount to the nearest whole rupee. For this, amounts up to 49 paise are to be ignored, and amounts from 50 to 99 paise are to be rounded off to the next rupee. Throughout the chapter, these rules have been ignored and the Rs./$ quotes are given up to 2 decimals, only to make the computations convenient. These quotes result in a higher spread, while in the actual market the spread does not usually exceed 1 or 2 paise. The student should keep this digression from the real-time market quotes in mind while going through the chapter.

Box 2: Euro and its Constituents

On January 1, 1999, the various European currencies were irrevocably locked to the euro (and through it to each other) at the following rates:

DM/Euro	:	1.955830
FF/Euro	:	6.559570
S/Euro	:	13.760300
BF/Euro	:	40.339900
DG/Euro	:	2.203710
FmK/Euro	:	5.945730
£Ir/Euro	:	0.787564
Lit/Euro	:	1936.270000
Lux F/Euro	:	40.339900
Esc/Euro	:	200.482000
Ptas/Euro	:	166.386000

Up to July 1, 2002, these currencies coexisted with the euro, and their exchange rates with other world currencies were calculated through the ruling euro rates. Recalling from Chapter International Monetary System, from January 1, 1999, all interbank payments are made in euros, there are no interbank quotes directly between the dollar and local currencies, all new government debts are denominated in euros, the ECB conduct repo transactions only in euros, and all stock exchange quotations for equities and trades and settlements of government debt and equity are in euro. On the retail level, the bank statements and the credit card bills give the euro equivalents of the national currency figure.

Source: www.bergduffy.com/personnel/articles/eurotalk.html.

Inverse Quotes

For every quote (A/B) between two currencies, there exists an inverse quote (B/A), where currency A is being bought and sold, with its price expressed in terms of currency B. For example, for a ∈/$ quote, there exists a $/∈ quote. The implied inverse quote can be calculated from a given quote in a very simple way. Let us take the example of a ∈/$ quote. Let the ∈/$ quote in Frankfurt be:

∈/$: 1.4118/1.4121

The (∈/$) bid rate is the rate at which the bank is ready to buy dollars (which also means the rate at which it is ready to sell ∈, which will be the ask rate in the $/∈ quote). Hence the (∈/$) bid rate would correspond to the ($/∈) ask rate. In ∈/$ terms, this rate is 1.4118. In $/ ∈ terms, it would be the reciprocal of this figure, i.e., 1/1.4118 which is equal to $0.7083/∈. Similarly, the (∈/$) ask rate would correspond to the ($/∈) bid rate. In ∈/$ terms, this rate is 1.4121, which is equal to $0.7082/∈ (1/1.4121). Hence, to calculate the implied inverse quote, the bid and the ask terms of the given quote have to be reversed and their reciprocals calculated. For this particular example, the calculations can be shown as:

$$\text{Implied } (\$/\in)_{bid} = 1/(\in/\$)_{ask} \quad \ldots \text{ Eq. (1)}$$

$$\text{Implied } (\$/\in)_{ask} = 1/(/\$)_{bid} \quad \ldots \text{ Eq. (2)}$$

So, the implied inverse rate is:

$/∈: 0.7082/0.7083

These equations can be generalized as:

$$\text{Implied (B/A) quote: } \frac{1}{(A/B)_{ask}} / \frac{1}{(A/B)_{bid}} \quad \ldots \text{ Eq. (3)}$$

Now suppose that the actual B/A quote differs from the implied inverse quote. The result may be an arbitrage opportunity similar to the one when two banks quote widely different rates for a pair of currencies. Let the $/∈ quote in New York be:

$/∈: 0.7068/0.7072

In this scenario, there is a possibility of buying ∈ in New York for $0.7072/∈ and selling them in Frankfurt for $0.7082/∈, thus making a riskless profit of $0.0010/∈. This arbitrage activity involving buying in one market and selling in another is termed two-way arbitrage. Such arbitrage opportunities quickly go away on profit-making by arbitrageurs. As they buy ∈ in New York, the ask rate of the $/∈ quote goes up, and as ∈ is sold in Frankfurt, the ask rate of the ∈/$ quote will go up till its reciprocal becomes lower than the increasing ask rate of the $/∈ quote. Hence, to avoid arbitrage opportunities, the ask rate of the actual B/A quote should be higher than the bid rate of the implied B/A quote and the bid rate of the actual B/A quote should be lower than the ask rate of the implied B/A quote (i.e., the two quotes must overlap).

As can be observed, the synthetic inverse rate acting only as a limit on the actual inverse rate, is due to the presence of transaction costs (the costs to be incurred by a player in the market for buying or selling a currency) as a difference between the bid and ask rates. One more transaction cost is the lump sum payment required to be made to the dealer, from whom a currency is bought or sold, as his fees or commission. These transaction costs make arbitrage activity less effective, as the profit stands reduced by the amount of the costs required to be incurred by the arbitrageur. Hence, the actual inverse rates can differ from the synthetic inverse rates by the amount of the transaction costs. In the absence of such transaction costs, the inverse rates would have to be exactly equal to the synthetic inverse rates. If there were no spread between the bid and the ask rates for a currency (i.e., a person could buy a currency at the same price at which he could sell it) and there was no commission or fees to be paid to the dealer, the $/∈ price in New York would have to be the exact reciprocal of the ∈/$ price in Frankfurt. Let us assume that the ∈/$ rate in Frankfurt were:

∈/$: 1.4118

Then the $/∈ rate in New York would be 1/1.4118, i.e., $0.7083/∈. Otherwise, an arbitrageur would have the opportunity of making profits, and in the process, would drive the rates in the two markets towards equalization.

Cross Rates

In the foreign exchange markets, it is a practice to quote most of the currencies against the dollar; and to calculate the exchange rates between other currencies with the dollar as the intermediate currency. For example the ∈/£ rate will be calculated through the ∈/$ quote and the $/£ quote. The ∈/£ rate thus calculated is called a cross rate or the synthetic rate. Though generally the third currency used is the dollar, the cross rate between two currencies can be calculated using any other currency as the intermediate currency.

These synthetic rates can be calculated using a process similar to the one we used in calculating the implied inverse quote. Let us assume that we need to calculate the Switzerland franc/Canadian dollar (SFr/Can$) rate from given SFr/$ and $/Can$ quotes. Let the given quotes be:

SFr/$: 5.5971/5.5978

$/Can$: 0.7555/0.7562

For calculating the synthetic rates, we shall have to see how the arbitrageur will operate if he wishes to operate in the markets giving the SF_r/$ and the $/Can$ rate, instead of using the direct SFr/Can$ quote. The $(SFr/Can\$)_{bid}$ rate will be the number of francs which a bank would be ready to pay to buy one Can$. The arbitrageur, say X, can sell 1 Can$ for: $0.7555.

The bank will be ready to buy one dollar for: SFr5.5971.

Hence, for selling one Can$, X will get,

$0.7555 \times 5.5971 = 4.2286$ francs

That is, for buying one Can$, the bank would be ready to pay: SFr4.2286.

Hence, the synthetic $(SFr/Can\$)_{bid}$ rate:

$= 4.2286$

$= 5.5971 \times 0.7555$

$= (SFr/\$)_{bid} \times (\$/Can\$)_{bid}$

Similarly, the (SFr/Can$) ask rate will be the number of francs the bank will require to be paid for selling one Can$. In terms of the $/Can$ rates, a bank would take 0.7562 dollars to sell one Can$. To be able to pay these dollars, X would need to buy them in the SFr/$ market. X can buy a dollar in that market for SFr 5.5978. Hence, X can buy one Can$ for:

$5.5978 \times 0.7562 = 4.2330$ francs.

In other words, the bank would be ready to sell one Can$ for: 4.2330 francs.

So, the synthetic $(SFr/Can\$)_{ask}$ rate:

$= 4.2330$

$= 5.5978 \times 0.7562$

$= (SFr/\$)_{ask} \times (\$/Can\$)_{ask}$

Hence, the synthetic quote is:

SFr/Can$: 4.2286/4.2330

These rates can be generalized as:

$$\text{Synthetic } (A/C)_{bid} = (A/B)_{bid} \times (B/C)_{bid} \quad \ldots \text{Eq. (4)}$$

$$\text{Synthetic } (A/C)_{ask} = (A/B)_{ask} \times (B/C)_{ask} \quad \ldots \text{Eq. (5)}$$

Where A, B and C are three currencies.

These synthetic rates can also be calculated if the inverse quotes are available for any of the required rates. For example, if instead of the (B/C) rates, the (C/B) quote is available, the implied inverse rate can be calculated and used. In such a case, the synthetic rates can be calculated as:

$$\text{Synthetic } (A/C)_{bid} = (A/B)_{bid} \times 1/(C/B)_{ask} \quad \ldots \text{Eq. (6)}$$

$$\text{Synthetic } (A/C)_{ask} = (A/B)_{ask} \times 1/(C/B)_{bid} \quad \ldots \text{Eq. (7)}$$

As in the case of implied inverse rate, the synthetic quote and the actual quote between a pair of currencies should overlap (i.e., the bid rate of one should always be lower than the ask rate of the other). There are two reasons for this. First, if the actual rates are too much out of line with the cross rates, then market players in genuine need of a currency would buy and sell through the markets giving them more favorable rates. The second reason is the arbitrage opportunity which would arise in case of a misalignment of actual and cross rates. In both the cases, the resultant demand-supply mismatch would force the synthetic cross rate and the actual rate to come in line with one another. Let us see how the arbitrage process works. As we have seen, the synthetic quote between the franc and the Can$ is:

SFr/Can$: 4.2286/4.2330

This synthetic quote has been calculated from the following given quotes:

SFr/$: 5.5971/5.5978

$/Can$: 0.7555/0.7562

Now suppose that the actual quote between the franc and the Can$ is:

SFr/Can$: 4.2333/4.2343

As we see, the synthetic ask rate is less than the actual bid rate, giving the arbitrageurs a chance to make a profit by three-point arbitrage (the process of making arbitrage profits involving three markets, where three transactions have to be entered into to achieve the desired results). To make profits, a person should buy low and sell high. The rate at which the arbitrageur, say X, can sell one Can$ against the franc is SFr 4.2333/Can$. The rate at which X can buy one Can$ (through the synthetic market) is SFr 4.2330/Can$. Let us say that X starts with one franc.

With one franc, he can buy:

$$\frac{1}{5.5978} \text{ dollars.}$$

Since 0.7562 dollars fetch one Can$, with 1/5.5978 dollars X can buy:

$$\frac{1}{0.7562} \times \frac{1}{5.5978} \text{ Can\$}$$

These Can$ can then be sold by X in the SFr/Can$ market for:

$$4.2333 \times \frac{1}{0.7562} \times \frac{1}{5.5978} \text{ francs} = \text{SFr}1.000058.$$

Thus, X makes a profit of SFr 0.000058 for every franc bought and sold.

Now let us see what will happen if the actual rates are:

SFr/Can$: 4.2278/4.2283

The actual ask rate is now lower than the synthetic bid rate. X can now buy Can$ at SFr 4.2283/Can$ and sell them through the synthetic market at SFr 4.2286/Can$. In the SFr/Can$ market, X can sell one franc for:

$$\frac{1}{4.2283} \text{ Can\$}$$

As each Can$ can be sold for 0.7555 dollars, X can sell the Can$ for:

$$0.7555 \times \frac{1}{4.2283} \text{ dollars}$$

Since each dollar fetches 5.5971 francs, X can sell the dollars for:

$$5.5971 \times 0.7555 \text{ x } \frac{1}{4.2283} \text{ francs} = \text{SFr}1.000073 \text{ francs.}$$

So, X makes a profit of 0.000073 francs for every franc bought and sold.

These arbitrage processes will adjust the rates in both the cases in all the three markets in such a way that the actual SFr/Can$ rates will come in alignment with the synthetic rates. We can write the conditions for no arbitrage possibility as:

$$(A/C)_{bid} \leq (\text{actual})(A/C)_{ask} \quad (\text{synthetic}) \qquad \ldots \text{Eq. (8)}$$

$$(A/C)_{ask} \geq (\text{actual})(A/C)_{bid} \quad (\text{synthetic}) \qquad \ldots \text{Eq. (9)}$$

Using equations 4 and 5, we can rewrite the above equations as:

$$(A/C)_{bid} \leq (A/B)_{ask} \times (B/C)_{ask} \qquad \ldots \text{Eq. (10)}$$

$$(A/C)_{ask} \geq (A/B)_{bid} \times (B/C)_{bid} \qquad \ldots \text{Eq. (11)}$$

where all the rates are actual rates.

Equations 10 and 11 are called the no-arbitrage conditions. These signify the limits imposed by the synthetic rates on the actual quote for a pair of currencies (upper and lower limits for the bid and the ask rates respectively). The actual rates only have to be within these limits, but they need not necessarily be the same as the synthetic rates. In fact, the synthetic rate having been calculated from two quotes, includes the bid-ask spread of both the quotes. This results in the synthetic rate having a very high bid-ask spread. In reality, a bank giving direct quotes between two such currencies may be able to quote at much lower spread, provided its business volumes in these currencies is high. In the example given above, the actual SFr/Can$ quote may be something like:

SFr/Can$: 4.2298/4.2313

As in the case of inverse rates, transaction costs allow the actual A/C quote to deviate from the synthetic cross rates to some extent. As mentioned earlier, in the absence of such costs, the bid and the ask rates will be the same. These single rates will force the actual A/C quote to be exactly equal to the synthetic cross rates.

According to Eq. (10),

$$(A/C)_{bid} \leq (A/B)_{ask} \times (B/C)_{ask}$$

It can be rewritten as:

$$1 \leq \frac{(A/B)_{ask} \times (B/C)_{ask}}{(A/C)_{bid}}$$

Or,

$$(A/B)_{ask} \times (B/C)_{ask} \times (C/A)_{ask} \geq 1 \qquad \ldots \text{Eq. (12)}$$

Similarly, Eq. (11) says that:

$$(A/C)_{ask} \geq (A/B)_{bid} \times (B/C)_{bid}$$

It can be rewritten as:

$$1 \geq \frac{(A/B)_{bid} \times (B/C)_{bid}}{(A/C)_{ask}}$$

Or,

$$(A/B)_{bid} \times (B/C)_{bid} \times (C/A)_{bid} \leq 1. \qquad \ldots \text{Eq. (13)}$$

TYPES OF FOREIGN EXCHANGE TRANSACTIONS

Foreign exchange transactions can be classified on the basis of the time between entering into a transaction and its settlement. They can basically be classified into spot and forward contracts. Spot transactions are those which are settled after two business days from the date of the contract. A forward contract (also called an outright forward) is one where the parties to the transaction agree to buy or sell a commodity (here, a currency) at a predetermined future date at a particular price. This future date may be any date beyond two business days. The price and the terms of delivery and payment are fixed at the time of entering into the contract. In the forex markets, forward contracts generally mature after 1, 2, 3, 6, 9, or 12 months.

A forward contract is normally entered to hedge oneself against exchange risk (i.e., the uncertainty regarding the future movements of the exchange rate). By entering into a forward contract, the customer locks-in the exchange rate at which he will buy or sell the currency.

Forward Quotes

Forward quotes are given just like spot quotes given earlier. The same rules regarding calculation of implied inverse rates, synthetic cross rates etc. apply to the forward rates also. The conditions to be fulfilled for ensuring that there is no scope for two-way arbitrage and three-way arbitrage are also the same. For example, the three-month forward rate between the £ and the ¥ may look like:

3-m ¥/£ : 182.70/75

The implied inverse rate would be:

3-m £/100¥ : (1/182.75 × 100) / (1/182.70 × 100)

= 0.5472/0.5473

If the 2-month forward $/Aus$ and the $/SGD quotes are:

2-m $/Aus$: 0.6883/88

2-m $/SGD : 0.5754/58

then the SGD/Aus$ synthetic cross rates will be:

2-m SGD/Aus$: (1/0.5758 × 0.6883)/(1/0.5754 × 0.6888)

= 1.1953/70

DISCOUNT AND PREMIUM

A currency is said to be at a premium against another currency if it is more expensive in the forward market than in the spot market. In this case, its forward rate will be higher than its spot rate. This happens when the future spot rate is expected to be higher than the current spot rate. Conversely, a currency is said to be at a discount if it is cheaper in the forward market than in the spot market. In this case, its forward rate will be lower than its spot rate. This happens when the future spot rate is expected to be lower than the current spot rate. Let us assume the Rs./$ quotes to be:

Rs./$: 39.26/28

3-m Rs./$: 39.62/66

Here, the bank is ready to give only Rs.39.26 currently in exchange for a dollar, while it is ready to give Rs.39.62 after 3 months. Similarly, the bank is charging only Rs.39.28 for selling a dollar now, while it is charging Rs.39.66 for a delivery 3 months hence. So, the dollar is expected to be more expensive in the future, and hence is at a premium against the rupee. On the other hand, the rupee is expected to be cheaper in the future and hence is at a discount against the dollar.

Let us now assume the $/£ quotes to be:

$/£ : 2.0946/52

3-m $/£ : 2.0889/98

Here the dollar is at a premium against the pound, while the pound is at a discount against the dollar. It is possible that a currency may be at a premium against one currency, while being at a discount against another at the same time. It is also possible that a currency be at a premium against another for a particular forward maturity, while being at a discount against the same currency for another forward maturity. Example the $/£ quotes may be:

$/£ : 2.0946/52

2-m $/£ : 2.0954/60

3-m $/£ : 2.0889/98

Here, the pound is at a premium against the dollar for the 2-month maturity, but at a discount for the 3-month maturity. It is also possible to have such a situation where a currency is at a premium against another for a particular forward maturity, but a discount between two forward maturities. Example the $/£ quotes may be:

$/£ : 2.0946/52

1-m $/£ : 2.0965/69

2-m $/£ : 2.0954/61

Here, the pound is at a premium against the dollar for both the forward maturities, but at a discount between the one-month and the two-month maturities.

There is an important aspect about forward rates which need to be observed here. Notwithstanding whether the base currency is at a premium or at a discount, the bid-ask spread increases as one goes into future. In the Rs/$ quotes (where the base currency, i.e. the dollar is at a premium), the spread increased from 2 paise to 4 paise. In the $/£ quotes (where the base currency is at a discount), the spread increases from 6 points to 9 points. This happens because the liquidity in the market decreases with increasing maturity of the contract. This makes it difficult for the bank to offset the positions created in the retail market. Longer the maturity, lower the trading volume, higher the possibility of loss on account of movement of exchange rates in an unfavorable direction. It is important to remember that the risk (due to which the spread increases for a forward maturity) is not of the exchange rate moving unfavorably between the date of the contract and its maturity, but that of an unfavorable movement in the exchange rate between the time of the contract and the time when the bank offsets its position.

The difference between the spot rates and the forward rates can be expressed in terms of swap points. In the rupee-dollar example, the swap points will be 36/38(39.62 – 39.26 and 39.66 – 39.28). In the dollar-pound example, the 3-month swap points would be 57/54 (2.0946 – 2.0889 and 2.0954 – 2.0898). From this, we can observe the following rules:

i. When the swap points are low/high (as in the rupee-dollar example given above), currency B is at a premium, A is at a discount. Add swap points to spot rate to get the outright forward rate, deduct swap points from the outright forward rate to get the spot rate.

ii. When the swap points are high/low (as in the dollar-pound example given above), currency B is at a discount and A is at a premium. Deduct the swap points from the spot rate to arrive at the outright forward rate, add them to the outright forward rate to arrive at the spot rate.

iii. The bid side swap points (i.e., on the left side of the swap points quote) are to be added to or subtracted from the spot bid rate (depending on whether the currency is at a premium or discount) to arrive at the forward bid rate. The ask side swap points added to, or subtracted from the spot ask rate, give the forward ask rate.

The annualized percentage premium on currency B can be calculated as follows:

$$\frac{\text{Forward}\,(A/B)_{mid} - \text{Spot}\,(A/B)_{mid}}{\text{Spot}(A/B)_{mid}} \times \frac{12}{m} \times 100$$

where m is maturity of the forward contract in months. A negative figure signifies that currency B is at a forward discount and A is at a premium, with a positive figure signifying the opposite. In the rupee-dollar example, the annualized percentage premium on the dollar can be calculated as follows:

$$\text{Spot (Rs./\$)}_{mid} = \frac{39.26 + 39.28}{2} = \text{Rs.}39.27/\$$$

$$\text{3-m (Rs./\$)}_{mid} = \frac{39.62 + 39.66}{2} = \text{Rs.}39.64/\$$$

$$\text{Premium} = \frac{39.64 - 39.27}{39.27} \times \frac{12}{3} \times 100 = 3.77\%$$

Similarly, in the \$/£ example, the annualized discount on the pound for the 3-month maturity works out to 1.06%.

An important point that needs to be noted here is that the pound being at 1.06% annualized discount does not necessarily mean that the dollar will be at 1.06% annualized premium against the pound. Let us verify with the help of an example. The implied inverse quotes in the Rs./\$ example would be:

\$/Rs. : 0.0255604/0.0255694

3-m \$/Rs. : 0.0249664/0.0250034

Hence,

$$\text{Spot } (\$/\text{Rs.})_{mid} = \frac{0.0255604 + 0.0255694}{2} = \$0.0255649/\text{Rs.}$$

$$\text{3-m}(\$/\text{Rs.})_{mid} = \frac{0.0249664 + 0.0250034}{2} = \$0.0249849/\text{Rs.}$$

Therefore, the annualized percentage discount on the rupee will be:

$$= \frac{0.0255649 - 0.0249849}{0.0249849} \times \frac{12}{3} \times 100 = -9.28\%.$$

Thus, while the dollar is at a 3.77% premium against the rupee, the rupee is at a 9.28% discount.

Usually, the forward rates are not quoted straight. Instead, the premium or discount is quoted for different periods. The following is an extract from 'The Economic Times', which describes the rates in the Mumbai interbank market.

Table 2: Forward Premia (indication only) PAISE PER USD (to be changed)

Month	Jan.	Feb.	Mar.	Apr.	May	June
Exporters	5	22	44	70	91	116
Importers	7	24	47	73	94	119
Annualized	7.52	5.73	5.85	6.4	6.3	6.43

Source: The Economic Times.

We can observe from the above table that forward premiums/discounts are quoted in subsidiary unit of the currency (paise here). Exporters and importers for May means that exporters selling foreign currency under the forward contract will receive a premium of 91 paise per dollar, and the importers buying foreign currency under the forward contract will pay a premium of 94 paise per dollar.

In the Indian context, when the maturity of a forward contract is extended by cancelling the existing contract and entering into a new contract for the extended duration, it is referred to as rolling over a forward contract. Rolling over of a forward contract can be used to hedge for longer term maturities for which forward contracts are not available. For example, in India, forward contracts for maturities greater than one year are not allowed. Suppose, a party has an exposure for 3 years for which it wishes to hedge itself against movements in exchange rates. In such a case, it can hedge itself at least partially by initially booking a forward contract for the maximum maturity available, and then rolling over the contract at the end of that time period. However, this does not act as a perfect hedging mechanism, but

provides an opportunity to hedge exposures at least partially. This is because at the time of booking the initial contract, the customer would not know the price he would need to pay at the time of rolling it over.

FORWARD RATES VS. EXPECTED SPOT RATES

If the speculators in the market were risk-neutral and there were no transaction costs, then the forward rate would be equal to the market's expected future spot rate. This is so, because otherwise it would be possible to buy in one market and sell in the other in order to make profits. Let us take the case where the forward rate is lower than the expected spot rate. In such a case, the speculator would buy a forward contract expecting to sell in the spot market in the future at a higher price. The resulting increased demand in the forward market would increase the forward rate and drive it towards equalization with the expected future spot rate. If the forward rate is higher, speculators would sell in the forward market, thus pushing the forward rate down. In reality, however, there is also the risk of the spot rate turning out to be different from the expected spot rate and the speculators are not really risk-neutral. They expect to be compensated for the risk that they take on. In addition, there is the presence of transaction costs to be contended with. These two factors result in the forward rate being different from the spot rate to some extent.

Broken-date Forward Contracts

A broken-date contract is a forward contract for a maturity which is not a whole month or for which a quote is not readily available. For example, if the quotes are available for a 6-month forward and a 9-month forward, but a customer wants a quote for a 7-month forward, it will be a broken-date contract. The rate for a broken-date contract is calculated by interpolating between the available quotes for the preceding and the succeeding maturities. Let us assume that in July, the quote for a contract maturing on August 31 is:

SFr/$: 5.5879/85

At the same time, the quote for a contract maturing on October 31 is:

SFr/$: 5.5908/20

Now suppose a customer wants to enter into a forward contract with the bank maturing on September 29, for purchasing dollars from the bank. For this purpose, the bank has to give a quote. It can be observed that the dollar is at a premium and the swap points are 29/35 between August and October maturity. On the ask side, the premium is 35 points which is spread over 61 (30 + 31) days. The required maturity is 29 days away from the August maturity. Hence, the premium charged by the bank over and above the August rate will be 35 x 29/61, i.e., 17 points. Hence, the rate charged will be 5.5885 + 0.0017 = SFr 5.5902/$. Similarly, the buy and the sell rates can be calculated for any intervening date between two given maturities.

Option Forwards

Under the forward contract discussed until now, the settlement of the contract has to take place on a specific date. This type of a contract can be used only when the customer knows the precise time as to when he would need to buy/sell a currency. There are circumstances in which the customer may know the estimated time when the need to deal in a foreign currency may arise, but may not be sure about the exact timing. For example, an exporter who has shipped his goods abroad, may be aware that the ship would be expected to reach its destination in a month's time and expects to receive his payment within one month from the consignment being received by the buyer. Yet, he would not know the exact date the ship will reach and hence the date on which he will receive his payment. Similarly, for an importer, the time of requirement of foreign currency will depend upon the time when he receives communication from the foreign supplier regarding the dispatch of goods. Another example could be of a person who has bid for a contract. If the person's need for dealing

in foreign currency is dependent upon his bid being accepted, then he may not be knowing when the need will arise. These kinds of needs can be fulfilled by a contract called the option forward contract or the option forward. Under this contract, the customer of the bank has the option to ask for the contract to be settled anytime during a particular period, referred to as the option period. For example, a customer enters into an option forward contract on September 29 for selling dollars to the bank. The contract matures on December 31. The customer takes the option to sell dollars to the bank any time in December. Here, the month of December is the option period. Giving quotes for this kind of a contract is not as straightforward as giving a quote for an outright forward contract. This is so because the rate at which the exchange of currencies will take place is fixed, while the timing of the exchange is not. If the bank quotes a rate which is appropriate for deals done at a particular period of time, and the exchange actually takes place at an unfavorable time, the bank would incur a loss on the deal. For example, if the bank enters into a contract to sell dollars to a customer when the dollar is commanding a forward premium, and the bank's quote reflects the premium only up to the beginning of the option period, it will incur a loss if the customer exercises the option at the end of the option period (because the bank would get lesser premium than it would have charged for the complete period). Similarly, if the dollar was at a forward discount and the bank's quote were to reflect the discount for the full period, the bank would be incurring a loss were the customer to exercise the option in between the option period. To avoid a loss (or rather, to make the maximum profit), banks follow these rules for giving a quote:

i. When the bank is buying a currency, it will add on the minimum premium possible (when the currency is at a premium) and deduct the maximum discount possible (when the currency is at a discount) from the spot rate. This would result in the bank quoting the rate applicable to the beginning of the option period when the currency is at a premium, and the rate applicable to the end of the option period when the currency is at a discount.

ii. When the bank is selling a currency, it will add the maximum premium possible (when the currency is at a premium) and deduct the minimum discount possible (when the currency is at a discount) from the spot rate. This would result in the bank's quoting the rate applicable to the end of the option period when the currency is at a premium, and the rate applicable to the beginning of the option period when the currency is at a discount. Thus, the bank considers the applicable quotes for the beginning and the end of the option period and gives a quote which is disadvantageous to the client, which, in effect, is the cost incurred by the client for the flexibility.

Suppose, the Euro/Swiss franc rate is given as:

Spot Euro/SFr : 1.2245/49

3-m forward : 10/15

4-m forward : 15/25

The Swiss franc is at a premium. If the bank contracts to sell SFr, with the option to take delivery exercisable by the customer anytime during the 4th month, the bank will load the maximum premium to the spot rate. It will implicitly be assuming that the customer will demand delivery when the currency is most expensive, and hence will charge the maximum rate. So, it will quote the rate Euro 1.2274/SFr (1.2249 + 0.0025). If the contract were to buy SFr with the option to give delivery exercisable by the customer anytime during the fourth month, the bank would have assumed that the customer would choose to exercise his option when the SFr is at its cheapest, i.e., at the beginning of the fourth month. Hence, the bank would have loaded the minimum premium to the spot rate while giving the quotation. The rate would have been Euro 1.2255/SFr (1.2245 + 0.0010).

Note that the 3-m forward rate is the rate applicable to the beginning of the option period (as the end of the third month is the beginning of the fourth month), and the 4-m forward rate is the rate applicable to the end of the option period.

Suppose the Can$/£ rate is:

Can$/£ : 2.5643/49

2-m : 20/15

3-m : 30/20

The bank enters into a forward contract whereby the customer has the option to buy pounds from the bank anytime during the third month. As the pound is at a discount and the bank would like to sell it at the maximum price possible, it will deduct the minimum discount from the spot rate, which is 15 points. The bank will hence quote Can$ 2.5634/£ (2.5649 – 0.0015). If the forward contract is such that it gives the customer the right to *give* delivery any time during the third month, the bank would have deducted the maximum discount in order to buy pounds at the cheapest rate possible. The rate would be Can$ 2.5613/£ (2.5643 – 0.0030).

How would the bank decide on its quote if a currency is at a premium at the beginning of the option period, and at a discount during the option period? The bank would follow the simple rule of buying at the lowest and selling at the highest *price*. For example, if the SFr/Aus$ quotes were:

SFr/Aus$: 3.4925/30

1-m : 3.4935/45

2-m : 3.4930/42

For an option forward giving the right to the customer to buy Aus$ anytime during the second month, the bank would quote the rate of SFr3.4945/Aus$. If the customer's option were to sell Aus$, the rate given by the bank would be SFr3.4930/Aus$.

Swaps

A transaction whereby two currencies are exchanged by the parties involved, only to be exchanged back later, is termed currency swap. The quantity exchanged of one of the currencies remains constant in both the legs of the swap, though the quantity of the second generally changes. So, a swap is nothing but the selling of one currency at a point of time to purchase it back later at a lower or a higher price.

A currency swap is a combination of two transactions – one spot and one forward – with an exchange of currencies taking place at predetermined exchange rates. The forward leg is in the opposite direction to that of the spot leg, i.e., the party selling currency A in the spot leg buys it in the forward leg and vice-versa. As mentioned, the price of the currencies is different in the spot leg from that of the forward leg. This happens because of the expected depreciation/appreciation of the currency w.r.t. the other currency. For example, two parties may enter into a swap whereby the first party sells one million pounds to the second party against dollars in the spot leg @ $1.6708/£, and the second party sells one million pounds to the first party against dollars one month forward @ $1.6652/£. Here the number of pounds exchanging hands is constant, whereas the number of dollars exchanging hands is changing, depending on the exchange rate applicable to the two legs of the swap transaction. As opposed to a swap transaction, an outright forward is not accompanied by any spot deal.

A swap transaction whereby the foreign currency is bought in the first leg and sold in the second leg against the local currency is called a swap-in or buy-sell swap. For example, a swap-in dollars in India would mean dollars bought against the rupee in the first leg and sold in the second leg. A swap-out or a sell-buy swap is the exact opposite, i.e., the foreign currency is sold in the first leg and bought in the second leg against the local currency. A forward-forward swap is the one where both the legs of the transaction take place in the future. For example, if dollars are bought one month forward @ Rs.45.50/$ and sold two months forward @ Rs.45.70/$, it will be a forward-forward swap.

One of the uses of swaps is for hedging by entities investing or borrowing abroad. Hedging is the process through which an attempt is made to eliminate risk (or at least reduce it to tolerable levels) in a transaction. Take the example of a Canadian citizen who is investing in US bonds. He would know the amount of US dollars he would receive on maturity, but not the $/Can$ exchange rate that would prevail at that time. This would make his Can$ returns uncertain. To remove this uncertainty, the investor can enter into a swap-in dollars, whereby he would buy the dollars spot (which he could then use to invest in the bonds) and sell them forward at the time of maturity. This would fix the exchange rate at which he would translate his dollar earnings to Can $, thus making his Can$ returns certain. Similarly, a person raising money abroad may enter into a swap-out to fix his total cost of borrowing.

Swaps can also be used in place of option forwards. In the evnt of a person entering into a contract to sell dollars, with the month of December as the option period (given in the section on option forwards), the same objective can be met through use of swaps. Initially, the customer can sell dollars forward, with the maturity on December 1st. If by the end of November, he realizes that he would be receiving the dollars only by December 20, he can enter into a buy-sell swap for 20 days. This way he would be able to hedge his position in a cheaper way. Of course, for resorting to a cheaper method, he would have to pay the price of not knowing the premium/discount that will be applicable to the swap transaction till he actually enters into it. Hence, while option forward is likely to be more expensive than a swap transaction, it removes the exchange risk completely. On the other hand, in such situations the risk is not completely removed in a swap transaction, due to the uncertainty of the total cost of hedging.

The most important players in the swap markets are the banks. They use the swap markets to hedge their positions arising from merchant transactions. For example, if a bank sells more spot dollars than it has purchased, it creates a short (oversold) position. If the bank does not cover its open position, it may lose if the dollar appreciates since it will have to buy the dollar at a higher price. To cover its position, bank can buy dollars in the interbank spot market. A bank having a long (overbought) position can cover itself by selling dollars in the interbank spot market. However, if the bank has sold forward more dollars than it has bought forward (or vice-versa), it will have to cover its position in the interbank forward market. While it is easy to find counterparty in the spot market, it is difficult to find counterparty with an exactly opposite exposure having a matching maturity. Hence, the banks prefer hedging by using swaps instead of outright forwards. Another reason for banks preferring swaps is that swaps have finer rates than outright forwards. A bank having an overbought forward position will enter into a swap to sell forward in the relevant maturity and buy the currency spot. Then the bank can sell the currency spot to counter the spot buying. Conversely, a bank with an oversold forward position can enter into a sell-buy swap, whereby it buys in the relevant forward maturity and sells spot. To cover the spot sale, it can buy spot in the interbank market. In the interbank markets, the delivery week for the forward leg of the swap can be specified. Banks generally use rollovers to cover the resultant intra-week exposures.

The difference in the spot and the forward leg prices of a swap are given as swap points, just as in the case of a forward quote. In fact, the swap points applicable to outright forwards and swaps are the same. Yet, the way in which these points are to be added to/subtracted from the spot rate is different from the way in which the forward rate for a currency is calculated. The way to calculate the exchange rate applicable to the forward leg of a swap transaction is shown in the following example.

Assume that the following quotes are available in the inter-bank market:

Rs./$: 39.26/30

3-m : 60/70

Suppose a bank wants to go for a buy-sell swap. It will buy dollars spot @ Rs.39.26/$. (As the bank would be dealing in the interbank market, it would have to buy at the ask rate. This needs to be remembered for the subsequent workings also). As the swap points are in low/high order, the dollar is at a premium. The bank will get 60 points premium if it sells dollars forward. To arrive at the rate applicable to the forward leg of a swap transaction, the relevant swap points are added to/deducted from (depending on whether the currency is at a premium or discount) the rate at which the spot leg of the transaction has taken place. Hence, the rate for the forward sale will be Rs.39.90/$ (39.30 + 0.60). As we can see, the rate which the bank gets for selling dollars in the forward leg of the swap is better than what it would have got had it sold dollars outright forward (39.26 + 0.60 = 39.86).

If a bank wanted to go for a sell-buy swap, the rate applicable to the spot sale would have been Rs.39.26/$. The dollar being at a premium, the bank would need to pay the 70 points premium for buying dollars forward. In accordance with the above-mentioned principle, the rate applicable to the forward leg would be (39.26 + 0.70) Rs.39.96/$. This rate is again better than the outright forward rate of (39.30 + 0.70) Rs.40.00/$.

Since the swap points are added to/deducted from the specific spot rate which is used for the spot leg of the swap, the spot rate does not really matter (as the real profit or cost of the swap is reflected in the swap points, which remain the same irrespective of the spot rate used). In fact, in many cases, the rate applied to the spot leg of the swap transaction may not equal either the bid or the ask rate of the bank's spot quote.

A forward-forward swap can be considered a combination of two spot-forward swaps. For example, a swap to buy dollars after 3 months and to sell dollars after 4 months can be taken as a combination of two spot transactions – (a) to sell dollars spot and buy them after 3 months; and (b) to buy dollars spot and sell them after 4 months. Identical rates are applied to the spot legs of both the swaps, and hence the spot transactions cancel out. The forward legs of the two swaps remain, and the premium/discount applicable to these decides the net profit/cost of the forward-forward swap.

SETTLEMENT DATES

The settlement date of a forex transaction, also called its value date, is the day on which the transaction is settled by a transfer of deposits. The settlement date for a spot transaction is generally the second *business* day from the date of the transaction, except for transactions between the US dollar and the Canadian dollar, and those between the US dollar and the Mexican peso. In these two cases, the settlement takes place the next business day. This gap between the transaction date and the settlement date is needed in order to enable the banks to confirm and clear the deals through the communication networks.

The term 'business day' implies that neither of the days between the transaction date and the settlement date (including the settlement date) should be a holiday, either in any of the settlement locations, or in the dealing location of the market-making bank (i.e. the bank who gave the quote). The settlement locations are the countries whose currencies are involved in the transaction, and the dealing locations are the countries in which the banks involved in the transaction are located. For example, if a German bank sells Mexican peso against Canadian dollars to an Indian bank, Mexico and Canada would be the settlement locations, while Germany and India would be the dealing locations. In case any of the following two days is a holiday in either of these locations, the settlement date is shifted to the next business day.

According to these rules, a transaction entered into on a Monday would be settled on the following Wednesday (assuming that both Tuesday and Wednesday are working days in both the settlement locations and the dealing location of the market-making bank). Following the same rules, a transaction entered into on a Thursday would be settled on Monday, Saturday and Sunday being holidays in most of the countries. In order to avoid credit risk, both the parties turn over their deposits on the same day as a rule. The exception is made in the case of transactions involving any of the mid-east currencies. These countries have their weekly off on Friday and have Saturdays and Sundays as working days. So, if a deal is struck on a Wednesday involving any of these currencies against, say, the franc, the franc deposit will be turned over on Friday, while the mid-east currency will be transferred on Saturday. For a deal struck on Thursday, the mid-east currency deposit will be transferred on Saturday, while the francs will be transferred on Monday.

The settlement date for a forward contract depends on two things – the settlement date for a spot transaction entered on the same date as the forward contract, and the maturity of the forward contract in months. For arriving at the settlement date for a forward contract, first the settlement date for the corresponding spot transaction is calculated, and then the relevant number of calendar months is added to it. For example, if a 3-month (or 90 days) forward contract is entered into on July 20, first the spot settlement date will be calculated (in accordance with the previously specified rules). Suppose that it comes to July 23 because of July 21 being a holiday. Then the settlement date for the forward contract will be October 23. If it is a holiday on that day, the settlement date will be shifted to the next business day, i.e., October 24. By adding 'calendar months' it is meant that the specified number of months will be added to the spot settlement date, not 30 or 31 days (or the multiples thereof). Suppose the spot settlement date is the last date of a month, then the settlement date for the forward contract will be the last date of the relevant month, irrespective of the number of days in the two months. For example, if a one-month forward contract is entered into on January 29, the spot settlement date would be January 31. The settlement date for the forward contract would be February 28 (or February 29 if it is a leap year). One important point that has to be remembered while rounding off the settlement date due to holidays, etc. is that the rounding off should not shift the settlement date to the next calendar month. For example, if the settlement date of the forward contract is coming to October 31 which is a holiday, the settlement cannot be done on November 1. In such a case, the settlement date will be shifted to the previous business day. So, the settlement date would be October 30.

The maturities of forward contracts are generally in whole months. Yet, banks generally stand ready to offer forward contracts of maturities in accordance with the specific need of the client. This quite often gives rise to contracts with broken-date maturities. For example, a bank may enter into a forward contract to deliver a specified number of dollars to a client after 55 days. For calculating the settlement date of such a contract, first the relevant number of whole months is added to the spot maturity date. Then out of the total maturity of the forward contract, the number of days which represent these whole months (which is obtained by multiplying the number of whole months by 30) are deducted. The balance number of days are then added to the settlement date, which was arrived at by adding the whole months to the spot settlement date. Let us say, the transaction date for the 55-day forward contract is October 25. The corresponding spot value date will be October 27. There is one whole month in 55 days. So one month will be added to October 27 to get November 27. Then 30 will be deducted from 55, leaving a balance of 25 days. When added to November 27, this gives us December 22, which will be the settlement date for the 55-day forward contract.

Short-Date Contracts

As said in the previous section, the settlement date for a spot transaction is two business days after the transaction date. There are some transactions which are an exception to this rule, i.e., where the settlement date is less than two business days after the date of the transaction. Such transactions, for which the settlement date is before the spot settlement date, are referred to as short-date contracts.

These transactions can be in the form of either outright contracts or swaps. The various swaps available in the market are: between today and tomorrow (called the cash/tom, C/T; it is also referred to as the overnight swap, O/N), between today and spot day (cash/spot, C/S), between tomorrow and next day, i.e., the spot day (tom/next, T/N or tom/spot, T/S) and between spot and the next day (spot/next, S/N). Strictly speaking, the S/N is not a short-date contract since the settlement does not take place before the spot day.

As in the case of swaps, the interbank market gives swap points for these contracts. A bank buying a currency has to pay the higher of the swap points as premium, and gets the lower of the swap points as discount. On the other hand, a bank selling a currency to the market will get the lower of the premium points, but will have to pay the higher of the swap points if the currency is at a discount. Here again, the spot rate to/from which these points are added/subtracted becomes irrelevant.

First Quote

At the start of the day, when a bank is required to give the first quote, the dealer has to consider a number of factors which affect the exchange rate between two currencies. The foremost would be the previous night's closing rate. That rate would serve as the starting point, which would be adjusted for expected changes on account of other factors.

The most important factor is the expected demand-supply position in the market on that day. This factor reflects the effect of a number of other factors. For example, at the beginning of a day, there are certain expectations regarding the inflow and outflow of a foreign currency. The prevalent interest rate in the domestic economy reflected by the call money market rates also affects the expected demand and supply, as investors' demand for the domestic currency (and hence for the foreign currency) would depend on the level of domestic interest rates (higher the rates, more the demand for the domestic currency as investors would need to buy it for investing in the local call money markets. If the investors choose to cover their positions in the forward exchange market, it would also result in an increase in the supply of the domestic currency in the forward market, thereby increasing the forward premium on the foreign currency). The demand-supply position would also be affected by the expected happenings in the stock markets. Suppose the Foreign Institutional Investors (FIIs) are expected to unload their holdings in the domestic stock market. This would leave them with surplus funds, which they would need to convert into foreign currency in order to be able to invest elsewhere, thus increasing the demand for the foreign currency. The overnight rate is adjusted according to the demand and supply position expected to prevail in the market on that day. If the supply is expected to exceed demand, the rate is revised to be on the lower side. If the supply is expected to be less than the expected demand, the rate is revised to be on the higher side.

In addition to these factors, the bank's own overnight position as to whether it is net long in the foreign currency or is net short, also affects the quote it gives to the market. A net short position would result in the bank trying to buy the foreign currency, and hence a higher rate. A net long position will have the opposite effect on the quote.

The bank's view regarding the cross currency market would also affect the bank's quote. For example, if the bank expects the dollar to firm up in the international markets and hence goes long on the dollar there, it would need to go short on dollars in the local market to set-off its position. In such a case, the bank would need to give a lower rupee/dollar quote than it would otherwise have given, in order to be able to sell dollars.

There are a number of economic and other factors in addition to the ones mentioned above, which would affect the first quote. All these listed factors and other factors which are likely to influence the exchange rates would need to be considered by the dealer giving the day's first quote. Whether the dealer's analysis is in line with the market's analysis or not, will be made clear by the buy or sell orders he receives from the market. If the dealer's quote is out of line with the market's expectations, he may have to change his quote accordingly.

QUOTES FOR VARIOUS KINDS OF MERCHANT TRANSACTIONS

There are different kinds of purchase and sale transactions in the retail market. The simplest is the outward or inward remittance. In this kind of transaction, the bank has to simply receive or send a currency through Telegraphic Transfer (TT), demand draft, postal order or Mail Transfer (MT). Since the work involved in such transactions is the least, a bank offers better rates for them. These rates are called the TT buying and TT selling rates. While the TT selling rate is applied for outward remittances in foreign currency (not being proceeds of import bills) and to cancellation of an earlier booked forward purchase contract, the TT buying rate is applied to inward remittances and for cancellation of a forward sale contract.

In India, TT buying and selling rates have to be determined in accordance with FEDAI rules. These rates are to be based on the base rate which may be derived from the on-going market rate. This base rate is marked up to cover the dealer's margin (profit). The maximum permissible margin was earlier prescribed by FEDAI. Now it is left to the discretion of the ADs, subject to restrictions on the maximum spreads and other provisions relating to the calculation of exchange rates as specified by FEDAI. Bank managements generally specify the guidelines to their ADs in this regard. The ADs are also restricted from loading too high a margin by the competition that exists in this field. The margins prescribed by FEDAI which are now indicative are:

TT purchase : 0.025% to 0.080%

TT sale : 0.125% to 0.150%

The maximum permissible spreads between the TT Buying and TT selling rate are as follows:

US$: 1.00 percent of the mean rate (the mid-rate)

Pound, DM, Yen, French franc, Swiss franc, Dutch Guilders and Australian dollars: 2.00 percent of the mean rate.

Other Currencies: No limit at present but ADs are instructed to keep the spread to a minimum.

The TT rates are to be arrived at in the following manner:

Spot TT Buying Rate

Take the base rate and deduct the appropriate margin from it. For example, if the base rate for dollars is Rs.39.26 and the AD wishes to charge 0.08% margin, the spot TT buying rate would be:

Base rate
Less: Margin @ 0.08%
Spot TT buying rate

Spot TT Selling Rate

Take the base rate and add the appropriate margin to it. For example, if the base rate for dollars is Rs.39.34 and the AD wishes to charge a margin of 0.15%, then the TT selling rate would be:

Base rate	39.340
Add: Margin @ 0.15%	0.059
Spot TT buying rate	39.399

Forward TT Buying Rate

Take the base rate. Add (deduct) the on-going forward premium (discount) to (from) the base rate, depending upon the delivery period. From this, deduct the appropriate margin. For example, if a customer wants to sell dollars one month forward, with the base rate at Rs.39.26 and one month premium on dollar being 15 paise, the forward TT buying rate would be calculated as:

Base rate	39.2600
Add: Premium	0.1500
	39.4100
Less: Margin @ 0.08%	0.0315
Forward TT buying rate	39.3785

Forward TT Selling Rate

Take the base rate. Add (deduct) the on-going forward premium (discount) to (from) the base rate, depending upon the delivery period. To this, add the appropriate margin. For example, with the base rate for dollar at Rs.39.34 and the one month forward premium at 20 paise, the one month forward TT selling rate will be:

Base rate	39.34000
Add: Premium	0.20000
	39.54000
Add: Margin @ 0.15%	0.05930
Forward TT selling rate	39.59930

In addition to these rates, the ADs are required to charge the following amounts from their customers for various kinds of transactions:

i. No additional charge for inward remittances for which credit has already been made to the nostro account of the AD.

ii. An additional margin of 0.125% to be charged on the TT buying rate and interest to be recovered from the customer @15% for 10 days' transit period, for inward remittances (for example DDs) where the amount has not been credited to the nostro account of the AD and the reimbursement has to be obtained from the overseas drawee bank (in case of a DD) or the overseas correspondent bank (in other cases).

iii. On inward remittances by way of customer's personal cheque, an additional margin of 0.15% on the TT buying rate is to be charged. In addition, interest for transit period of 15 days is to be recovered from the customer at domestic commercial rate of interest.

iv. For all foreign currency outward remittances (not being proceeds of import bills), a minimum flat charge of Rs.100 is to be made.

v. On all outward rupee remittances, the charge is to be:

Up to Rs.10,000	0.25% subject to a minimum of Rs.10
Over Rs.10,000	0.125% subject to a minimum of Rs.25

The second kind of merchant rate is the bill buying and bill selling rate. These rates are applied to transactions in foreign currency denominated bills of exchange. As for TT rates, the bill buying and selling rates have to be calculated in accordance with FEDAI guidelines. The base rate is loaded with a margin, which is left to the discretion of the AD. The indicative exchange margins given by FEDAI are:

Bill buying	0.125% to 0.150%
Bill selling (over the TT selling rate)	0.175% to 0.200%

Bill Buying Rate

This rate is applied when the AD is giving the rate for an export transaction. The transaction can be either in the way of realization of a collection bill (where the amount has already been credited to the AD's nostro account and the AD is only required to convert it into rupees), or in the form of purchase or discounting of an export bill (where the AD will be providing finance to the exporter till the bill gets collected and then convert the amount received into rupees). For the first type of transaction, the appropriate margin is deducted from the base rate to arrive at the bill buying rate. For the second type of transactions, the bill buying rate can be arrived at in the following manner. Take the base rate. Add (deduct) the on-going premium (discount) to (from) the base rate, the amount of premium (discount) depending on the notional due date (which includes the remaining tenor of the bill, the normal transit period and the grace period; the normal transit period and the grace period being specified by FEDAI guidelines). From this, deduct the appropriate margin. This will give the applicable bill buying rate. In addition, the AD will also charge interest from the customer for the credit extended for the period between the purchasing/discounting of the bill and the notional due date.

The bill buying rate can be calculated as follows. Let the base rate for dollar be Rs.39.26 and the premium for two months (till the notional due date) be 40 paise. If the AD requires a 15% margin, the rate will be:

Base rate	39.2600
Add: Premium	0.4000
	39.6600
Less: Margin @ 0.15%	0.0595
Bill buying rate	39.6005

In addition, for both kinds of transactions, the AD has to charge a commission @ 0.25% subject to a minimum of Rs.10 as collection charges. The banks have been given the discretion of waiving the commission for an instrument having value upto Rs.5,000.

Bill Selling Rate

The bill selling rate is applied when the AD is giving the quote for an import transaction. This rate can be arrived at by adding the appropriate margin to the base rate. For example, if the base rate for dollars is Rs.39.34 and the AD requires a 0.02% margin over the TT selling rate, the bill selling rate will be:

Base rate	39.3400
Add: Margin @ 0.15%	0.0590
TT Selling rate	39.3990
Add: Margin @ 0.2%	0.0788
Bill selling rate	39.4778

The third kind of merchant transaction is the purchase and sale of foreign currency notes and Traveler's Cheques (TCs). The rate applicable to such transactions is calculated in the following manner:

TC Buying Rate

Take the one month forward buying rate given by RBI as the base rate. If the RBI rate is not available, take the on-going market rate. Deduct margin from the base rate @1%. The resultant rate will be the TC buying rate. For example, if the one month forward rate is Rs.39.39, the TC buying rate would be:

Base rate	39.39
Less: Margin @ 1%	0.3939
TC buying rate	38.9961

TC Selling Rate

Take the TT selling rate and add a margin of 0.5% to it. Adding the margin is optional for the AD. On this gross amount, a commission is added (again at the option of the AD) at a maximum rate of 1%. If the TC is issued against foreign currency remittance, then the commission will be charged @ 0.25%. This gives the TC selling rate. For example, if the TT selling rate is Rs.39.399/$ as calculated earlier, the TC selling rate would be:

TT selling rate	39.399
Add: Margin @ 0.5%	0.1969
	39.5959
Add: Commission @ 1%	0.3959
TC selling rate	39.9918

The TC buying and selling rates thus arrived at, may be rounded off to the nearest 5 paise to get the final TC buying and selling rates.

The following table is an extract from HDFC bank's TT buy and TT sell rates as on December 5, 2007.

Table 3: Foreign Exchange Rates December 5, 2007

Currency (in Rs.)	T.C. Selling	T.T. Selling	Cash Selling	T.C. Buying	T.T. Buying	Cash Buying
USD	40.0000	39.7400	40.1000	38.8500	39.0900	38.7500
EUR	59.1500	58.8300	59.2500	57.3000	57.6100	57.2000
GBP	82.4000	81.9500	82.6000	79.8500	80.2500	79.6500
JPY	0.3640	0.3618	0.3750	0.3525	0.3546	0.3415
CHF		35.6800	36.9000		34.9400	33.7500
AUD	34.8500	34.6600	35.3500	33.8000	33.9800	33.3000
CAD	39.7000	39.4800	40.2000	38.1000	38.3100	37.6000
SGD		27.6600	27.8600		26.8400	26.6900
DKK		7.9200			7.6900	
SEK		6.3000			6.1100	
HKD		5.1300	5.2100		4.9800	4.9400
NOK		7.3100			7.0900	
MYR		11.9700	12.0600		11.6200	11.5400
NZD		30.4300			29.5300	
AED		10.9000	11.0100		10.5800	10.4900

	Libor Rates				Swap cost	
Tenor	USD	EUR	GBP	CHF	USD/INR 1-year	1.43%
1 month	5.25%	4.85%	6.75%	2.67%	USD/INR 6-month	1.08%
6 months	4.91%	4.79%	6.35%	2.80%	GBP/INR 1-year	–0.13%
12 months	4.42%	4.72%	6.05%	2.90%	EUR/INR 1-year	1.15%

Explanation of terms:

T. C. Selling – Rate applicable when a customer buys Foreign Currency Travellers Cheques from the bank.

T. T. Selling – Rate applicable when a customer sends an outward remittance through Telegraphic Transfer.

Cash Selling – Rate applicable when a customer buys Foreign Currency Cash from the bank.

T. C. Buying – Rate at which Foreign Currency Travellers Cheques deposited by the customer is converted into rupees.

T. T. Buying – Rate at which a Foreign Inward Remittance received by Telegraphic Transfer is converted into rupees.

Cash Buying – Rate at which Foreign Currency Cash deposited by the customer is converted into rupees.

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Source: http://www.hdfcbank.com/forexpdf/forexrates.pdf.

INDIAN FOREX MARKETS

Prior to 1992, the Indian forex markets were totally regulated. The value of the Indian rupee was fixed, first in terms of the pound and later the US dollar. This value was revised once in a while when the regulator felt the need. All inward and outward remittances were required to be converted at this rate of exchange. The liberalization of the forex markets started in 1992. In March 1992, a dual exchange rate system was put into place. This was known as Liberalized Exchange Rate Management System (LERMS). Two exchange rates were prevailing during this period, one determined by RBI and the other determined by the market. This was the beginning of moving towards a market-oriented rate. Under this system, 40% of current account receipts were required to be converted at official rate and the balance could be converted at market determined rates. This was later modified to become the Unified Exchange Rate System which came into effect from March 1, 1993. Under this system, all forex transactions are required to be routed through the ADs at market determined rates. The RBI also announces its rates (which act as reference rates) based on market rates. As mentioned earlier, only permitted persons can deal in foreign exchange (ADs etc.). Hence, any other person desiring to buy or sell foreign exchange can do so only through these permitted persons, and only for permissible transactions.

In August 1994, RBI announced relaxations on current account transactions and delegated further powers to ADs. They can now allow remittances for various purposes like travel, studies, medical treatment, gifts and services to the extent specified by RBI under the various provisions of the Exchange Control Manual. From time to time, RBI comes out with rules regarding the various players who are allowed to operate in the forex market, the various permissible instruments (like forward contracts, swaps etc.), the conditions in which these instruments can be used, etc. It thus regulates the operations of the market. Some of the important regulations, and the relevant FEDAI guidelines as on January 7, 1999 are given below:

Forward Exchange Contracts

- Can be booked only for genuine transactions and where there is exposure to exchange risk, not for speculative purposes.
- Cannot be booked for anticipated transactions only for firm exposure.
- Can be booked in the currency in which the importer is exposed to exchange rate or in any other permitted currency, i.e. any freely convertible currency.
- Value of the forward cover should not exceed the value of the goods contracted for.
- The period and the extent of the exposure to be covered is left to the choice of the importer. However, the last date of delivery of the forward contract should not exceed six months from the date of shipment/expected shipment date (in case of contracts booked for covering exports or imports).
- Rollover forward covers are permitted to be booked as necessitated by the maturity dates of the underlying transactions, market conditions and the need to reduce costs to the customers. Each time a forward contract is rolled over, the new contract can be for a maximum period of six months.
- In case of merchant trade transactions (i.e., transactions where some goods are imported only to be exported elsewhere, in the same or a refined form), forward contracts will have to be booked simultaneously for both legs of the transactions or for the net amount of expected profit.
- No ready sale or purchase should be made for a transaction for which a forward contract has already been booked.
- Forward contracts can be cancelled by the party concerned whenever required. The exposure can be covered again by the customer through the same or another AD subject to genuine exposure risk and permissibility of the transaction. However, for non-trade transactions, contracts once cancelled cannot be rebooked. Corporates can rollover such contracts on maturity at ongoing rates.
- Forward cover can be taken by resident corporate clients in respect of dividend due to overseas investors, who have made a direct foreign investment in India. The cover can be provided only after the Board of Directors has decided upon the rate of dividend.
- Forward cover can also be taken for foreign currency loans to be raised, anytime after the final approval for the loan arrangements has been obtained from RBI.
- For GDR issues, forward cover can be obtained once the issue price has been finalized.
- On each forward sale/purchase contract booked, the ADs are required to charge a minimum commission of Rs.250 (FEDAI rules).

Other Regulations

a. Exporters and certain other recipients of forex, at their option, can retain a portion of the proceeds in forex in a foreign currency account opened with ADs in India. This account is known as Exchange Earners' Foreign Currency deposit.

b. Cross currency exposures can be covered in the overseas market through ADs, without necessarily covering the rupee/dollar leg of the transaction.

c. All actual out of pocket expenses of the bank such as postage, telex charges including those of the corresponding bank shall be recovered from the customer.

d. R – Returns are required to be submitted by ADs to the Exchange Control Department of RBI – pertaining to the transactions in foreign exchange, and in rupee with overseas banks during each fortnight. These returns serve as the principal source of information for compilation of BoP data. They also help RBI to check whether the powers delegated to ADs have been correctly exercised.

Early Delivery/Extension/Cancellation of Forward Exchange Contracts

In many cases, a customer books a forward contract on the basis of an estimation regarding the time when he would need to deal in the foreign currency. With the uncertainties prevailing in international trade, in many cases the customers may find themselves receiving export proceeds beyond the estimated due date, or preferring to pay for their imports before the due date to take advantage of a depreciating foreign currency or for any other reason. The actual date of delivery or purchase of foreign currency may vary from the date for which forward contract is booked, for a variety of reasons. In such circumstances, forward contracts may be extended or cancelled, or an early delivery could be requested by the customer, if the bank is willing to accommodate him. In these cases, the customers will have to bear the losses arising out of the premature/extended performance or cancelling of the contract. The charges that the customer has to pay to the bank are regulated by FEDAI Rule No.8. The rule says that:

i. Customers can request for an early delivery/extension/cancellation of a forward contract on or before the maturity date of the contract.

ii. The bank has to a charge a minimum sum of Rs.100 for entertaining any such request from the customer.

iii. **Early Delivery:** If a bank accepts or gives early delivery, in addition to the flat charge of Rs.100, the bank has to charge/pay the swap charges for the early delivery period from/to the customer, irrespective of whether the bank actually enters into a swap or not. This swap cost/ gain may be recovered from/paid to the customer, either at the beginning of the swap period or at its end, as the bank may deem fit. As a result of the swap, if the bank faces an outlay of funds, it has to charge interest from the customer at a rate not less than the prime lending rate, for the period of the swap. If there is an inflow of funds, the bank may, at its discretion, pay interest to the customer at the rate applicable to term deposits with maturity equal to the period of the swap. The timing of this cash flow too is left to the discretion of the bank.

Let us see an example for early delivery. An exporter enters into a forward contract with a bank to sell 1 million US dollars to the bank, settlement date December 31. The contract price is Rs.39.20/$. On November 28, the exporter asks the bank to take delivery on November 30. The spot rate on that date is 39.02/07. The dollar is at a premium, with one month swap points being 10/15. To offset its position created by the early delivery, the bank will have to enter into a one month sell-buy swap. In the process, it will have to

sell dollars spot @ Rs.39.02 and will have to pay a premium of 15 paise for the swap. This swap cost of 15 paise will be charged to the customer. On November 30, the bank buys dollars from the exporter @ Rs.39.20/$, i.e., the earlier contracted rate. Since on that day the bank pays Rs.39.20/$ (to A) and receives Rs.39.02/$ (from the market), there will be an outlay of funds to the extent of 18 paise per dollar for the duration of the swap, i.e. one month. The bank will charge interest at a rate not lower than the prime lending rate on this outlay for one month from the customer. In addition to the swap cost and the interest, A will have to pay Rs.100 to the bank. The net inflow to A can be calculated in the following manner:

Assume that the bank charges interest @17%.

Inflow from dollar sale: 1,000,000 x 39.20	=		Rs.39,200,000
Swap charges paid: 0.15 x 1,000,000	=	150,000	
Interest paid: 0.18 x 1,000,000 x 0.17/12	=	2,550	
Flat charge	=	100	
Total outflow	=		152,650
Net inflow	=		39,047,350

iv. **Extension:** An extension of a contract entails cancelling an existing contract and rebooking a corresponding forward contract. The cancellation is required to be done at the relevant TT buying or selling rate as on the date of cancellation, and the rebooking would be done on the ongoing rate for a new forward contract. The bank is required to collect/pay the difference between the rate at which the original contract was entered, and the rate at which it is cancelled, from/to the customer. This may be done either at the time of cancellation or at the time of maturity of the original contract. This would be in addition to the flat charge. Let us take an example:

Illustration 1

Extension before Due Date

An importer enters into a forward contract with a bank whereby the bank will sell 1 million dollars to the importer @ Rs.39.20, settlement date November 30. On November 15, the importer requests the bank to extend the contract up to December 31. On the day of the request, the forward TT buying rate for November 30 is Rs.39.25, and the Bill selling rate for maturity December 31 is Rs.39.30. The bank will cancel the original contract (i.e., enter into an exact opposite contract, here, to sell dollars) at Rs.39.25 and book a new forward contract at Rs.39.30. The difference of 5 paise (39.20 – 39.25) per dollar would be passed on to the customer on either November 15, or on November 30. On December 31, the importer will buy dollars from the bank @Rs.39.30. In addition, at the time of cancellation, the importer will pay Rs.100 to the bank. The net outflow for the importer will be:

On cancellation:		Rs.
Gain on cancellation: 0.05 x 1000,000 =		50,000
Less: Flat charges	:	100
Net amount receivable	:	49,900
On December 31, the importer buys dollars from the bank for: 39.30 x 10,00,000 = 39,300,000		
The importer's net outflow (ignoring timing of the different flows)	:	3,93,00,000
Less: Net amount receivable		49,900
		3,92,50,100

Illustration 2

Extension as on Due Date

You as a banker booked a forward contract for USD 4,00,000 at Rs.39.3200 covering a TT remittance against a bill for collection and covered yourself in the local interbank market at Rs.39.3650, however on the maturity date your customer requested you to extend the contract by one month.

Assuming the on-going market rates for US dollar are as under:

Spot rate USD 1	: Rs.39.4925/5075
1 month forward	: Rs.700/800
2 months forward	: Rs.1000/1100
3 months forward	: Rs.1300/1400

What will be the extension charge customer has to pay if you require an exchange margin of 0.05% for TT buying and 0.07% for TT selling rate.

Solution

The forward purchase contract will be cancelled at the TT selling rate for US dollar	= Rs.39.5075
Add: Exchange margin at 0.07% (45.7075 x 0.0007)	+ Rs.0.02765
	= Rs.39.5351
Dollar bought from customer under original contract at	Rs.39.3200
It is sold to him under the cancellation contract at	Rs.39.5351
Exchange difference per dollar payable by a customer	Rs.0.2151
Exchange difference for USD 4,00,000 is Rs.4,00,000 x 0.2151	Rs.86,040

So Rs.87,760 will be recovered as cancellation charges from the customer.

The banks will book a fresh forward purchase contract for the customer at the rate given below:

Spot rate for buying dollar in the interbank market	Rs.39.4925
Add: One month premium	+ Rs.0.0700
	Rs.39.5625
Less: Exchange margin at 0.05% (39.5625 x 0.0005)	– Rs.0.0198
Forward TT buying rate for dollar	Rs.39.5427

On extension Rs.86,040 will be recovered as cancellation charges from the customer and the fresh contract will be booked at Rs.39.5427.

v. **Cancellation:** In case of cancellation of a contract, it is required to be cancelled at the appropriate TT selling or buying rate, and the difference between the contracted rate and the cancellation rate is to be collected from/paid to the customer. In addition, the flat rate is required to be collected.

vi. If in the above example, the importer had requested the bank to cancel the contract on November 15 rather than getting it extended, the customer would have got 5 paise per dollar and would have paid charges of Rs.100 to the bank. The importer's net inflow/outflow would be:

Gain on cancellation: 0.05 x 10,00,000	=	Rs.50,000
Less: Flat charges	=	100
Net amount receivable	=	49,900

Any amount to be collected/paid by the bank on account of early delivery/ extension/cancellation of a forward contract (except for the flat charge) shall be ignored if it is less than or equal to Rs.50.

Illustration 3

The bank entered into a forward contract with its customer on 15th March for US dollars 5000 @ Rs.38.45, delivery due on 15th June. It covered itself in the market at Rs.38.4025. On May 5, the customer requests the bank to extend the contract up to July 15. Calculate the extension charges recoverable from the customer assuming the following rates in the interbank market on May 5:

Spot	USD 1 = Rs.37.9300/9400
Spot/ May	38.0300/0425
Spot/June	38.4300/4425
Spot/July	38.7300/7500

Exchange margin 0.10% on buying as well as on selling.

On Cancellation

The forward purchase contract will be cancelled at the forward sale rate for delivery in June.

Interbank forward selling rate	Rs.38.4425
Add: Exchange margin at 0.10%	Rs.0.0384
	Rs.38.4809

Rounded off, the rate applicable is Rs.38.4810.

Bank buys dollars under original contract at	Rs.38.4500
It sells under the cancellation contract at	Rs.38.4810
Difference per dollar payable by the customer	Rs.0.0310
Exchange difference for USD 5000 payable by the customer is	Rs.155.000

On Rebooking

The forward purchase contract will be rebooked with delivery on July 15. Since forward dollar is premium, the forward margin will be rounded off to lower month of June.

Forward market buying rate for June	Rs.38.4300
Less: Exchange margin at 0.10%	Rs.0.0384
	Rs.38.3916

Rounded off the rate quoted will be Rs.38.3920

Summary

The bank will recover Rs.155 from the customer and rebook the contract at Rs.38.3920 per dollar.

CONVERTIBILITY

The government which took over office on July 21, 1991 inherited a crisis driven economy. The situation of the Balance of Payments was precarious. Inflation reached double digits with a disastrous effect on the poorer sections of the society. International confidence in India weakened which resulted in reduced capital inflows. The oil crisis further aggravated the already worsening Balance of Payments. The immediate recourse was to draw on the facilities of the International Monetary Fund (IMF) with its conditions. However, the government went a step further and initiated a few very bold reforms in a phased manner. These reforms included introduction of partial convertibility of the rupee, liberalization of export-import policy, reduction of tariff rates, etc.

Convertibility means that a foreign currency can be converted into domestic currency without any restriction and vice-versa. Convertibility as defined by Article VIII of the IMF states:

"No member shall, without approval of the fund, impose restrictions on the making of payments and transfers for current international transactions.

Each member shall buy balances of its currency held by another member if the latter, in requesting the purchase, represents:

i. That the balances to be bought have been recently acquired as a result of current transactions.

ii. That their conversion is needed to make payments for current transactions.

The buying member shall have the option to pay either in the currency of the member making the request or in gold."

If we look back to the world economy prior to 1945, all domestic currencies were supported by gold reserves, which means that gold was the basis for transaction in different currencies and that each currency could be converted against others at a specified rate. However, with the passage of time, gold standards collapsed and the dollar took its place. Under the dollar standard, countries which pegged their exchange rates to the US dollar were required to keep the actual rate within 1% of the selected parity value. To ensure this arrangement, the Central Banks had to intervene whenever the market forces caused the exchange rate to cross the allowed range. With the collapse of the dollar standard, the era of floating exchange rates or managed floats dawned in 1972. Though a few futile attempts were made to revive the fixed exchange system, none of them could succeed. Leading economists then started to strive for a final solution to the volatility of the exchange rates. The Louvre Accord was signed in 1987 where a decision was taken to shift to the "Managed Float". As per this strategy, all monetary authorities were to act in mutual coordination in order to keep the exchange rates stable in their respective economies even in the times of crisis. With the passage of time, even the floating exchange system became outdated as it led to exchange rate instability. Cross-border capital outflows increased, causing economists to start ruminating again on a final solution. They finally realized that to close all such loopholes, the currencies have to be made fully convertible against each other.

A currency is said to be fully convertible:

- When there is no restriction on transactions to be executed between one country and another.
- When both residents and non-residents are allowed to convert their currency holdings into either gold or generally accepted foreign currency with no bar on the amount of currency to be converted.

However, if convertibility is restricted to certain foreign currencies, transactions and/or people, it is termed partial convertibility. Internal partial convertibility is permissible to residents whereas external convertibility is meant for non-residents.

The first step towards full convertibility typically is to make it convertible on current account and only then move on to convertibility on capital account.

Convertibility on Current Account

The convertibility on current account means that there are no restrictions in transacting foreign currency on current account. In other words, the foreign currency transactions except those for creating or liquidating foreign assets/liabilities are free from any type of restrictions.

With the 1992-93 budget, the partial convertibility on current account (dual exchange rate system) was introduced in India. It meant:

- 40% of all foreign exchange earnings through exports would be surrendered at the official exchange rate (RBI rate).

- Balance 60% can be sold at market-determined rate through the authorized dealers in foreign exchange (to be announced on every working day by the FEDAI in consultation with banks). Units in the EPZs and 100% EOUs were the only privileged ones to be permitted to convert 100% of their earnings at the market rate. Due to the special status already given to the EPZs and EOUs, forecasting had to be changed so as to bring in more transparency.

FULL CONVERTIBILITY ON CURRENT ACCOUNT

The budget of 1993-94 changed the ratio for current account transactions from 40/60 to 0/100, i.e., the exchange rate was unified. This meant that the market rate and the official exchange rate would be the same. In common parlance, it is often termed as achieving full convertibility on current account. However, in reality it is not so as the RBI's permission is still required for most of the exchange transactions. Moreover,

- Authorized Dealers can release the amount for current account transaction only up to a prescribed limit.
- Income on NRIs' NRNR account is eligible for repatriation only in a phased manner.
- Debt servicing to the former rupee payments area is not freely repatriable.
- There is no free current account transfer as the dividend balance requirement of the dividends on foreign direct investment in consumer goods sector does not apply.

Making the rupee fully convertible on the current account meant the acceptance of Article VIII of the IMF. It meant that India would have to abide by the conditions imposed by the IMF; refrain from imposing restrictions on the making of payments and transfers for current international transactions; and not engage in multiple currency practices without the approval of the IMF.

The RBI has announced certain relaxations in current account payables in matters relating to:

- Indicative limits on current account payments.
- Non-Resident (Non-repatriable) Rupee Deposit Scheme (NRNR).
- Foreign Currency (Ordinary) Non-Repatriable Deposit Scheme (FCONR).
- Repatriation of investment income by non-residents.

Convertibility on Capital Account

Capital convertibility means conversion of rupees into any foreign currency. The currencies could be banked or could be used to acquire assets like real estate, financial instruments, gold jewelry and so on in any foreign country. Foreign nationals will be free to convert their currencies into rupees to acquire such assets in India, and there will be freedom to sell such assets and repatriate funds into any other currency of their choice. Thus, transactions by foreigners in India and by Indians abroad in money market, treasury bills, CDs, bills of exchange and derivatives could be permitted.

In simple terms, free transformation of domestic currency to a foreign currency and vice-versa could take place, i.e., say one can walk into a bank, submit dollars and demand rupees instead and vice-versa.

Integration of our markets with the world markets will mean that Indian investors will have an access to invest in foreign companies which have not set shops in India. Instead of keeping a regular track of the BSE, NSE, OTCEI, Indian investors will be studying the likes of the Dow Jones Index and the Nikkei. Competition will be fierce in the domestic scene as they try to lure the investors. Industries can attract/capital from abroad without any restrictions by the authorities.

BENEFITS OF CAPITAL ACCOUNT CONVERTIBILITY

There are many benefits to Indians from CAC. To list a few:

i. Rates of return on debt and equity are high in India by world standards. With convertibility, foreign money will come into India to arbitrage this differential away and reduce these rate of return. Thus, the cost of capital for Indian companies in equity and debt financing will drop. The lower cost of capital will make more investment projects viable.

ii. With convertibility, Indians could hold their portfolios internationally. Instead of being constrained only to Indian real estate, equity and debt holdings, they could reduce the risk by diversifying. In case of a bad year here, when Indian assets generate poor returns, foreign assets could continue to generate good returns.

iii. Convertibility will make it possible for Indian firms to interact with Indian households in (say) the markets of UK. This would provide alternatives for Indian households and firms, to generate competition for their financial industry and elevate the urgency of reforms in the financial sector.

iv. With convertibility, volatility in the interest rates and in the dollar-rupee will rise, but given the tradition of our governmental control, Indians are used to some cushioning response from the government, i.e., expecting low volatility. This raises the urgency of developing futures and options on interest rates and on the dollar-rupee, which would provide people a method to manage these risks.

In 1997-98 Union Budget, the Finance Minister announced that Capital Account Convertibility (CAC) of the rupee would be soon looked into and a Committee on CAC was thus formulated, headed by Sri. S. S. Tarapore, former Deputy Governor of the RBI, to submit a report by 1st June 1998.

The fruits of convertibility may be sweet, but the Committee has stipulated stringent conditions to be met before the rupee is made fully convertible thus, thrashing the criticism of the non-converts while adhering to the basic goal of convertibility.

Summary of First Tarapore Committee Report

The following is a summary of the First Tarapore Committee report on Capital Account Convertibility submitted on 3rd June, 1997.

ISSUE IN CAPITAL ACCOUNT CONVERTIBILITY

1. The Committee is of the view that there are several benefits of a more open capital account: the availability of a larger capital stock to supplement domestic resources and thereby higher growth, reduction in the cost of capital and improved access to international financial markets.

   Capital Account Convertibility (CAC) allows residents to hold an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic real and financial stocks, lowering funding costs to borrowers and prospects of higher yields for savers. An associated gain from CAC is the dynamic gain from financial integration. Allocative efficiency improves as a result, and this can stimulate innovation and improve productivity.

   CAC provides the impetus for domestic tax regimes to rationalize and converge upon international tax structures. This removes inducements for domestic agents towards evasion and capital flight. The Committee emphasizes that capital controls turn progressively ineffective, costly and even distortive.

2. The Committee recognizes that the institution of financial sector reforms in India revealed the weaknesses which had been in the system for a long time. The introduction of CAC would require more protective policy action, as an open capital account could bring these weaknesses under sharper focus. CAC would impose a strong discipline upon the financial system and would expedite the early rectification of infirmities in the system and lead to widening/deepening of markets to enable the spreading/distribution of risks.

3. The Committee's survey of the international experience with CAC revealed that countries which initiated the moves to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shifts in the stance of macroeconomic policies. Furthermore, these countries were less vulnerable to backtracking and reimposition of controls. Countries with weak initial conditions were constrained to adopt drastic macroeconomic policies to facilitate the move to CAC. Some of these countries had to face interruptions and reintroduce capital controls in the evaluation of CAC.
4. The Committee noted that most countries considered a strong balance of payments position as a necessary precondition for the move to CAC and universally built up reserves. The Committee's survey of the country experiences shows that strengthening of the financial system emerged as the most important precondition for CAC. Fiscal consolidation is another important precondition for CAC among all countries. An important concomitant in the process of CAC is the conduct of an appropriate exchange rate policy.
5. In the specifics of capital account liberalization, in the countries studied by the Committee, restrictions on inflows and related outflows by non-residents and residents were removed first, followed by relaxation of restrictions on outflows by residents. Among residents, corporates and non-banks usually received preferential treatment, followed by banks and individuals. Most countries maintained, or were required to impose, some controls on capital inflows during the transition to CAC.

PRECONDITIONS/SIGNPOSTS FOR CAC

6. Based on an assessment of macroeconomic conditions, the Committee is of the considered view that the time is now opposite to initiate a move towards CAC. The Committee however, recognizes that the initial conditions do contain certain weaknesses and the entrenchment of preconditions can be achieved in the Indian context only over a period of time. The establishment of preconditions needs to be viewed as processes rather than as one-time indicators. The Committee, therefore, recommends that the implementation of CAC be spread over a three-year period, 1997-98, 1998-99 and 1999-2000. The Committee stresses that implementation of measures towards CAC should be sequenced along with the authorities making an assessment of the progress towards the attainment of the conditions/signposts stipulated for the relevant year. Depending on this assessment, implementation of measures could be accelerated or decelerated.
7. Fiscal consolidation, a mandatory inflation target and strengthening of the financial system, should be regarded as crucial preconditions/signposts for CAC in India. In addition, a few important macroeconomic indicators should also be assessed on an ongoing basis. These are: the conduct of exchange rate policy, the Balance of Payments (BoP) and the adequacy of foreign exchange reserves.

Fiscal Consolidation

8. The Committee recommends a reduction in the GFD/GDP ratio from a budgeted 4.5% in 1997-98 to 3.5% in 1999-2000. The reduction in the center's gross fiscal deficit should be accompanied by a reduction in the states' deficit as also a reduction in the quasi-fiscal deficit.
9. The practice of financing the amortization of government market loans out of fresh borrowings, is clearly unsustainable and this practice could invariably result in a crisis situation. The Tenth Finance Commission has recommended the institution of a Consolidated Sinking Fund (CSF) for the public debt, and the Committee, while strongly endorsing this recommendation, stresses that the institution of a CSF is an important ingredient in achieving the pre-condition on fiscal consolidation.

10. Monetary management is often clouded by the monetary authorities' concern about the Government's borrowing program, and therefore, the Committee recommends that steps should be initiated to separate the debt management policy from monetary management and to this effect the RBI should set-up its own Office of Public Debt. The RBI should totally eschew from participating in the primary issues of Government borrowing.

11. Transparent and internationally comparable procedures for fiscal accounting should be adopted so as not to blur the true magnitude of the GFD/GDP ratio as also the constitutes of the budget as a whole. The Committee recommends that the Government of India should consider an early introduction of a system of fiscal transparency on the lines of the New Zealand Fiscal Responsibility Act.

Mandated Inflation Rate

12. In the context of a move towards CAC, effective measures should be taken to evolve a more specific commitment on the inflation rate. The Committee recommends an early empowering of the RBI on the inflation mandate. There should be a medium-term inflation mandate approved by the Parliament and only the Parliament should alter that mandate. Once the mandate is given, the RBI should be free to use the instruments at its command to attain the medium-term inflation target.

    Intensification or withdrawal of public intervention in price formation or a shock in the real sectors could warrant a review of the mandate, but there should be clear and transparent guidelines on the circumstances in which the mandate could be changed. The Committee recommends that the mandated rate of inflation for the three-year period 1997-98 to 1999-2000 should be an average of 3%–5%. Such a mandate would necessarily provide greater independence to the RBI.

Consolidation in the Financial Sector

13. The Committee recommends that interest rates be fully deregulated in 1997-98 with total transparency to ensure that there are no formal or informal interest rate controls.

14. The strengthening of the financial system is the most important precondition of the move to CAC. Noting the systemic dangers of some of the weak banks growing at rates faster than the system, the Committee recommends that the weak banks be converted into what are called narrow banks. The incremental resources of such banks should be restricted only to investments in government securities, and in extreme cases of weakness such banks should not be allowed to increase these advances. A severe restraint on their liability growth should also be applied. Such measures are unavoidable if the financial system is to be safeguarded during the move towards CAC.

15. The Committee recommends a time-frame for signposts which should be attained in relation to CRR and NPAs, as part of a progressive move towards CAC.

16. The Committee recommends that the financial institutions should also be made to function with a targeted mandate to reduce the quantum of NPAs within a time-bound program.

Exchange Rate Policy

17. The RBI should have a Monitoring Exchange Rate Band of +/– 5% around the neutral Real Effective Exchange Rate (REER). The RBI should ordinarily intervene as and when the REER is outside the band. The RBI should ordinarily not intervene when the REER is within the band. It could, however, use its judgment to intervene even within the band to obviate speculative forces and unwarranted volatility. The Committee further recommends that the RBI should undertake a periodic review of the neutral REER which could be changed as warranted by the fundamentals.

18. The Committee stresses that credibility of the exchange rate policy would be vital in the context of CAC, and to this extent there must be transparency in the exchange rate policy:

    i. The neutral REER, i.e., the base period should be announced.

    ii. The REER Monitoring Bank should be declared.

    iii. The REER should be published on a weekly basis with the same time lag as the publication of the reserves.

    iv. Changes in the neutral REER should be made public.

19. The Committee recommends that as part of exchange rate management, greater attention should be focused on ensuring that the forward exchange markets reflect the interest rate differentials.

Balance of Payments

20. The Committee recognizes that, in view of the growing degree of integration of the Indian economy, the size of the Current Account Deficit (CAD) which can be sustained without encountering external constraint, is a function of the degree of openness of the economy, which can be defined in terms of the ratio of Current Receipts (CR) to GDP. Accordingly, the Committee recommends that, as a broad rule of thumb, over the three-year period – 1997-98 to 1999-2000 – external sector policies should be designed to ensure a rising trend in the CR/GDP ratio from the present level of 15% and the endeavor should be to reduce the debt service ratio gradually from 25% to 20%. The CAD/GDP ratio would need to be consistent with the above parameters.

Adequacy of Reserves

21. In the context of a move to CAC, capital flows would have a more significant effect on the Balance of Payments. Conventional indicators in terms of import cover do not provide a good indicator of the adequacy of reserves. As a broad guideline, the Committee recommends that the following four indicators be used in the Indian context for evaluating the adequacy of reserves.

    i. Reserves should not be less than six months of imports. This ratio is higher than earlier norms as it would take into account the uncertainties and volatility in capital flows which can arise in the context of a move to CAC. Under this formulation, the foreign exchange reserves would, at present, need to be about $22 billion.

    ii. Reserves should not be less than three months of imports plus 50% of debt service payments plus one month's exports and imports to take into account the possibilities of leads and lags. On this basis, the present requirement would be $24 billion. When more accurate data on leads and lags is available, the requirement for resources could be adjusted appropriately.

iii. The short-term debt and portfolio stock, which is equivalent to 70% of the level of reserves, should be lowered to 60% by using the formulation that incremental short-term debt and portfolio liabilities should be accompanied by equivalent increases in reserves, which would ensure that this ratio would decline to the desired extent. On this basis, the reserves would need to rise from the present level of $26 billion to $31 billion.

iv. The net foreign exchange assets to currency ratio (NFA/currency ratio) should be prescribed by law at not less than 40%. The present ratio is 70% and the objective should be to maintain it around the present ratio. The implication would be that at the present time, the stipulation under the proposed ratio of a minimum of 40% would be around $15 billion. Under the desired ratio of 70%, the requirement would be a little over $26 billion.

22. The Committee recommends that a uniform regulatory system needs to be adopted for banks and non-banks, particularly FIs, in relation to prudential norms, market participation, reserve requirements and the interest rate regime.

23. In the context of a move towards CAC, the Committee recommends that reserve requirements on banks, non-resident liabilities and overseas borrowings should be at least on par with those on domestic liabilities. Furthermore, as one of the instruments for moderating capital inflows, the RBI should use the instrument of CRR to impose higher reserve requirement on non-resident liabilities, including overseas borrowings.

24. The Committee is of the view that risk management is a critical area to which banks and non-banks (including FIs) must bestow immediate attention. The Committee thus recommends that:

i. The RBI should prescribe prudential norms for rupee mismatches.

ii. Banks should move to 100 percent mark-to-market valuation of investments.

iii. Banks should adopt best practices of risk management suggested by the expert group on forex markets (Chairman, Mr. O.P. Sodhani).

iv. Banks should follow international accounting and disclosure norms.

v. Capital prescriptions should be stipulated for market risk.

25. A successful move to CAC requires an effective supervisory regime which needs to pick up warning signals. Weaker entities need to be monitored more closely and frequently.

26. As risks faced by the financial sector are much higher in developing countries, the Committee recommends that the RBI should consider the imposition of even more stringent capital adequacy standards than the Basle norms, and income recognition and asset classification, norms should be tightened expeditiously. There could also be steeper capital requirements for banks with higher level of NPAS.

27. The Committee is of the view that much more needs to be done to enable public sector banks to operate with a greater degree of autonomy to cope with the rapidly changing environment. The Committee recommends that the more efficient public sector banks need to be allowed, may, actively encouraged, to break away from the pack and their activities should not be hemmed in by concerns for the weak banks.

The Committee recommends that the Fls should also be given a greater degree of operational freedom within the framework of strict prudential norms. While issues of autonomy are often posed as one of the regulator/owner giving freedom to the entities, there is also the issue of entities taking on their rightful autonomy. The board should be so constituted that they effectively operate as autonomous units. The Committee emphasizes that autonomy is never given, but always earned.

28. The Committee recommends that a comprehensive banking legislation and enforcement machinery be put in place, not only to reduce the quantum of NPAS, but also to ensure that such a framework serves as a deterrent to future defaulters. In the context of CAC, a comprehensive review of all banking and finance related enactments needs to be taken up, which have engendered inflexibilities/rigidities in the system.

29. The Committee is of the view that without a greater degree of technology absorption, the market participants will be ill-equipped to build strong risk management systems and management information systems. Upgradation technology can pave the way for easy payment and will strengthen the financial system.

30. The Committee underscores the need for strong initiatives on the part of market participants to upgrade the human resource skills to enable Indian financial entities to compete meaningfully with their counterparts abroad. In order that they attract the best talent and expertise, individual banks and Fls should have freedom to determine their personnel policies including recruitment and wage policies without being constrained by any rigidities.

CAC and Gold

31. In the context of CAC, there is a strong case for liberalizing the overall policy regime on gold. The Committee is of the view that the policy on gold is, to some extent, in the nature of a precondition for a successful move to CAC.

Timing and Sequencing of Measures

32. The Committee recommends that alongside further measures of liberalization of capital inflows, it is desirable to simultaneously liberalize controls on outflows as a means to contend with capital inflows. An early albeit cautious beginning to allow capital outflows is desirable, as the system is attuned to a totally rigid ban on certain outflows and the system needs to develop confidence that some capital outflows, far from being destabilizing, would be conducive to the overall efficiency of deployment of resources.

33. The Committee recognizes that while the timing and sequencing of CAC proposed can be undertaken under the existing laws and regulations relating to foreign exchange, they would be facilitated by the proposed changes in the legislative framework governing foreign exchange transactions.

34. The timing and sequencing of measures for liberalization of capital outflows and inflows are set out in relation to various economic agents viz., corporates, banks, non banks and individuals. A three-year road map is outlined with Phase I (1997-98), Phase II (1998-99), and Phase III (1999-2000). Concomitant measures for the development and integration of the foreign exchange, money and securities markets are also set out. Some of the important measures are:

    i. Direct investment in ventures abroad by Indian corporates should be allowed up to $50 million at the level of authorized dealers in terms of transparent guidelines by the RBI and beyond $50 million through the Special Committee. The restrictions on repatriation of dividend, etc. within a time period should be removed. Ventures abroad should not be confined to exporters/exchange earners.

    ii. Corporates should be allowed to freely open offices abroad for promoting their business.

    iii. ECB ceiling should not be applicable to loans with an average maturity of 10 years and above, which, in Phase II could be reduced to 7 years and above. Restriction on end use of ECB for rupee expenditure should be removed.

iv. The RBI approval for various purposes while execution of projects should be dispensed with subject to guidelines and reporting.

v. Exporters/exchange earners may be allowed 100% retention of earnings in EEFC accounts with complete flexibility in operation of the accounts for current and permitted capital transactions and cheque writing facility in these accounts may also be allowed.

vi. Foreign direct and portfolio investment and disinvestment should be governed by comprehensive and transparent guidelines and prior RBI approval at various stages may be dispensed with subject to reporting by ADS. Direct/portfolio investment may be open to all non-residents on par with NRIs and FIIs.

vii. Banks may be allowed to borrow from overseas markets and deploy their funds outside India. Borrowings (short and long-term) may be subject to an overall limit of 50 percent of unimpaired Tier I capital in Phase I, 75% in Phase II and 100% in Phase III with a sub-limit of short-term borrowing. Deployment of funds outside India should be permitted subject to the adherence to Section 25 of the Banking Regulation Act and prudential norms relating to open position and gap limits.

viii. SEBI-registered Indian investors may be allowed to set-up funds for investments overseas subject to an overall limit of $500 million in Phase I, $1 billion in Phase II and $2 billion in Phase III.

ix. Individuals may be allowed to invest in assets in financial markets abroad to the extent of $25,000 in Phase I, $50,000 in Phase II and $100,000 in Phase III. Similar limits may be allowed to non-residents for their non-repatriable assets in India.

x. Residents may be allowed to have foreign currency-denominated deposits with corporates and banks (only rupee settlement).

xi. Residents may be allowed to obtain loans from non-residents $250,000 on repatriation basis with interest at LIBOR with no restrictions on use of funds.

xii. The non-resident non-repatriable rupee deposit scheme should be discontinued in Phase I. Maturity proceeds, if kept in a special NRE account for 3 years with no early withdrawal facility, should be allowed for full repatriation.

xiii. All participants of spot markets should be allowed participation in forward markets: FIIs, non-residents and non-resident banks may be allowed forward cover to the extent of their assets in India.

xiv. All-India FIs fulfilling requisite criteria should be allowed to become full-fledged ADS.

xv. Currency futures may be introduced with screen-based trading and efficient settlement systems.

xvi. Participation in money markets may be widened, market segmentation removed and interest rates deregulated.

xvii. The RBI should withdraw from primary market in government securities, role of primary and satellite dealers should be increased, fiscal incentives should be provided for individuals investing in government securities and the government should set-up its own office of public debt.

xviii. Banks and FIs should be allowed to participate in gold markets in India and abroad and deal in gold products.

35. The Committee underscores the critical importance of monitoring information on various types of capital flows and stocks. In this context, an expeditious revamping of the statistical information system should be undertaken.

36. While CAC, to some extent, privatizes decisions relating to foreign assets in order to ensure tax compliance, it is necessary for India to institute arrangements with other countries for sharing tax information on a multilateral basis, akin to the agreement negotiated by the OECD countries.

37. The RBI should ensure ongoing monitoring of policies undertaken to entrench the preconditions/signposts and also ensure that measures on the phased move towards CAC are carefully implemented. The phased program outlined here could be accelerated or decelerated depending on the performance vis-à-vis the preconditions/signposts.

38. The Committee recommends that at the end of the three-year phasing, stock-taking of the progress on the preconditions/signposts as well as the impact of the measures outlined by the Committee should be undertaken. CAC is a continuous process and further measures could be undertaken in the light of the experience gained.

    Experts argue that, there is no guarantee that the Tarapore Committee's recommendations will be implemented within the recommended time frame, since the road being bumpy, one is not sure whether the time frame of three years is reasonable for Indian conditions. Convertibility has to be an irreversible decision. If there were a run on the rupee, or if for any other reason we suddenly reverse and declare that the rupee is no more convertible, it will be most unfortunate as it will send wrong signals. So, we have to make ourselves doubly sure that the decision for convertibility, if implemented, is sustainable.

Present Position in India

Convertibility of capital for non-residents has been a basic tenet of India's foreign investment policy all along, subject of course to fairly cumbersome administrative procedures. It is only residents – both individuals as well as corporates, who continue to be subject to capital controls. However, as part of the liberalization process, the government has over the years been relaxing these controls. Thus, a few years ago, residents were allowed to invest through the mutual fund route and corporates to invest in companies abroad, but within fairly conservative limits.

In 2002, the RBI announced a flurry of measures.

i. Up to November 2001, Indian residents returning from abroad could retain only $ 500 and this was raised to $ 2,000. Now the surrender requirement has been, for all practical purposes, done away with as residents can maintain non-interest bearing foreign currency checking accounts without limits while the Basic Travel Quota (BTQ) has been raised from $ 5,000 to $ 10,000. All individuals holding valid passport, traveling on business are entitled to carry BTQ of $25,000 or its equivalent foreign currency for every visit.

ii. This was further liberalized with various permissible payments such as Eurorail passes not being deducted from BTQ. The question now is not whether the BTQ is adequate, but whether people have the rupees to buy dollars! This, in a nutshell, is an acid test of genuine liberalization.

iii. Current payments for medical expenses are now permitted upto $50,000 without the red tape of tortuous documentation; similar relaxations have been made for educational expenses. The measures of no documentation for small value remittances up to $500 appear innocuous, but it is a step in the right direction.

iv. The RBI has liberalized Foreign Institutional Investment (FII) limits, FIIs being permitted in exchange-traded derivatives and the sharp increase in the automatic route for Indian direct investment abroad. The relaxation of FII forward cover facilities, the two-way fungibility of ADRs /GDRs and Indian mutual funds investment abroad are significant.

v. For individuals, there have been significant relaxations. Non-Resident Indians (NRIs) holding Non-Resident Non-Repatriable Deposit Accounts (NRNR) now enjoy full repatriability. (This is deserved by those who put their money in NRNR accounts in the dark days of 1991 and 1992). NRIs having Non-Resident Ordinary (NRO) accounts which are non-repatriable have been handsomely rewarded – inheritances are now fully repatriable, and these accounts can be used with large limits for education and medical expenses. Also, sale of property held by NRIs from non-repatriable resources can be remitted abroad if the property is held for atleast ten years. NRIs now virtually enjoy full capital account convertibility.

Second Tarapore Committee Report on Full Capital Account Convertability

A Committee to set out the Road map towards fuller capital account convertability was appointed in March, 2006 under the Chairmanship of Mr. S. S. Tarapore. The committee was of the opinion that full capital convertibility is the need of the hour to enable the economic liberalization meaningful and fruitful. The summary of the recommendations/observations of the committee is given in Annexure 1 at the end of the chapter.

Exchange Control

Exchange control refers to the control by the government or a centralized agency, of transactions involving foreign exchange. Any stipulation or regulation that restricts the free play of forces in an exchange market, is termed the exercise of exchange control.

The origin of exchange control can be traced back to the 1930s. After the First World War, many countries of Europe found themselves with depleted gold reserves and foreign exchange. Therefore, they imposed payment restrictions to prevent massive capital withdrawals and instill stability in the domestic economy. Since then a number of countries have adopted exchange control systems.

Exchange controls are imposed to stabilize the exchange rates, in order to prevent the fluctuations of the free market rates that are temporary and speculative. The exchange control also aims to keep the currency at a higher value in terms of foreign currencies, so that imports become cheaper and also the external debt may be repaid at a cheaper rate, controlling inflation at the same time. Sometimes, the currency is also undervalued, to simulate exports through lower prices.

Exchange Control in India

Exchange control was introduced in India on September 3, 1939 at the outbreak of the Second World War by virtue of the emergency powers derived under the financial provisions of the Defence of India Rules, to conserve the non-sterling currencies and utilize them for essential purposes. In the post-war period, control over the foreign exchange transactions made prudent use of the foreign exchange reserves. Thus, the Foreign Exchange Regulation Act (FERA) was enacted in 1947. It has been replaced by the Foreign Exchange Management Act in 1999.

In India, exchange control is administered by the Reserve Bank of India. The exchange control is related to and supplemented by trade control and is the responsibility of the Director General of Foreign Trade in the Ministry of Commerce. The exchange control is comprehensive and covers supervision over the settlement of financial transactions relating to exports and imports as well as invisibles and capital transactions.

FERA VS. FEMA

FERA was first enacted in 1973, at a time when there was scarcity of foreign exchange. It was inherited from the British government, which had passed laws controlling foreign exchange, to keep control over its colonies. India needed the law in the early years of foreign exchange scarcity. Therefore, FERA was a sacrosanct necessity.

The Foreign Exchange Regulation Act, 1973 was drafted with the objective of introducing the necessary changes for the effective implementation of the government policy and removing the difficulties faced in the working of the previous enactment.

The basic statute of FERA empowered the government and the RBI to regulate, allow or prohibit transactions. Under FERA, almost all transactions, which were permitted, were based on notifications and circulars.

FERA was formulated to obtain the RBI permission in respect of most of the regulations. In order to understand the operative part of the regulations, one had to refer to the Exchange Control Manual (ECM) as well as the various notifications issued by the RBI and the central government.

FERA contained 81 sections of which 32 sections were related to the operational part and the rest covered penal provisions, authority, and powers of the Enforcement Directorate.

TRANSITION FROM FERA TO FEMA

FERA was introduced when India's foreign exchange reserves position was not satisfactory. Foreign exchange had become a very precious commodity and there was a dire need to optimize its utility. FERA was a resounding success then.

However, due to the major changes in the Indian economy and liberalization of industrial and trade policies, consistent with the fast changing international economic and trade relations, the need for a more conducive climate to increase the inflow of foreign investment and capital in the country to accelerate industrial growth and promotion of trade (especially exports) was felt.

Further FERA, contained certain special restrictions concerning foreign investment and the activities of individuals and concerns in India, having non-resident interests. Though, it was necessary to regulate the activities of foreign companies or branches of such companies and foreign citizens in India, the paramount need was to remove the special restrictions in respect of companies registered in India, and to simplify the regulations regarding foreign investment to attract better flow of foreign capital and investment.

The transition from FERA to FEMA was a transition from the era of regulations to permissions. This transition has also taken away the concept of "exchange control" and brought in the concept of "exchange management". In view of this change, the title of the regulation has been changed to "Foreign Exchange Management Act".

In order to replace FERA with FEMA, some crucial aspects were to be addressed.

i. The Indians who have become foreign citizens should be welcomed to invest in their motherland along with the Indian citizens who have become NRIs. Since dual citizenship is riddled with problems, the word "citizen" was to be dropped from the Act.

ii. The difference between the Income Tax Act, and FERA in respect of Indian origin was to be scrapped.

FEMA was enacted in response to the dynamic needs of the industry, exporters and importers. Its preamble lays down its objective as to consolidate and amend the law relating to foreign exchange, and to facilitate external trade and payments to promote the orderly development and maintenance of foreign exchange market in India. Its emphasis is on the RBI laying down the regulations rather than granting permissions on a case-to-case basis.

ABOUT FEMA

The much-awaited Foreign Exchange Management Act (FEMA) came into force from 1.6.2000 amidst eager expectations from all quarters of trade, commerce and industry of the country. FEMA, had several special liberalized features, unlike its more stringent predecessor, FERA. It is a right step towards the liberalization of economic laws in India, which have become inevitable in the current globalized economic scenario.

FEMA includes certain interesting definitions. They are:

A Capital Account Transaction is defined as one that alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or, assets or liabilities in India of persons resident outside India. FEMA classifies the capital account transactions as

i. **Prohibited Capital Account Transactions:** Unless specifically allowed, no person shall undertake or sell or draw foreign exchange to or from an authorized person for any capital account transaction. Persons residing outside India are not allowed to make investment in India, in any form, in any company or partnership firm or proprietary concern or any entity, whether incorporated or not.

ii. **Permissible Capital Account Transactions:** Any person can sell or draw foreign exchange to or from an authorized person for a capital account transaction specified under, provided that the transaction is within the limit, if any, specified in the regulations relevant to the transaction.

A Current Account Transaction is defined as the one that is not capital in nature and includes payments due in connection with foreign trade, other current business services and short-term banking and credit facilities in the ordinary course of business. It includes payments due as interest on loans and net income from investments. FEMA classifies current account transactions under three categories:

i. **Banned Transactions:** These are the transactions, which are totally prohibited, and no transaction relating them can therefore be undertaken.

ii. **Transactions Requiring Approval from Appropriate Authorities:** These are the transactions that require permission from the appropriate Ministry/Department of the Government of India irrespective of the amount.

iii. **Transactions Permitted within Prescribed Limits:** These are transactions for which limits have been prescribed and the RBI's permission is required only if the remittance exceeds the limit.

The above definitions will be found useful even in the income tax proceedings, as the income tax law has no precise meaning of capital and current account transactions, and has left it to judicial interpretation on the basis of facts and circumstances of the case.

FEMA defines an export as taking any goods and provision of services from India to any person outside India. There is also a corresponding definition of import.

Section. 2(zb) of FEMA defines service to mean service of any description which is made available to potential users and includes the provision of facilities in connection with banking, financing, insurance, medical and legal assistance, chit fund, real estate and so on. It also includes providing entertainment and purveying news or other information. It does not include the rendering of any service free of charge or under a contract of personal service.

The most interesting part of FEMA relates to the definition of a person resident in India. FEMA incorporates the inclusive definition of the term person and takes in any agency, office or branch owned or controlled by such a person. Section. 2(v)

of FEMA is in contrast with Section. 2(p) of FERA. FEMA omits the term citizen. Any person residing in India for more than 182 days during the course of the preceding financial year will be considered a resident of India. The concept of the preceding financial year was not present in FERA.

The definition excludes persons going outside India for employment or for carrying on business and those who go out with the intention of staying abroad for an uncertain period. A body corporate registered or incorporated in India will be deemed to be resident in India even if a foreigner or non-resident holds its entire share capital. Again, an office, branch or agency in India will be deemed to be the resident in India even if it is owned or controlled by a person resident outside India.

FEMA also defines Repatriate to India as bringing into India the realized foreign exchange and the selling of such foreign exchange to an authorized person in India for rupees, or the holding of realized amount in an account with an authorized person in India to an extent notified by the Reserve Bank, and includes use of the realized amount for discharge of a debt or liability denominated in foreign exchange.

Other Salient Features of the Act

- Full freedom is provided to a person resident in India who was earlier outside India to hold or transfer any foreign security or immovable property situated outside India and acquired when he/she was a resident there. Similar freedom is also given to a resident who inherits such security or immovable property from a person resident outside India.
- A person resident outside India is also permitted to hold shares, securities and properties acquired while he/she was a resident in India. Similarly, a person resident outside India is also permitted to hold such properties inherited from a person resident in India.
- Exchange drawn can also be used for the purpose other than which it was drawn provided drawing is otherwise permitted for such purpose.
- The Exchange Earners' Foreign Currency (EEFC) account holders and Residents' Foreign Currency (RFC) account holders are permitted to freely use the funds held in the EEFC/RFC accounts for payment of all permissible current account transactions.
- The rules for foreign investment in India and Indian investment abroad permit Indian companies engaged in certain specified sectors to acquire shares of foreign companies engaged in similar activities by share swap or exchange through issue of ADRs/GDRs up to certain specified limit.
- Proceeds of exports have to be brought in within 180 days, but the reference to the date has been deleted.
- The limit for permitting overdraft in Non-Resident Operation (NRO) accounts has been dispensed with. The Authorized Dealers (ADs) may permit overdraft in such accounts as per their discretion and commercial judgement.
- The scheme for raising foreign currency loans by residents from Non-resident Indians not exceeding US 250,000 would continue to be operated by the Reserve Bank.
- FEMA has placed more responsibility on the shoulders of the Authorized Dealers. The RBI informed that it no longer would prescribe documentation for various categories of current account transactions, which are handled by the Authorized Dealers. The ADs will not only have to prescribe the documents, which their branches will have to ask for from their customers and verify, but also will have to keep them safe till the Reserve Bank verifies the same.
- The ADs will henceforth have an additional responsibility to refuse in writing if they believe that the transaction offered was in violation of the provisions of the Act, and also shall have to report the details of the transaction to the RBI if it has a reason to believe that any contravention/evasion is contemplated by the customer.

FEMA also includes other provisions relating to dealings in foreign exchange, holding of foreign exchange, export of goods and services, realization and repatriation of foreign exchange and exemption from realization and repatriation in certain cases.

FEMA contains only 49 sections whereas the law preceding it contained 81 sections. FEMA, as its Preamble says, is an Act to consolidate and amend the law relating to foreign exchange with the following objectives:

i. To facilitate external trade and payments, and

ii. To promote the orderly development and maintenance of foreign exchange market in India.

Unlike FERA, FEMA seeks to regulate and manage only those specified transactions relating to foreign exchange in India, which seek to control any thing and everything that has something to do with foreign exchange. In other words, FEMA promotes foreign trade rather than prevent its misuse.

The new Act has been divided into 7 chapters. The first 3 chapters containing sections 1-12 relate to the operational part of the Act whereas the other 4 chapters covering sections 13-49 deal with penalties, adjudication and appeals, enforcement directorate, etc.

The new Act extends to the whole of India and is applicable to all branches, offices and agencies outside India owned and controlled by resident Indians. It is also extended to any contravention thereunder committed outside India by any person to whom this Act applies. Many provisions of FERA like the ones relating to blocked accounts, Indians taking employment abroad, employment of foreign technicians in India, contracts in evasion of the Act, vexatious search and seizure, etc., have been totally withdrawn from FEMA.

Under FEMA – Section 3 – a general or special permission of the RBI is required for a person to:

i. Deal in foreign exchange or foreign securities;

ii. Transfer foreign exchange/foreign securities to any person other than an authorized person;

iii. Make or receive payments outside India in any manner, otherwise through an authorized person on behalf of a person resident outside India; or

iv. Enter into any financial transactions in respect of acquisition of assets outside India.

The provisions dealing with exports of goods and services have been highly simplified. Section. 7 of FEMA only requires the exporters to furnish correct particulars, to the RBI, such as export value of the goods, payment for services, and where it is not ascertainable, the value, which the exporter expects to receive, and other relevant details as may be required by the RBI. As another notable feature, the FEMA – Section 5 allows the sale or drawal of foreign exchange from an authorized person in all cases where it is a current account transaction unless otherwise prescribed by the Central Government. Current account transaction for this purpose means all transactions other than those relating to foreign assets and liabilities of Indians and Indian assets and liabilities of foreigners.

In other words, under the new Act, for a current account transaction, everything is free unless regulated and for the capital account transactions everything is regulated unless freed. The RBI's approval shall be required for transactions indicated u/s 6(3) only if the transaction is of capital account in nature.

FEMA u/s 6 has specified a long list of cross-border transactions, which can be prohibited, restricted or regulated by the RBI. The list includes the following:

i. Issue/transfer of securities;

ii. Borrowing/lending in foreign exchange;

iii. Export, import or holding currency;

vi. Acquisition/transfer of immovable properties; and

v. Giving of guarantees/surety, etc.

Liberalization has been made in Section 8 under which any resident is required to realize and repatriate the amount of foreign exchange due/accrued to him in the manner as directed by the RBI. It is notable here that FERA did not allow residents doing anything, which aided in non-realization or delay in realization of foreign exchange.

The definition of the term "person resident in India" has been aligned with the Income Tax Act, 1961. As per FEMA, the residential status of a person now depends upon his stay (more than 182 days during the preceding financial year) in India – Sec. 2(v).

If a person resident in India owns or controls any office, branch or agency outside India, such office, branch or agency would be deemed to be the resident in India under FEMA and will be covered by the exchange regulations. Sec. 2(v) of FEMA uses the expression owned or controlled by a person resident in India. The corresponding expression under Section 6 of the Income Tax Act is "control and management" with respect to the Hindu undivided family, partnership firms, companies, and so on. It has been pointed out that mere control of the branch, office or agency by a person resident in India is enough to invite the attention of FEMA. The management of the office or agency may be located outside India, but by virtue of ownership or control the agency will have to take FEMA into account. Control is different from management as known to jurists under IT law. It is obvious that the definition under FEMA is very different from the corresponding definition of a person resident in India.

Under Section 6 of the IT Act, overlapping of the two statutes cannot be avoided. For example, Section 10(4)(ii) provides for exemption of income by way of interest on monies standing to the credit of an individual in a non-resident (external) account in accordance with FERA, 1973, provided such individual is a person resident outside India as defined in Section 2(q) of FERA or is a person who has been permitted by the RBI to maintain the aforesaid account.

Critics have already pointed out that the importation of the concept of the previous financial year can bring in unintended hardships for returning Indians. They can become resident Indians under Section 2(v) from the year following the financial year in which they had spent more than 182 days in India. Many strict provisions relating to search and seizure which were very similar to that of the Customs Act, 1962 have no appearance in FEMA.

The powers of search and seizure conferred by Section 37 are confined to contravention as mentioned in Section 13. This is a welcome move, as it will relieve the industry, trade and commerce from the so-called autocracy of the Directorate of Enforcement due to the unreasonably unlimited powers granted to it under FERA. The penal provisions have been noticeably simplified. Under Section 13 of FEMA, penalty for any kind of contravention has been specified as below:

i. Where the amount is quantifiable thrice the amount involved in such contravention.

ii. In all other cases up to Rs.2 lakh.

iii. In case of continuing contravention Rs.5,000 per day.

It is notable that FERA had prescribed more stringent imprisonment and fine without limits u/s 56.

Unlike FERA, which treated every offense as criminal, FEMA treats all economic offenses as civil. Under FEMA, there is no presumption of existence of a guilty mind and so the prosecution must prove that a person has committed an offense. The question of civil detention/arrest arises under FEMA only when the person to

whom the notice for payment of penalty had been served, fails to pay the fine within 90 days from the date of service of such notice. The civil detention is made on the following lines:

i. Where the amount involved exceeds Rs.1 crore, detention is for 3 years.

ii. In other cases, detention is for 6 months.

It is also notable that such an arrest/detention is clearly a civil detention and not an imprisonment.

Unlike FERA, which contained severe provisions leading to imprisonment even in trivial cases, FEMA has provided for pecuniary punishment for all economic offenses. It is only where the punishment is not complied with, that civil detention is resorted to and the warrant of arrest arises only when the person has not complied with the civil detention. Section 35 of FERA which empowered the ED officers to arrest any person if they had reason to believe that the person was guilty of FERA violations, finds no place in the new FEMA.

Under FEMA, authorized dealers and money changers have been clubbed together under a new definition of authorized person which also includes an offshore banking unit. Under the new provisions, an authorized person must satisfy himself that the transaction which he is undertaking on behalf of someone, does not violate any provisions of FEMA. If the authorized person does not follow the directions of the RBI or does not furnish the information required by it, he shall be punishable with a penalty up to Rs.10,000 plus Rs.2,000 for each day of continuing default.

Adjudicating Authorities can be appointed by the Central Government, u/s 16 of the FEMA, to deal with the complaints and to hold inquiry into the alleged contraventions u/s 13. Such authorities shall dispose off the complaints finally within one year from the date of receipt of the complaint. If not they must record the reasons for such non-disposal of the complaint within the said period. This will, of course, help prevent accumulation of pending cases before the authorities.

FEMA has provided for a comprehensive set-up of Appellate Authorities. Any person aggrieved by an order of an Adjudicating Authority, being an Asst. Director/Deputy Director of Enforcement may prefer an appeal to the Special Director (Appeals). Further, any person aggrieved by an order of any Adjudicating Authority, other than Asst. Director/Deputy Director may prefer an appeal before the Tribunal. The order of Special Director (Appeals) can also be appealed against before the Tribunal.

Every such appeal to Special Director (Appeals) or the Tribunal must be filed within a period of 45 days from the date of receipt of a copy of the order made by the Adjudicating Authority concerned. The Tribunal shall dispose off the appeal finally within 180 days from the date of receipt of appeal. If it fails to dispose the case within 180 days, it shall record the reasons in writing for such non-disposal of the appeal within the prescribed period. Another notable feature is that the aggrieved person can choose to appeal directly to the Tribunal against the orders of the adjudicating authorities.

Civil courts will have no jurisdiction to entertain any suit or proceeding which an Adjudicating Authority, Special Director–Appeals, or the Appellate Tribunal are entitled to determine under FEMA.

FEMA has stipulated a sunset period of 2 years for transition from FERA to FEMA. In other words, after the expiry of 2 years from the date of enforcement of FEMA, no offense under FERA could be tried by any court of law or Adjudicating Authority.

Regulation and Management of Foreign Exchange

FERA contains elaborate and, in many cases, overlapping provisions to cover every conceivable transaction in foreign exchange, transactions with and by non-residents, etc., making the law fairly lengthy and complex.

The proposed law (FEMA) attempts to cover most of the transactions, in few provisions. Also, the new law is more transparent in its application. The control over such transactions will be more by regulations notified by the RBI in the prescribed manner rather than circulars and guidelines. Powers have been given to the RBI to notify regulations to control branches, offices, or other places of business of non-residents. The categories of authorized dealers and money changers have been merged under one common category of authorized persons though it seems that the sub-categories would still remain in practice. Such authorized persons can now be permitted to deal in foreign securities also, apart from foreign exchange. Another sub-category called Offshore Banking Unit has also been made. Some areas require specific permission of the RBI/Government of India. In rest of the cases, no such permission is required and a person can remit funds and acquire assets, incur liability in accordance with the specific provisions laid down in the Act or notifications issued by the Reserve Bank/Government of India under the Act, without seeking their approval.

According to FEMA, no person can deal in or transfer any foreign exchange or foreign security to any person not being an authorized person; or make any payment to or for the credit of any person resident outside India in any manner; or receive (through an authorized person) any payment by order or on behalf of any person resident outside India in any manner without the general or special permission of the Reserve Bank of India.

Similarly, no person resident in India can acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India except with the general or special permission of the Reserve Bank of India.

The Reserve Bank can, by regulations, prohibit or restrict the following:

- Transfer or issue of any foreign security by a person resident in India – transfer or issue of any security by a person resident outside India.
- Transfer or issue of any foreign security by any branch office or agency in India of a person resident outside India.
- Any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India.
- Deposits between persons resident in India and persons resident outside India.
- Export, import or holding of currency or currency notes.
- Transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India.
- Acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India.
- Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred (i) by a person resident in India and owed to a person resident outside India, or (ii) by a person resident outside India.

According to FEMA, a person resident in India can hold, own or transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India, or inherited from a person who was resident outside India.

Similarly, a person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was a resident in India.

A comparative analysis of the corresponding provisions in FERA reveals that many of the provisions contained are either relaxed or are totally omitted in FEMA. Some of them are:

- Taking or sending any security to a place outside India.
- Provisions relating to restrictions on holder of a security who is a nominee.
- Making of declaration as to the status of the transferee.
- Making entries in registers, books, etc., relating to securities. Relaxations to this were in any case provided under FERA by the Reserve Bank of India subject to specified conditions.
- Transfer of securities in a company registered in India by a foreign national to a person resident in India.

The Foreign Exchange Management Act (FEMA) which came into effect from 1st June as a replacement for the stringent Foreign Exchange Regulation Act (FERA) has failed to take off as the government is yet to constitute and frame the rules for the functioning of the Appellate Tribunal for the foreign exchange.

Interbank Transactions and Cover Operations in India

The authorized dealer banks quote rates to customers and enter into transactions on the basis of cover rates provided with a permissible amount of profit margin. For the transaction to actually culminate in profit, however, it is necessary for the bank to effect the cover transaction at a rate equal to or better than the base rate. The efficacy of a dealing room lies in the conduct of market operations to maximize the profit realized from difference in rates at which currencies are bought and sold, with minimal risk and within such limits as laid down by the management.

The exchange market in India consists of:

i. **Authorized Dealers:** Banks authorized to deal in foreign exchange.

ii. **The Reserve Bank of India:** To the extent it is available to cover merchant transactions.

iii. **Overseas Banks:** To the extent banks in India can deal with them within the framework of the RBI regulations.

Sources of Exchange Rates

Reserve Bank of India Rates: The Reserve Bank presently announces reference rates on the US dollar for Authorized Dealers. The RBI also announces spot selling rate for the US $ to cover eligible imports on spot basis only.

Interbank Market Rates: The Indian interbank market has a fair amount of activity in Re./US dollar. The rates for other currencies are largely from the crosses obtained from the Re./US dollars. In recent years, the market has also become active in cross-currency deals mainly in $/£, $/DM and $/Yen.

The market operates through foreign exchange brokers who are accredited by the FEDAI. The broker is not allowed to hold positions and is only expected to obtain and communicate prices to enable contracts between banks. Two way quotes are common and some amount of direct dealing between banks also takes place.

Overseas Market Rates: The rates in the market are necessarily influenced by the rates obtained in the overseas market. The market will constantly endeavor to maintain rates against the rupee for different currencies in alignment with the overseas cross rates obtained. Cross-currency trading activity is influenced largely by movements in the overseas markets hence the overseas market rates necessarily play a very significant role in determining the rates in the Indian market.

Reserve Bank of India Regulations on Interbank Dealings

The Reserve Bank of India is statutorily vested with the authority to determine the manner in which exchange rates are arrived at for merchant as well as interbank dealings. It also has authority to regulate the interbank transactions either directly, by issuing necessary instructions to the banks, or through the Foreign Exchange Dealers' Association of India. The Reserve Bank's objective in this direction has been to develop an active foreign exchange market within the country so as to enable a competitive price support for merchant transactions. Towards this end, the Reserve Bank requirements are:

a. Banks are allowed to freely buy or sell any permitted currency both spot and forward, in the interbank market in India, against the rupee as also against another permitted currency. The bank should, however, ensure that at the close of each day, exchange position (the extent of difference between purchases and sales in a foreign currency) is kept square, near square or according to their own risk bearing capacity.

b. Balances held in foreign currency accounts abroad should be commensurate with operational needs. Banks are neither allowed to lend nor invest in foreign currencies. However, banks can transfer incidental surpluses in the account on a day-to-day basis to special interest bearing account with automatic retransfer to their current account wherever such facility is offered by the correspondent.

c. Banks may buy or sell permitted currencies both spot and forward from/to overseas banks, in the general currency area, against another permitted currency provided:

   i. The purchase or sale is in cover of a merchant transaction or an exchange position resulting from an interbank transaction with another bank, covering its merchant commitment. Banks should, however, endeavor to minimize resort to overseas markets.

   ii. In their overseas cover transactions, banks should endeavor to obtain cover of a matching maturity. When this is not possible, the resulting mismatch should be rectified as far as possible within five working days.

d. Banks are allowed to sell rupees to overseas banks against permitted currencies on spot basis for funding their rupee accounts in India. The rate quoted should be the composite rate worked out on the basis of interbank rate prevailing at that time and the RBI spot buying rate. Surplus rupee funds in the accounts of overseas banks can also be converted in to foreign currency by the bank maintaining the account. The RBI has freed stipulations on overnight limits. It has asked the individual banks to ask for individual bank limits after getting the same duly approved by it.

e. Banks are not allowed to borrow abroad without the specific approval of the RBI. However, general permission has been granted for incidental overdrawals provided the sum of overdrawals in all the accounts maintained by the bank does not exceed the equivalent of Rs.2 million. Any excess beyond this limit is to be corrected within 5 days.

FEDAI RULES REGARDING INTERBANK DEALINGS

i. Exchange contracts should be for definite amounts of foreign currency. When the contract has a period of option for delivery, the option shall lie with the buyer and shall not exceed a calendar month.

ii. Spot contracts will be delivered on the second succeeding business day (Saturdays shall be treated as a holiday) provided it is not a holiday at any of the 3 centers – contracting center, center of settlement of rupee or the second foreign currency. If it is a holiday, the contract shall be delivered on the next working day at all the 3 centers.

iii. In forward contracts, if the fixed date of delivery, or last date in the option period is a known holiday, as on the date of contract, at any of the 3 centers, the contract shall fall due the preceding business day. If, however, the fixed date or last date of delivery is later declared a holiday, the contract shall fall due on the succeeding business day.

iv. Interbank dealings should be routed only through exchange brokers recognized by the FEDAI. Direct dealings between banks are permitted at centers serviced by recognized brokers' associations (presently Mumbai, Kolkata and Chennai) subject to the minimum lots being US $500,000 or Pounds 250,000 or equivalent. In other centers, direct dealing is permitted without any stipulation on size of lots.

v. No remuneration other than brokerage at rates authorized by FEDAI is payable to the exchange brokers. The brokerage is payable by both parties to the contract.

vi. The seller's bank shall be responsible for delivery of foreign currency funds to the buyer's bank on the value date with no additional cost to the buyer. In case of option contracts, the buyers bank shall give two clear days of notice for the pick up and deliver the RBI cheques on the date of pick up.

vii. In the event of late delivery of foreign currency funds, regardless of cause of such delay, the seller bank shall be liable to pay overdue interest at 2% over the prime rate for currency, for the duration of such delay. However, if the buyer bank has not lodged the claim within 30 days of the due date for delivery, interest claim shall be limited to 60 days or the actual overdue period whichever is less. If the funds are delivered to the account of a branch, other than the notified branch of the bank, with the same correspondent, the seller bank is liable only for such miscellaneous charges as may be levied for retransfer of funds by the correspondent.

The above provision is to only provide for interest compensation on incidental delays. Deliberate non-delivery of funds will attract additional penalties as may be decided by the FEDAI.

viii. On delayed settlement of rupee funds, the buyer bank is liable to pay interest at the minimum lending rate prescribed by the RBI from time to time. The claim shall be lodged within 15 days of the due date. If not, interest claim will be limited to a maximum period of 30 days. Interest compensation for delayed disbursement of rupee T.T. remittance arising out of purchase of rupees by overseas correspondent as also out of vostro-to-vostro transfers will be at a minimum lending rate prescribed by the RBI.

FOREX DEALING ROOM OPERATIONS

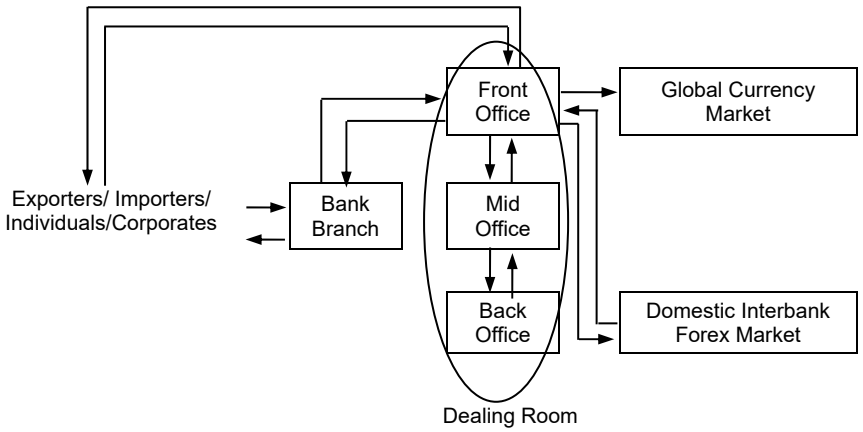
Forex market is an Over-the-Counter (OTC) market in which currencies are bought and sold against each other. The market is basically characterized by – no physical presence, huge size, dominated by financial flows, deep, highly liquid and efficient, pre-ponderance of interbank flows, sleek being screen-based, highly volatile 24 hours a day market and yet a profit center with simultaneous potential for losses.

Dealing Room

A dealing room is a centralized establishment, usually of a commercial bank, which is willing to offer a two-way dealing price for different currencies at all times even when they may not wish to deal, all but during the prescribed business hours. It is a common practice amongst dealers to quote only the last two points of the rate as every dealer is expected to know the full price. A dealer tries to make profit while quoting his rate rather than attempting it from the quote made to him.

Usually, a dealer calls other dealing rooms for a quotation rather context/currency tends to quote his spread in such a way that it itself expresses his unwillingness to carry out the deal. At times, the dealer also prefers to qualify his quote with words like "good for standard lots", "choice price", etc. To sum up, the whole range of transactions in the forex market are carried out through the Dealing Rooms of the participating banks.

Figure 2: Forex Dealing Room Set-up



Source: Icfai Research Team.

Banks trading actively in the forex market and offering a variety of products usually segregate their trading activities into:

Front Office – Dealing Room

Mid Office – Risk Management, Accounting Policies and MIS

Back Office – Settlement, Reconciliation and Accounting

Front Offices are equipped with Electronic Data Processing Systems matching volumes of business undertaken. These systems ensure automatic recording of trading date, time and transaction serial number with no scope for the dealers to alter the same. These systems usually are multi-user type so that positions of various dealers can be consolidated and results can be obtained. The Chief Dealer can login to any part of the system to see the overall totals.

A large Dealing Room is controlled by a Chief Dealer, who may not actually deal himself. He is responsible to implement management policies. He leads morning discussions with his Junior Dealers on forecasts and strategies for the day, before the dealing actually begins. Usually, he would be responsible to assess the effectiveness of dealers working under him as also to guide them in their day-to-day business transactions. Senior Dealers work under him and are individually responsible for a group of currencies/a major currency/spot forward trades.

A dealer is supposed to be endowed with the following traits among other characteristics

- Survival instincts;
- Good understanding of the changing nature of markets;
- Quick to react to new opportunities and situations;
- Quick in reversing a previous stance;
- Overcome the natural tendency to salvage something from a loss making situation;
- Predict/guess as to what the market will do next rather than standby his own view; and
- Able to work under stress.

To be effective, a dealer has to be trusted in the forex market. He can very quickly gain a reputation as a good or bad dealer.

Dealers are free from accounting work of any kind as otherwise they would not be able to concentrate on the market. They maintain "deal slips" indicating the name of the broker, if any, the counter-party bank, currency, amount, time, rate and due date under their signature as soon as the deal is struck and pass on the same to the back office for further processing. However, in an automatic system, separate "deal slips" are redundant.

Some Dealing Rooms do maintain gadgets like voice recorders, etc., to record the Dealing Room conversations for speedy resolution of differences.

Mid Office/Back Office of a Dealing Room constitutes the accounting department, which plays an equally important role by providing an operational support. It undertakes the following among others:

- Obtain confirmation of contracts from counter-parties; check contents of contracts and signing thereon; rectification of effects on the same day;
- Obtain stamped agreements from the counter-parties and keep record of computer-generated confirmation slips;
- Evaluation of monthly profit and loss;
- Submission of daily currency position;
- Maintenance of positions and funds registers; and
- Preparation of rate-scan reports and enquiries into wide variations, if any, in the deals struck from the ongoing market rates.

OBJECTIVES OF DEALING ROOM OPERATIONS

- **To give the best possible service to customers:** Through adequate number of well attended phones and telex operations, sound counsel is provided on economic development, competitive rates and capability to transact the entire amount of currency deal requested by the customer.
- **To manage the bank's position so that inventory in each foreign currency is kept at the desired level:** The above objective is achieved by matching the inflows and outflows of various currencies with matching deployment.
- **To produce a profit for the bank while accomplishing the first two objectives:** The same is achieved through exchange rate differentials, etc.

Participants

CORPORATES/FIRMS/INDIVIDUALS

- To pay for imports, convert of export receipts, hedge receivables and payment of interest and principal of foreign currency loans.
- Giant multinationals of course do take speculative positions purely for profit generation through their own well-established treasury/dealing room.

COMMERCIAL BANKS

- 90% of the World Forex Trade is accounted for by interbank transactions;
- Trade in currencies to meet client requirements;
- Merchant transactions are less than 2%; and
- Buy and sell on their own account and carry inventory of currencies for speculative purpose since Foreign Exchange trading profits have become an important source of revenue for commercial banks.

CENTRAL BANKS

- Intervene to move exchange rates in a particular direction as desired by the local government.

Market Makers

- Major commercial banks act as 'Market Makers' in most of the major currencies by offering "two-way" quotes and are prepared to take either side of the transaction.
- In a normal two-way market, a dealer expects "to be hit" on both sides of his quotes in roughly equal amounts. However, it is always not necessary. He may suddenly find "being hit" on one side of his quote, much more often than the other side. It means that he is either buying many more dollars than he is selling or vice-versa. This leads to the trader building up "a position".
- If he has sold more $ than bought, then he is said to have a "short position".
- If he has bought more $ than sold, then he is said to have a "long position".
- In a highly volatile forex market, a long/short position for too long can be risky.
- For instance, net short position may lead to a loss if it is to be covered at an appreciated price or gain if the currency depreciates.
- Similarly, a net long position may lead to a loss if it is to be covered at a lower price or again if it is to be covered at a higher price.
- Therefore a dealer, realizing that he has built up an undesirable net position quickly adjusts his bid offer quote in such a manner that it discourages one type of deal (which has already landed him in a over position) and encourages the opposite deal.

BROKERS

- Act as middlemen between two market-users.
- They provide information to market-making banks about prices at which there are firm buyers and sellers in a pair of currencies.
- Execute bank's instructions to buy or sell a specific amount of currency at specified rate and collect commission at the conclusion of the deal.
- Acquire information about general state of the market.

IN THE INDIAN CONTEXT

- Brokers are prohibited from acting as principals and maintaining positions in foreign currencies;
- Brokers' notes should be received promptly by the dealers before the close of the day's business;
- Nomination of brokers for deals not done through them is not permitted;
- It is desirable to have a panel of brokers and air-shuffling of business among them; and
- Dealers to be separated from maintaining broker-wise record and payment of brokerage claims, etc.

TRADING MECHANISM

Interbank market deals are done on the telephone. Say, a trader of bank A, needing GBP against Dollars, calls his counterpart of Bank B and asks for a quote. If the price is acceptable, a deal is struck and both enter the details – amount bought/sold, the price, identity of the counter party, etc., in their computerized record systems. Later, a written confirmation is sent. On the day of settlement, Bank 'A' transfers Dollars to Bank B and 'B' transfers GBP to A.

However, non-bank customer transactions are entertained during normal banking business hours while interbank transactions are carriedout up to 4 P.M. only.

Dealing Room Terminology

Some of the terms of repeated expressions in the forex market and their accepted meaning are:

Jargon used	What it means
• Offered at; Comes at; I give at; I sell at; I offer at	Seller or lender of currency.
• I bid at; I pay at; I take at; I buy at	Buyer or borrower of currency.
• Bid, Wanted, Firm, Strong	Currency in question is appreciating/in demand/ buyers predominant.
• Offered, Weak	Currency in question is depreciating/sellers pre-dominant.
• Value today	Same day value.
• Value tomorrow	Next working/business day.
• End/end	Forward swaps for maturity on the last working day of the appropriate future month are described as End/end.
• Short dates	Deals for a broken number of days up to one week.
• Brokers/Odd Date	Value date which is not the regular forward date.
• Overnight–Today/ Tomorrow	Currency deposit transaction/simultaneous purchase and sale of currency for value today against the next working day.
• Tomorrow/Next; Tom/Next	Currency deposit transaction/swap for value the next working day against the spot value.
• Spot/Next	Currency deposit transaction/swap for the spot value date against the next working day.
• Weekend	Currency deposit transaction/swap for value the last working day of the week, normally Friday against the first working day of the following week, normally Monday.
• Outright/outright	Purchase or sale of currency for delivery for any day other than spot not being a swap transaction.
• Par	Forward price is same as the spot.
• Parity or same	No proposition on the rates quoted by the other party. It does not imply that the party using this expression is ready to do a deal at the rates quoted.
• For indication/information	Quotes no firm.
• Details	Needs of a dealer regarding rate and dates following a transaction.
• Mine	Dealer takes the spot/forward/deposit whichever has been quoted from the counter party. It is dangerous to use the expression unless amounts have been qualified first.
• Yours	Opposite of Mine.
• Point/pip	Last decimal place of a quotation.
• Mio	One million.
• Billion/Milliard	One thousand millions.
• At your risk	Quote is subject to change.

Regulatory Framework

To set-up a foreign exchange dealing room, the banks should obtain a license from the RBI as an Authorized Dealer to trade and maintain positions in the overseas currencies. The banks should obtain approval from the Reserve Bank of India for the overnight open exchange position and the aggregate gap limits as per the guidelines contained in the Exchange Control Manual of the RBI. In a recent guideline issued by the RBI, the Authorized Dealers are allowed to maintain higher open positions as deemed fit in the context of their foreign exchange operations and being approved by their respective boards. This open position is, of course, subjected to maintenance of the capital adequacy 15% of their unimpaired Tier I capital. This could be in the form of foreign currency deposits, overseas money market instruments, which must be rated at least A1+ by S&P or P1 by Moody's.

The banks should submit the following reports to the RBI:

- Daily statements of foreign exchange turnover in Form FTD and Gaps position and Cash Balances in Form GPB through a wide area network.
- Monthly statement (in USD million) indicating:
  - Aggregate Gap Limit (AGL) approved.
  - Maximum AGL on any day in the month.
  - Value at Risk (VaR) limit approved.
  - Maximum VaR on any day in the month.

The bank should also submit a report in the Form BAL to the RBI explaining all the foreign currency held by it, on a fortnightly basis, within 7 days of the completion of the fortnight.

Payment Systems

Once a deal is finalized, the dealers will specify where they want the currencies to be delivered. For example, in a $-pound transaction, the buyer of the $ may want $ to be credited to his account with the New York Bank whereas the receiver of the pound may want it to be credited to his account in a bank located in London.

To cope up with such mind boggling volumes, the banks have given up the traditional system of settlement through cheques and instead have developed the electronic interbank funds transfer systems. Best known among those are CHIPS in New York and CHOPS in London. "Netting", i.e., interbank payment arising out of Forex transactions is another development known as FXNET.

Basic Documentation

Dealers usually maintain "deal slips" indicating the name of the broker, if any, the counter-party bank, currency, amount, time, rate and the due date under their signature as soon as the deal is struck and pass on the same to the back office for further processing. However, with the entry of automatic and electronic processing systems, these deal slips have become redundant.

The banks should use only those documents, which are legally enforceable and effective, while transacting in the market, after consulting with other market participants. The most basic of such documents are:

- Confirmations of contracts
- Stamped agreements
- Evaluation report of profit and loss on a monthly basis
- Registers recording positions and funds.

However, in our country such online payments/settlement are still in the process of development.

Risks in Dealing Room Operations

The free flow of capital all around the globe and the concomitant rise in volumes, have made the need for risk identification in Dealing Room operations and its management quite imperative.

Managements therefore formulate policy-guidelines and control mechanism for smooth functioning of the Dealing Room, perhaps covering broad parameters viz.,

- Business strategies for trading in different product groups markets;
- Limits for counter parties;
- Procedures for measuring, analyzing, monitoring and managing risks;
- Ceilings for risk position;
- Procedures applicable to situations like overshooting of limits and market extremities;
- Functions and responsibilities of front, middle and back office;
- Internal accounting and reporting;
- Internal control and monitoring systems;
- Maintaining confidentiality.

It is also desirable to obtain written acknowledgement of such guidelines from the operating staff of dealing rooms.

Let us take a look at the different types of risks associated with forex dealing.

OPEN POSITION RISK

– Long / overbought plus } Bought more GBP than sold

– Short / oversold plus } Sold more GBP than bought

If one is overbought and the currency weakens, one will be able to square the overbought position by selling the currency at a loss. Same is the case if one is oversold and the currency hardens.

MATURITY MISMATCH RISK

Gaps arising out of Merchant transaction position and others. Unmatched forward maturities may cause loss if forward differentials go against the bank.

CREDIT/COUNTER PARTY RISK

Failure of counter party to honor his side of the contract.

CONTRACT RISK

Assume one has sold forward $ to a customer say at Rs.48.55 per $. Before the contract matures, if the customer fails, we have to dispose off the earmarked dollars in the market at the existing rate despite it being weakened to Rs.48.15 per dollar. This is nothing but Replacement Cost. It is also known as Pre-settlement Risk.

CLEAN RISK

Assume we have sold Euros against $ and accordingly, we have credited Euros to the Bank A/c. say in Germany and are waiting for the German Bank to deposit Dollars in our New York A/c. Till the German Bank credits Dollars in our New York A/c, we will be running Clean Risk and if the bank fails to do so, we have to put up with the loss.

This type of risk, also known as Settlement Risk, may arise in international transactions owing to time-zone differences.

INTEREST RATE RISK

This risk arises owing to adverse movements in implied interest rates or actual interest rate differentials relating to foreign currency deposits, forward contracts, currency swaps, FRAs, etc.

LEGAL RISK

Defective/unenforceable agreements likely to frustrate the deals.

OPERATIONAL RISKS

- Omissions/commissions in operational procedures viz.
- Dealing and Accounting functions:
  - Follow-up the deal and confirm the contract confirmation.
  - Settle funds.
  - Pipeline transactions.
  - Overdue bills and contracts.

are likely to result in losses.

SOVEREIGN RISK

- Risk of externalization
- Basically political in nature
- Generally for banks in other countries.

How to Overcome/Reduce Risks

Banks, assessing the risks involved in trading and non-trading activities, usually come up with a well-drafted risk management procedure that could be well understood by dealers, back office staff, etc. Such a mechanism shall assist in limiting and monitoring risk prone activities across the Dealing Room.

Some of the time-tested mechanisms are:

OPEN POSITION RISK

- Since these positions are taken at a particular rate, any adverse movement in the rate leads to a loss.
- To prevent/minimize such losses, banks prescribe various limits consistent with the capital to undertake such activities.
  i. **Day Light Limit** – Dealer cannot take a position of more than a day light limit prescribed by the bank.
  ii. **Overnight Limit** – Fixes overnight limit for an open position in each currency. Usually lesser than daylight limits – Global limit for all the currencies put together is also fixed.
  iii. **Cut-loss Limit** – While undertaking transactions, if the rate goes on moving against the bank, one never knows, where the loss would end. Hence, banks fix a cut-loss limit. Irrespective of the dealer's view, if the rate moves so adversely that the resultant loss is equivalent to the limit, the dealer has to liquidate the position and book loss.

All deals done in a day should be accounted for against the corresponding limits. The limits when exceeded should be promptly reported to the Senior Management and approved.

In the Indian context, pipeline transactions and operations in foreign currency notes need to be specially attended to.

People not connected with dealing room operations should constantly monitor compliance of these limits through timely, accurate and comprehensive MIS.

MATURITY MISMATCH RISK

- Individual Gap Limit (IGL)
- Limit put on mismatch in the currency bought and sold for a particular month.

- Aggregate Gap Limit (AGL)
- Aggregate of gap limits for a particular currency – all the O/B and O/S positions for various months.
- Total Aggregate Gap Limit.
- Aggregate of all the AGLs in all currencies.

CREDIT RISK

Banks impose exposure limits on customers as well as on other banks. In general, separate limits are fixed for spot and forward, the latter being lower than the spot. In the case of forwards, the limit imposed is the maximum level of the net outstanding forward contracts.

OPERATIONAL RISK

- Dealing and execution functions are separated for early discovery of any transgressions of the imposed limits – by dividing dealing room into front office solely concentrating on dealings and back office for recording the transactions and pursuing settlements, etc.
- Further confirmation is obtained.
- Prompt follow-up of execution of funds transfer instructions.
- Monitor export bills and forward contracts for their delivery in accordance with the tenor.

LEGAL RISK

- To obviate the risks involved in enforcing compliance with contractual obligations/ securities, banks usually enter into the following master agreements with counter party banks/ credits.
- Spot and Forward Exchange – International Foreign Exchange Master Agreement.
- Foreign Exchange Options – International Currency Options Market Agreement.
- All others – International Swap Dealers' Association Master Agreement.

Banks also obtain specific confirmation for each transaction with full details regarding amount, rate, value date, etc., duly signed by the authorized signatories.

SOVEREIGN RISKS

Limits are fixed to overseas parties taking country risks too into consideration.

Reconciliation Nostro Balances

Reconciliation of Nostro Account Balances is quite essential to ensure that every transaction undertaken by a Nostro Account is correctly executed.

Reconciliation is undertaken through bank statements and mirror accounts. Unreconciled entries must be followed up on an ongoing basis else, computerized accounting system and micro filming procedures practised by overseas/ correspondent branches/banks may pose problems for back references.

No set-off of debit and credit items of write-off/appropriation to P & L of unreconciled entries is attempted, unless permitted by the Exchange Control Regulations and authorized by the bank.

MANAGEMENT OF RISKS IN VOSTRO ACCOUNT

Exchange Control Regulations command close monitoring of funds flow in Vostro Accounts with a view to avert hot money flows/speculative dealings on rupees. Similarly, sudden variations in operations say, unusually large operation in an otherwise inactive account, demand closer scrutiny to assess genuineness of the operation.

The amount of credit risk arising from drawings on branches can be immeasurable unless flow of information regarding paid drafts, etc., from drawee branches to account maintaining office, is prompt and accurate.

These risks are minimized by:

- Reducing the number of branches on whom drafts can be drawn;
- Imposing drawing limits per day;
- Securing draft advices directly from the correspondents/telex messages of large payment forms paying branches; and
- Prompt value dating.

Monitoring of Vostro Accounts further ensures discipline in the usage of credit lines extended to correspondent banks, identification of concealed overdrafts and interest recovery there against, etc.

Balance confirmation letters are mailed to the overseas banks maintaining Vostro Accounts and confirmations are obtained.

EVALUATION OF FOREIGN EXCHANGE PROFITS AND LOSSES:

Profits and Losses of foreign transactions are calculated at the end of each month, using the prescribed uniform standard accounting procedure.

Forex Trading has in fact become an important source of earning for banks and volumes are likely to double or quadruple in the coming days due to the ongoing reforms.

DEALING ETHICS AND CODE OF BEHAVIOR

A dealer must be ethical in his business. Unless he practises some ethics in his dealings, he cannot earn the trust of the counter parties to frequently visit him and conduct the trades. Some such dealing ethics prescribed by the Regulatory Authorities are listed below:

- Should only enter into transactions that he feels are prudent under existing market conditions. He should not assume positions, even with management approval, that in good conscience, he knows of such high risk as to jeopardize the capital of his bank or the funds of its depositors.
- Should make sure that he complies with his management's prescribed policies and limitations and conforms to all legal and administrative constraints.
- Should not spread rumors that could be injurious to the market or any competitor.
- Should offer assistance to competitor banks provided he does not jeopardize his own institution.
- Should not agree to 'wash names' for any reason.
- Should standby his word in all dealings directly between or through intermediaries.
- Should conduct his business in the market place in accordance with the established procedure, both as to definitive practices and intent of such practices.
- Should maintain the confidentiality of all foreign exchange transactions, whether concluded or not.
- Should not permit brokers to deal on their own account.
- Should not take advantage of an obvious misquote by any counter-party.
- Should always make sure that the dealers in his dealing room are properly instructed in the workings of the market and their responsibilities and obligations before being placed in positions of actually dealing in foreign currency.
- Should discourage improper conduct in the market by others.
- Should remember that his primary responsibility is to his bank and any irregularity by others within his own dealing room must be reported to the Management of Bank Auditors.

SUMMARY

- There are a number of intricacies involved in the operations of the foreign exchange market. In every forex market around the world, there is a regulatory authority which ensures the smooth functioning of these markets, regulating their operations to varying extent.
- Though the exchange rate between any two currencies is determined by the overall equilibrium between their demand and supply, it is also true that there is no single equilibrium market price for a currency.
- An exchange rate quotation is the price of a currency stated in terms of another. It is similar to the expression of the price of a commodity.
- Foreign exchange transactions can be classified on the basis of the time between entering into a transaction and its settlement. They can basically be classified into spot and forward contracts.
- The settlement date of a forex transaction, also called its value date, is the day on which the transaction is settled by a transfer of deposits. The settlement date for a spot transaction is generally the second business day from the date of the transaction.
- There are different kinds of purchase and sale transactions in the retail market. The simplest is the outward or inward remittance. In this kind of transaction, the bank has to simply receive or send a currency through Telegraphic Transfer (TT), demand draft, postal order or Mail Transfer (MT).
- The liberalization of the forex markets started in 1992. In March 1992, a dual exchange rate system was put into place. This was known as Liberalized Exchange Rate Management System (LERMS). Two exchange rates were prevailing during this period, one determined by RBI and the other determined by the market.
- Convertibility means that a foreign currency can be converted into domestic currency without any restriction and vice-versa.
- The Foreign Exchange Regulation Act (FERA), 1973 was drafted with the objective of introducing the necessary changes for the effective implementation of the government policy and removing the difficulties faced in the working of the previous enactment. FEMA (The Foreign Exchange Management Act, 2000) was enacted in response to the dynamic needs of the industry, exporters and importers. Its preamble lays down its objective as to consolidate and amend the law relating to foreign exchange and to facilitate external trade and payments to promote the orderly development and maintenance of foreign exchange market in India. Its emphasis is on the RBI laying down the regulations rather than granting permissions on a case-to-case basis.
- Interbank dealings should be routed only through exchange brokers recognized by the FEDAI.
- A dealing room is a centralized establishment, usually of a commercial bank, which is willing to offer a two-way dealing price for different currencies at all times even when they may not wish to deal all but during the prescribed business hours.
- Another important aspect is the interlinkages between the various financial markets, i.e., the money markets, the real markets and the forex markets.
- The understanding of the operations of various financial markets and the regulatory framework, is essential for a finance manager trying to manage foreign currency risk for his firm.

Appendix I

Following is the list of currencies of major countries, along with the symbols used to represent them:

Country	Currency	Symbol
Argentina	Peso	Arg$
Australia	Dollar	A/Aus
Austria	Schilling*	S/ATS
Bahrain	Dinar	BD
Belgium	Franc*	BF/BEF
Brazil	Real	R
Canada	Dollar	Can$
Chile	Peso	Ch$
Denmark	Krone*	DKr
Finland	Markka/Mark*	FmK/FIM
France	Franc*	FF/FRF
Germany	Deutsche Mark*	DM/DEM
Greece	Drachma*	Dr
Hong Kong	Dollar	HK$/HKD
India	Rupee	Rs.
Indonesia	Rupiah	Rp
Iran	Rial	Rls
Ireland	Pound/Punt*	£Ir/IEP
Italy	Lira*	Lit/ITL
Japan	Yen	¥
Korea	Won	W
Kuwait	Dinar	KD
Luxembourg	Franc*	LuxF/LUF
Malaysia	Ringgit	M$
Mexico	Peso	Mex$
Netherlands	Guilder (Dutch)*	NLG/DG/$f
New Zealand	Dollar	$NZ
Pakistan	Rupee	PRs.
Portugal	Escudo*	Esc/PTE
Russia	Rouble	Rb
Singapore	Dollar	S$/SGD
South Africa	Rand	R
Spain	Peseta*	Ptas/ESP
Sweden	Krona*	SKr
Switzerland	Franc	SFr/CHF
Thailand	Baht	B
The UAE	Dirham	Dh
The UK	Pound (Sterling)	£/£ Stg./GBP

The Euro (∈) has become the single currency for a majority of EMU countries since January 1, 1999. The currencies marked* were coexisted with euro till July 2002, after which euro is the only legal tender for EMU countries.

Chapter VI

Institutional Finance for Exports and Imports in India

After reading this chapter, you will be conversant with:

- Financing Exports
- Incentives available to Exporters
- Pre-shipment Finance
- Role of Customs Authorities in Exports
- Post-Shipment Finance
- Financing Imports
- Sources of Forex Flows
- Export-Import Bank of India
- Exchange Control Regulations Related to Merchant Transactions
- Department of Scientific and Industrial Research
- Export Credit Guarantee Corporation of India Limited

Introduction

Exports play a key role in the Indian economy. In order to give a boost to this sector, various incentives are extended to exporters. Exports help in augmenting the country's foreign exchange reserves, besides generating employment. It also gives a boost to the economic activity in the country ultimately improving the standard of living. Given the fact that exports play a very crucial role in India, any effort to promote exports cannot ignore the vital aspect of finance. The requirement of finance for an exporter may arise either at the pre-shipment stage or the post-shipment stage. Timely availability of credit at competitive rates enables an exporter to produce quality goods and complete the shipment within the delivery schedules prescribed by the overseas buyer. It simply enhances the credibility of Indian exporters and in the process increases their share in the market.

FINANCING EXPORTS

Banks extend financial assistance to exporters at pre-shipment and post-shipment stages. Financial assistance extended prior to shipment of goods from India falls within the scope of pre-shipment finance while the finance extended after shipment of the goods falls under post-shipment finance. The pre-shipment finance is provided to cater to the working capital needs i.e., for the purchase of raw material, processing, packaging, transportation, warehousing, etc., of the goods meant for export. Post-shipment finance is generally provided in order to bridge the gap between shipment of goods and the realization of proceeds. In India, investors can raise a substantial portion of the project cost through debt and equity instruments. Applications for long-term loans can be made to State Financial Corporations when the project is small – generally less than Rs.50 million – or to national-level financial institutions, such as IDBI and IFCI, when the project is large. Institutions expect concrete project and market reports, with reasonably firm costs and implementation plans. Other long-term financing options include leasing, hire purchase, deferred payment guarantee, etc. Capital markets, through equity shares, debentures and hybrids, are increasingly becoming the preferred route for raising finances in India. Investors can freely access the capital market and in most cases freely price the issue. Investors with both small as well as large fund requirements can mobilize funds from the market. Private placement with institutional investors is also possible. Indian companies also have the option of raising funds from international capital markets. Short-term finances for working capital requirements are available from commercial banks and through instruments such as fixed deposits, inter-corporate deposits and commercial papers.

INCENTIVES AVAILABLE TO EXPORTERS

The Reserve Bank of India has given various incentives to exporters in its effort to encourage exports:

- Exporters are eligible to avail finance at concessional rates of interest.
- Banks being the main source of finance are encouraged to extend credit liberally to exporters, including granting lines of credit for 2-3 years at a stretch.
- It is mandatory for banks to extend a minimum of 12% of net bank credit to the export sector.
- To compensate banks for extending finance at lower rates of interest, export refinance facility is provided by the Reserve Bank of India.
- To encourage banks to grant credit to exporters liberally, credit guarantee is arranged from the ECGC, for loans extended to exporters at both pre- and post-shipment stage.
- Exporters are also granted loans against duty draw back entitlements.

- Exporters can retain a certain proportion of export proceeds in foreign currency in the EEFC account at the rate of 70% in case of 100% E.O.U and 50% in case of any other person resident in India.
- Export earnings are not fully taxed.

We shall now focus on export finance in detail.

Export finance can be categorized into pre-shipment finance and post-shipment finance depending at what stage of export activity the finance is extended.

PRE-SHIPMENT FINANCE

Pre-shipment finance is basically a short-term finance (inventory finance) extended to exporters in anticipation of export of goods. This finance enables exporters to procure raw materials, process, manufacture, store and ship the goods meant for export.

Pre-shipment finance can be classified as:

i. Packing credit.

ii. Advance against incentives receivable from the government covered by ECGC guarantee.

iii. Advance against cheques/drafts received as advance payment.

iv. Advance against duty drawbacks.

Packing Credit

The Reserve Bank of India defines 'Pre-shipment packing credit' as 'any loan or advance granted or any other credit provided by a bank to an exporter for financing the purchase, processing, manufacturing or packing of goods prior to shipment, on the basis of letter of credit opened in his favor or in the favor of some other person, by an overseas buyer or a confirmed and irrevocable order for the export of goods from India or any other evidence of an order for export from India having been placed on the exporter or some other person, unless lodgment of export orders or letter of credit with the bank has been waived.'

It is a loan or advance granted to the exporter for purchase of raw materials/ processing/packing based on the Letter of Credit (LC) opened in his favor by the importer. The LC/Confirmed order will be retained by the bank and will be endorsed accordingly indicating that packing credit has been availed by the exporter.

Eligibility

An exporter who wants to avail pre-shipment finance should obtain an importer-exporter code number from the Directorate General of Foreign Trade (DGFT). In addition, the exporter should not be under the caution list/special approval list of the RBI/ECGC.

Usually, packing credit is extended to exporters who have the export order/Letter of Credit in their name. It can also be extended where the contract is concluded by exchange of messages between the two parties, with the opening of LC to be followed later on. In such instances banks may grant packing credit based on the communication, provided the following information is made available:

i. Name of the overseas buyer.

ii. Particulars of goods to be exported.

iii. Quantity and unit prices or value of order.

iv. Dates of shipment.

v. Terms of sales and payments.

Packing credit is also extended to support manufacturers/suppliers of goods who do not have LCs in their own name but orders have been placed by them for supply of goods through an LC holder.

Type of Finance

Packing credit is normally a funded advance. It takes the form of an unsecured/clean loan in the initial stages of disbursement of funds (i.e., when raw materials are yet to be procured). It is called extended packing credit. When the exporter gets a title to the goods it becomes a secured advance.

At times pre-shipment finance will be extended in a non-fund form, like issuing LCs favoring the suppliers of raw materials, opening guarantees for credit purchases, etc.

Quantum of Finance

Quantum of loan will not normally exceed FOB value of goods or domestic market value of goods whichever is lower. However, there are certain exceptions to this. Packing credit may be granted up to the domestic cost of goods even if it is higher than the FOB value, provided the goods are covered by export incentives of the Government of India and availability of Export Production Finance Guarantee offered by the ECGC. The excess of advance over FOB value should be adjusted from the cash incentives/duty drawbacks received.

Margin Requirements

Pre-shipment finance being a need based finance, banks have the freedom to determine the margin that is to be brought in by the exporters.

Margins serve three important purposes:

i. To ensure that the exporter has a stake in the business.

ii. To take care of erosion in the value of goods charged to the banker.

iii. To ensure that bank finance is not extended to cover exporter's profit margin.

The percentage of margin will depend on the nature of the order, commodity, capability of the exporter, etc. Disbursement of funds under packing credit takes place in phases depending on the length of the operating cycle.

Period of Credit

i. The period for which a packing credit advance may be given by a bank will depend upon the circumstances of the individual case, such as the time required for procuring, manufacturing or processing and shipping the relative goods/rendering of services. Thus, it is primarily the banks to decide the period for which a packing credit advance may be given.

ii. If pre-shipment advances are not adjusted by submission of export documents within 360 days from the date of advance, the advances will cease to qualify for concessional rate of interest to the exporter *ab initio*.

iii. The RBI would provide refinance only for a period not exceeding 180 days.

Disbursement of Packing Credit

i. Ordinarily, each packing credit sanctioned should be maintained as separate account for the purpose of monitoring the period of sanction and end use of funds.

ii. Banks may release the packing credit in one lump sum or in stages as per the requirement for executing the orders/LC.

iii. Banks may maintain different loan accounts at various stages of processing, manufacturing etc., depending on the types of goods/services to be exported, for example, hypothecation, pledge etc., accounts and may ensure that the outstanding balance in accounts are adjusted by transfer from one account to the other and finally by proceeds of relative export documents on purchase, discount etc.

iv. Banks should continue to keep a close watch on the end use of the funds and ensure that credit at lower rates of interest is used for genuine requirements of exports. Banks should also monitor the progress made by the exporters in timely fulfillment of export orders.

Liquidation of Packing Credit

All packing credit advances should be liquidated from funds received by the exporter from either one or a combination of any of the following sources:

i. Proceeds of export bills negotiated, purchased or discounted.

ii. Balances in Exchange Earners' Foreign Currency a/c (EEFC a/c) and from rupee resources of the exporter to the extent exports have actually taken place can also be used to repay/prepay the advance.

If a packing credit advance is not liquidated by export proceeds, that particular advance will not be entitled for concessional rate of interest.

Substitution of Contracts

Where an exporter has availed packing credit, but the export order cannot be executed because of cancellation of the order or for any other reason beyond the exporter's control, then banks are given the discretion to adjust the packing credit availed of, from the proceeds of any other export order subject to the Authorized Dealer being satisfied about the commercial necessity of such a switch-over.

'Running Account' Facility

Pre-shipment credit, as already mentioned, is normally provided on lodgment of L/Cs or firm export orders. It is observed that the availability of raw materials is seasonal in some cases. In some other cases, the time taken for manufacture and shipment of goods is more than the delivery schedule as per export contracts. In many cases, the exporters have to procure raw material, manufacture the export product and keep the same ready for shipment, in anticipation of receipt of letters of credit/firm export orders from the overseas buyers. Having regard to difficulties being faced by the exporters in availing of adequate pre-shipment credit in such cases, banks have been authorized to extend pre-shipment credit 'Running Account' facility in respect of any commodity, without insisting on prior lodgment of letters of credit/firm export orders, depending on the bank's judgement regarding the need to extend such a facility and subject to the following conditions:

i. Banks may extend this facility only to those exporters whose track record has been good as also EOU/Units in Free Trade Zones/Export Processing Zones (EPZ) and Special Economic Zones (SEZ).

ii. In all cases where pre-shipment credit 'Running Account' has been provided, letters of credit/firm orders should be produced within a reasonable period of time to be decided by banks.

iii. Banks should mark off individual export bills, as and when they are received for negotiation/collection, against the earliest outstanding pre-shipment credit on 'First In First Out basis (FIFO).'

iv. Packing credit can also be marked off with proceeds of export documents against which no packing credit has been drawn by the exporter.

Interest on Packing Credit

A ceiling rate is prescribed for rupee export credit linked to Benchmark Prime Lending Rates (BPLR) of individual banks available to their domestic borrowers. Banks thus have freedom to decide the actual rates to be charged within the specified ceilings. In case of ECNOS (Export Credit Not Otherwise Specified) category also, banks have been given freedom to decide their interest rate structure keeping in view the BPLR and spread guidelines.

Interest rates effective from May 1, 2007 to October 31, 2007 will not be exceeding BPLR minus 2.5 percentage points per annum. The other particulars pertaining to interest payments are:

i. Banks should charge interest on pre-shipment credit up to 180 days at the rate to be decided by the bank within the ceiling rate arrived at on the basis of BPLR. The period of credit is to be reckoned from the date of advance.

ii. Banks should charge interest on credit against incentives receivable from the Government covered by ECGC guarantee up to 90 days.

iii. If pre-shipment advances are not liquidated from proceeds of bills on purchase, discount etc., on submission of export documents within 360 days from the date of advance, the advances will cease to qualify for concessional rate of interest *ab initio*.

iv. In cases where exports do not take place within 360 days from the date of pre-shipment advance, such credits will be termed as 'ECNOS' and banks may charge interest rates prescribed for ECNOS from the first day of the advance.

v. In cases where packing credit is not extended beyond the original period of sanction and exports take place after the expiry of sanctioned period but within a period of 360 days from the date of advance, exporters would be eligible for concessional credit only up to the sanctioned period. For the balance period, interest rate prescribed for ECNOS will apply.

vi. If exports do not materialize at all, banks should charge relative packing credit for domestic lending rate plus penal interest rate, if any.

Pre-Shipment Credit in Foreign Currency (PCFC)

Exporters often complain about the high cost of capital vis-á-vis their competitors from other countries. In order to make their prices competitive and thereby give a boost to exports, the Government of India made available yet another mode of financing – financing exporters in foreign currency at internationally competitive interest rates.

i. The scheme is an additional window for providing pre-shipment credit to Indian exporters at internationally competitive rates of interest. It will be applicable to only cash exports.

ii. The exporter will have the following options to avail of export finance:

   a. To avail of pre-shipment credit in rupees and then the post-shipment credit either in rupees or discounting/rediscounting of export bills under the EBR Scheme.

   b. To avail of pre-shipment credit in foreign currency and discount/ rediscount of the export bills in foreign currency under the EBR Scheme.

   c. To avail of pre-shipment credit in foreign currency and then repay/ prepay it out of the balances in EEFC a/c, or rupee resources.

   d. To avail of pre-shipment credit in rupees and then convert drawals into PCFC at the discretion of the bank.

iii. Choice of Currency:

   a. The facility is extended in one of the convertible currencies – US Dollar, Pound Sterling, Japanese Yen, Euro etc.

   b. To enable the exporters to have operational flexibility, banks can extend PCFC in one convertible currency in respect of an export order invoiced in another currency. The risk and cost of currency conversion is borne by the exporter.

Period of Credit

i. The PCFC will be available for a maximum period of 360 days. Any extension of the credit will be subject to the same terms and conditions as applicable for extension of rupee packing credit and it will also have additional interest cost of 2 percentage points above the rate for the initial period of 180 days prevailing at the date of extension.

ii. Further extension will be subject to the terms and conditions fixed by the bank concerned and if no export takes place within 360 days, the PCFC will be adjusted at TT selling rate.

iii. For extension of PCFC within 180 days, banks are permitted to extend on a fixed roll over basis of the principal amount at the applicable LIBOR/ EURO LIBOR/EURIBOR rate for extended period plus permitted margin of one percent.

Liquidation of Credit

The credit will be self liquidating in nature and accordingly after the shipment of goods, the credit will be liquidated by submission of export documents for discounting/rediscounting under the rediscounting of export bills abroad scheme. PCFC should not be liquidated with foreign exchange acquired from other sources. The benefit such as credit by a part of export proceeds to EEFC account, etc., will accrue only after realization of the export proceeds or when the resultant export bills are rediscounted "without recourse" basis and not at the stage of conversion of pre-shipment credit to post-shipment credit.

PCFC can be liquidated out of proceeds of export documents on their submission for discounting/rediscounting under the EBR Scheme or by grant of foreign currency loans (DP bills). It can also be repaid/prepaid out of balances in Exchange Earners' Foreign Currency a/c (EEFC a/c), and also from rupee resources of the exporter to the extent exports have actually taken place. In case of cancellation of the export order for which the PCFC was availed of by the exporter from the bank, or if the exporter is unable to execute the export order for any reason, it will be in order for the exporter to repay the loan together with accrued interest thereon, by purchasing foreign exchange (principal + interest) from domestic market through the bank. In such cases, interest will be payable on the rupee equivalent of principal amount at the rate applicable to "Export Credit Note Otherwise Specified" (ECNOS) at pre-shipment stage plus a penal rate of interest to be decided by the bank from the date of advance after adjustment of interest of PCFC already recovered. Banks may extend PCFC to such exporters subsequently, after ensuring that the earlier cancellation of PCFC was due to genuine reasons.

Interest Rate Structure on Export Credit in Foreign Currency

In respect of export credit to exporters at internationally competitive rates under the schemes of 'Pre-shipment Credit in Foreign Currency' (PCFC) and 'Rediscounting of Export Bills Abroad' (EBR), banks are permitted to fix the rates of interest with reference to the ruling LIBOR, EURO LIBOR or EURIBOR, wherever applicable, as under:

Table1: Interest Rate Structure for Export Credit in Foreign Currency

	Type of Credit	Interest Rate (percent per annum)
i.	*Pre-shipment Credit*	
	a. Upto 180 days.	Not exceeding 1.0% over LIBOR/EURO LIBOR/ EURIBOR.
	b. Beyond 180 days and upto 360 days.	Rate for initial period of 180 days prevailing at the time of extension plus 2.0 percentage points i.e., (i) (a) above + 2.0%.

	Type of Credit	Interest Rate (percent per annum)
ii.	*Post-shipment Credit*	
	a. On demand bills for transit period (as specified by the FEDAI).	Not exceeding 1.0% over LIBOR/EURO LIBOR/EURIBOR.
	b. Against usance bills (credit for total period comprising usance period of export bills, transit period as specified by the FEDAI and grace period wherever applicable). Upto 6 months from the date of shipment.	Not exceeding 1.0% over LIBOR/EURO LIBOR/EURIBOR.
	c. Export bills (demand or usance) realized after due date but upto the date of crystallization	Rate for (ii) (b) above plus 2.0 percentage points.
iii.	*Export Credit Not Otherwise Specified (ECNOS)*	
	a. Pre-shipment credit.	Free@
	b. Post-shipment credit.	Free@

@ Banks are free to decide the rate of interest being rupee credit rate keeping in view the BPLR and spread guidelines.

Source: RBI master circular.

Advances against Incentives Receivable from Government of India

These advances are generally granted at post-shipment stage. However, in exceptional cases, where the value of material to be procured for export is more than the FOB value of the contract and considering the availability of receivables from the Government of India, advances are granted for a maximum period of 90 days for more than the FOB value. These advances are liquidated by negotiation of export bills and out of proceeds of receivables from the Government of India.

Export Credit against Proceeds of Cheques, Drafts etc., Representing Advance Payments

Where exporters receive direct remittances from abroad by means of cheques, drafts, etc., in payment for exports, banks may grant export credit at concessional interest rates to exporters of good track record till the realization of proceeds of the cheque, draft etc., received from abroad, after satisfying themselves that it is against an export order, it is as per trade practices, it is in respect of the goods in question and it is an approved method of realization of export proceeds as per extant rules.

If, pending compliance with the above conditions, as the exporter has been granted accommodation at normal concessional interest rate, banks may give effect to concessional export credit rate retrospectively once the aforesaid conditions have been complied with and refund the difference to the exporter.

Advance against Duty Drawback

Pre-shipment finance can also be extended against duty drawback entitlements provisionally certified by the customs. The loans so extended will be adjusted when the final assessment is made by the customs and duties are refunded by them. Duty drawback loans are normally granted by banks at the post-shipment stage for a period not exceeding 90 days at a lower interest rate as specified.

ROLE OF CUSTOMS AUTHORITIES IN EXPORTS

Freight forwarders act on behalf of exporters and importers in arranging services such as loading and unloading of goods, obtaining payment on behalf of customers, booking of space, and customs clearance for air cargo, sea cargo, land transportation, rail freight, custom agency services, multimodalism, door-to-door pick-up and delivery services, etc. Their earnings consist of commissions paid for their services.

Before proceeding to discuss about post-shipment finance, we shall, in brief, discuss the customs formalities to be followed by exporters for clearance of goods to be exported.

Customs Formalities for Clearance of Goods to be Exported from India

Certain formalities have to be fulfilled for clearance of exports by the customs authorities. The exporter is required to submit necessary documents for this purpose. The main document required by the customs authorities for permitting clearance is the shipping bill. While the exporter should submit the shipping bill in case of export by sea or air, he is required to submit a bill of export in case the export is by road. Shipping bills are of four kinds:

- White shipping bill prepared in triplicate is to be submitted for export of duty free goods.
- Green shipping bill prepared in quadruplicate should be submitted, for export of goods under which duty drawback is to be claimed.
- Yellow shipping bill in triplicate is to be submitted for export of dutiable goods.
- Blue shipping bill prepared in seven copies will be required, for exports under the DEPB scheme.

Other documents required for processing of shipping bills include:

- GR forms in duplicate for shipment to all countries.
- Four copies of the packing list giving details like contents, quantity, gross and net weights of each package.
- Four copies of invoice giving all relevant details like number of packages, quantity, unit rate, total F.O.B or C.I.F value, correct and full description of the goods, etc.
- Contract/LC or Purchase order of the buyer.
- AR4 (original and duplicate) and invoice.
- Inspection/Examination certificate.

The custom's appraiser first checks if the quantity and value declared on the shipping bill tallies with that indicated in the LC or purchase order. In addition, he will check if other formalities like exchange control regulations and pre-shipment inspections have been complied with or not. After verification, all documents, with the exception of the original GR form, the original shipping bill and a copy of the commercial invoice are handed over to the forwarding agent to be submitted to the dock appraiser. The original GR form is then forwarded by the customs department to the Reserve Bank of India. It is the dock appraiser who endorses the "Let Export" endorsement on the duplicate copy of the shipping bill. After endorsement, the documents are returned to the forwarding agent who submits the same to the preventive officer of the customs department who in turn endorses the

"Let Ship" endorsement on the duplicate copy of the shipping bill. The duplicate copy of the shipping bill is then handed over by the forwarding agent to the agent of the shipping company following which the captain of the ship in which the goods are loaded hands over a "Mate Receipt" to the Shed superintendent of the port. After payment of port charges, the forwarding agent is given the Mate receipt. The Mate receipt is then handed over to the preventive officer who records the certificate of shipment on all the copies of the shipping bill, original and duplicate copies of the AR4. Following this, the Mate receipt is handed over by the forwarding agent to the shipping company to procure the bill of lading.

After the goods have been shipped, the exporter should send a shipping advice to the importer enclosing relevant documents which include non-negotiable copy of bill of lading, invoice, packing specification, etc.

POST-SHIPMENT FINANCE

Post-shipment finance is defined as "any loan or advance granted or any other credit provided by an institution to an exporter from India from the date of extending the credit after shipment of the goods to the date of realization of the export proceeds". It is basically meant for financing export sale receivables of the exporter. Post-shipment finance can be availed on submission of commercial documents evidencing export to the Authorized Dealer. The exporter is required to submit the documents to the bank within 21 days from the date of shipment of goods. The documents to be submitted include all shipping documents and an extra copy of invoice, relating to any export declaration form endorsed by Customs/ Postal authorities.

Post-shipment finance can be classified as under:

- Negotiation/Payment/Acceptance of export documents under Letter of Credit.
- Purchase/discount of export documents under confirmed orders/export contracts, etc.
- Advances against export bills sent on collection basis.
- Advances against exports on consignment basis.
- Advances against undrawn balance on exports.
- Advances against receivables from the Government of India.
- Advances against retention money relating to exports.
- Advances against approved deemed exports.

ELIGIBILITY FOR POST-SHIPMENT FINANCE

Post-shipment finance is extended to the actual exporter or to an exporter in whose name the export documents are transferred. In case of deemed exports, finance is extended to the deemed exporters. In case of cash exports, exporters should submit GR/PP/VP/SOFTEX forms, as applicable along with the shipping documents for negotiation.

QUANTUM

Post-shipment finance can be extended up to 100% of the invoice value of the goods. However, banks are free to stipulate margin requirements as per their lending norms.

PERIOD OF FINANCE AND INTEREST RATES APPLICABLE

Post-shipment finance may be availed of either in Indian rupees or by using the rediscounting of export bills abroad scheme.

Even though post-shipment finance is not working capital finance, it may be offered on short-term basis or on a long-term basis depending upon the payment terms offered by the exporter to the overseas buyer.

The rate of interest depends on the nature of the bills, i.e., whether it is a demand bill or usance bill. A demand bill or a sight bill is one which is payable immediately on presentation. In case of a usance bill, the terms of payment are specified on the bill. Under this arrangement the importer is allowed a grace period for payment of the bill. Export finance availed against sight bills will be charged lower rates of interest for a maximum period of the Normal Transit Period (NTP) stipulated for the concerned bill as per FEDAI (Foreign Exchange Dealers Association of India) rules. FEDAI has fixed different transit periods for export bills drawn on different countries. The export bill (Demand) should normally be realized within that period. The transit period so fixed by the FEDAI is known as "Normal Transit Period" and mainly depends on geographical location of a particular country. Concessional rates of interest will be charged by banks up to the actual date of realization of export proceeds or NTP stipulated for the bill, whichever is earlier. Where the sight bill is not paid on or before the normal transit period, it will be considered as an overdue bill. The rate of interest charged for the overdue period, i.e., from the due date to 180 days from the date of shipment will be "Export credit not otherwise specified". For the period beyond 180 days from the date of shipment, higher rate of interest as given in the interest rate directive will be charged.

In case of usance bills, credit can be granted for a maximum duration of 365 days from the date of shipment inclusive of Normal Transit Period (NTP) and grace period, if any. However, banks need to closely monitor the need for extending post shipment credit up to the permissible period of 365 days and should influence the exporter to realize the export proceeds within a shorter period. Thus, for usance bills, the period of credit will be:

i. Normal transit period as fixed by the FEDAI.

ii. Usance period of the bill.

iii. Grace period if applicable in the country on which the bill is drawn.

Where an export bill has a usance period of more than 90 days, such a bill will not be eligible for concessional rates of interest. In this situation, banks are free to determine the rate of interest on such credit.

Where an export sight bill denominated in foreign currency purchased/discounted negotiated is not paid within 30 days after normal transit period and 30 days after notional due date in the case of usance bills, the foreign currency amount has to be reversed from export bills. The unrealized foreign currency amount will be crystallized by the bank at the prevailing TT selling rate by affecting a notional sale. The rupee equivalent amount so converted should be shown in the advances portfolio of the bank under the head "Advances against overdue export bills realizable" account. When the bills are actually realized, purchase should be reported in respective R-returns under the head "Purchases relating to reversed export bills".

Interest Rates Applicable:

Interest rates effective from May 1, 2007 to October 31, 2007 will not be exceeding BPLR minus 2.5 percentage points per annum for the following categories of credit:

Table 2: Various Categories of Post-Shipment Credit

Serial No.	Category of Credit
1.	On demand bills for transit period (as specified by FEDAI).
2.	Usance Bills (for total period comprising usance period of export bills, transit period as specified by FEDAI, and grace period wherever applicable). i. Up to 90 days. ii. Up to 365 days for exporters under Gold Card Scheme.
3.	Against incentives receivable from the government (Covered by ECGC) up to 90 days.
4.	Against undrawn balances (90 days).
5.	Against retention money (for supplies portion only) payable within one year from the date of shipment (up to 90 days).

Rediscounting of export bills abroad

The scheme was introduced by the Reserve Bank of India on 6th October, 1993. It serves as an additional window for early realization of export proceeds. Under this scheme, Authorized Dealers and exporters in India can have access to the overseas market for rediscounting of export bills. Authorized Dealers can have the eligible export bills in their portfolio for rediscounting abroad. Exporters also have been permitted for discounting their export bills directly subject to the following conditions:

i. Direct discounting of export bills by exporters with overseas bank and/or any other agency will be done only through the branch of an Authorized Dealer designated for the purpose.

ii. Discounting of export bills will be routed through designated bank/ Authorized Dealer from whom the packing credit facility has been availed of. In case, these are routed through any other bank/Authorized Dealer, the latter will first arrange to adjust the amount outstanding under the packing credit with the concerned bank out of the proceeds of the rediscounted bills.

SOURCE OF FUNDS

Authorized Dealers can utilize the foreign exchange resources available with them in Exchange Earners Foreign Currency Accounts (EEFC), Resident Foreign Currency Accounts (RFC), Foreign Currency (Non-Resident) Accounts (Banks) Scheme and Escrow Accounts to discount usance bills and retain them in their portfolio without resorting to rediscounting. In the case of demand bills these may have to be routed through the existing post-shipment credit facility.

For rediscounting of bills, Authorized Dealers may, wherever necessary, access the local market, which will enable the country to save foreign exchange to the extent of the cost of rediscounting.

It is comparatively easier to have a facility against bills portfolio (covering all eligible bills) than to have a rediscounting facility abroad on bill by bill basis, as various rediscounting agencies may require detailed information relating to the underlying transactions, such as names of exporters and importers, commodities exported, Letter of Credit details, etc.

Authorized Dealers can therefore arrange a "Bankers Acceptance Facility" (BAF). Each Authorized Dealer can have his own BAF limits fixed with an overseas bank or a rediscounting agency or an arrangement with any other agency such as a factoring agency.

Under the scheme, rediscounting is available in any convertible currency.

ELIGIBILITY CRITERIA

Export bills up to a usance period of 180 days from the date of shipment including normal transit period and grace period will be covered under this scheme.

SPREAD

Where the rate of interest on rediscounting does not exceed 1 percent over the six months LIBOR in case of rediscounting of bills with recourse basis and not more than 1.5 percent in case of bills without recourse basis, prior permission of the RBI is not required for arranging BAF or similar facility.

Where the rediscounting facility is arranged by the exporter himself, the rate of remuneration for the bank will be decided between the bank and the exporter.

REFINANCING OF REDISCOUNTED BILLS

Banks will not be eligible for refinance against bills discounted/rediscounted under this scheme and hence the bills discounted/rediscounted in foreign currency should be shown separately from the export credit figures reported for purposes of drawing export credit refinance.

Forfaiting

Forfaiting is a form of trade financing undertaken to facilitate export transactions. The process of forfaiting thus has a lot of significance as it undertakes to solve the cash flow problems of the party taking the benefit of factoring. In a forfaiting transaction, the exporter surrenders his right for claiming the payment for services rendered or goods supplied to the importer in favor of the forfeiter. A deed is prepared stating the same and the exporter receives cash payment from the facilitator. All the transactions of forfaiting are performed with the support of a bank, which assumes the default risk possessed by the importer. The exporter before extending finance for a forfaiting transaction looks into several critical aspects of the underlying goods or commodity. For example, the bank would pay special attention towards durability/Perishability nature of the goods, authentication of the product (date of manufacturing, product code, etc.), packaging arrangements and other precautions adopted during the stage of shipment, etc. After these checks and verifications, the banker provides the exporter with the funds. In other words, the forfaiting transaction helps an exporter with instant cash and eliminates his cash flow problems.

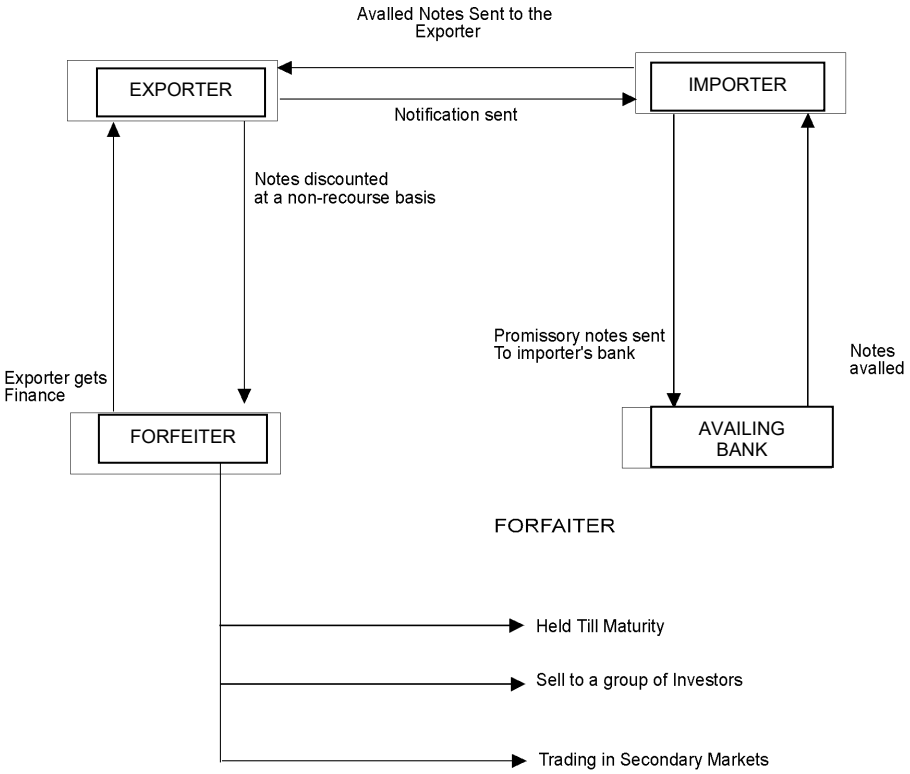
Forfaiting is a relatively new concept. It is a specialized form of factoring, which is undertaken on export transactions on a non-recourse basis. This, however, does not mean that factoring and forfaiting are one and the same type of trade financing.

Operating Procedures Associated with Forfaiting

The major parties around whom, a transaction of forfaiting revolves are: an exporter, an importer, a domestic bank, a foreign bank and a primary forfaiter. A primary forfaiter is a financial entity or an individual who does a contract of forfaiting with the exporter and sells the payments of the importer. There is also a secondary forfaiter too, who is a person or an intermediary who purchases the securities from the primary forfaiter and sells them in the secondary market. The act of the secondary forfeiter helps in the growth of the secondary market activities of the documents involved in a typical forfaiting transaction. The process of

forfaiting gets underway the moment an exporter asks for quotations from the overseas buyer on the issues of price, delivery, interest structure, currency involved, etc. Once the exporter is satisfied with the data received/quotation he approaches the Exim Bank, furnishes the name of the overseas party, name of the country, description of the goods, order details, base price, payback period and the details of the export agency who will facilitate the transaction for the exporter. To make a complete transaction of forfaiting, the forfaiter asks for details of the banker of the overseas importer. The overseas banker accepts and validates the documents of the transaction. This is known as the banker's co-acceptance. The co-acceptance serves as a yardstick for the forfaiter as to the credit quality and the marketability of the instruments accepted. The Exim Bank then collects from the overseas forfaiting agencies the representative quotes on rates of discount, documentation charges and the commitment charges, and informs the same to the exporter. If the terms are acceptable for the exporter, he requests the Exim Bank to obtain a firm quote from the forfaiter. The exporter initiates a contract with the help of the Exim Bank with the overseas forfaiting agency. On the execution of the deal, the Exim Bank issues a formal certificate to the party in India. Subsequently, the exporter ships the goods as per the specification.

Figure 1: Forfaiting



Source: Icfai Research Team.

With the shipment, the exporter's bank in India sends the relevant documents to the importer's bank. The importer's bank supplies them to the importer when the importer produces the availed promissory notes to the bank. In this context, let us discuss what avalization is all about. Avalization is an unconditional third-party (normally importer's or exporter's bank) guarantee of the payment of a bill of exchange or promissory notes. Bills of exchange in forfaiting transactions are backed by the co-acceptance of the banker of the foreign country, or in other words the banker of the importer. The co-acceptance is also known as avalization. After submission of the documents they are sent to the exporter by the bank. The exporter has to endorse the note with "Without Recourse" clause. Without recourse debt is a kind of debt instrument on which the right of recourse (or,

reverting in case of a difficulty in collection back to the originator) has been surrendered by the buyer. These without recourse notes are sent back to the forfaiting agency by the Exim Bank. On receipt of these papers the forfaiting agency, after verifying the signature of the avail releases payments at a discounted value in consultation with the Exim Bank. The transaction is done through the nostro account of the exporter's bank in the country where the forfaiting agency is located. After the overseas bank receives the proceeds, it transfers them to the exporter. All these are performed at the instructions given by the Exim Bank. Immediately after the inward remittance of the funds, the exporter is issued a Certificate of foreign inward remittance. On maturity of the Bills of Exchange or the promissory notes, the forfaiting agency presents certain documents to the co-acceptor for payment. The documents, which are presented at this time are commercial contracts between the foreign buyer and the domestic exporter, evidence of delivery of goods by the exporter to the overseas buyer, endorsement of debt instruments without recourse in favor of the forfaiter, etc.

Costs Involved in a Transaction of Forfaiting

A transaction of forfaiting involves different types of fees and charges. The fee charged by the forfaiter depends on the relationship with the exporter, volume of trade and above all the cost of funds of the forfaiter. The fees that come into play during a transaction of forfaiting fall into three broad categories.

COMMITMENT FEES

A commitment fee is payable to the forfaiter by the exporter in consideration of the commitment made by the forfaiter to execute a particular transaction of forfaiting at a particular discount rate and within a specific time. The commitment fee ranges between 0.5-1.5 percent per annum. It is always calculated on the unutilized amount of the forfaiting transaction. Irrespective of the execution of the export contract, the commitment fee is required to be paid.

DISCOUNT FEES

It is the cost payable on the credit promised under the factoring deal for the total period of credit under consideration. It is payable by the exporter to the forfaiter. Instead of charging the same separately, the forfaiter deducts it from the amount it owes to the exporter against the promissory note or bills of exchange, as the case may be. Discount rate is arrived at based on the London Inter Bank Offered Rate (LIBOR) for the period under consideration. The forfaiter pays the exporter the money almost instantly, but it has to wait quite some time to recover the same from the importer. During the intervening period, adverse movements in the international currency market may wipe out the profits of the forfaiter. So, this also includes the possible loss/gain that can be expected due to changes in the exchange rates in the intervening period.

DOCUMENTATION FEES

Documentation fees are generally charged for transactions involving elaborate legal formalities and complexities and they may not be applicable when the legal procedures and the documentation required are low.

Other Considerations Associated with a Transaction of Forfaiting

Apart from those described above, there are certain charges applicable on a case-to-case basis like charges for handling, etc. Besides all these, the Exim Bank (or, the forfeiter whatever the case may be) is entitled to receive service charges for its participation in the forfaiting service. The charges of Exim Bank are payable in Indian Rupee. However, the discount fees, commitment fees and the documentation fees are passed on to the overseas forfeiter. This is performed as per the Reserve Bank of India's AD (GP Series) Circular No.3 dated February 13, 1992. As per the guidelines issued by the RBI, the exporter should finalize the export contract in such a manner that the total amount earned by the exporter in foreign currency, after appropriating for the costs incurred in the forfaiting transaction, is equal to the price which the exporter would obtain if the goods were

sold on cash payment basis. The consignment has to be of a minimum value of $2,50,000 or its equivalent to be generally considered for forfaiting by the agencies. The contract may be executed in all the major currencies of the world like US Dollar, Pound Sterling and Japanese Yen, etc. The normal duration of the receivables in a forfaiting contract ranges from 1-5 years. The acceptance of a forfaiting offer by the forfaiting agency is also dependent on the agency's outlook on the country involved and it's risk perception on the macroeconomic fundamentals of that country.

FINANCING IMPORTS

Bank lending activities under import financing are mainly concentrated on activities like:

- Import of consumable inputs and channelized items.
- Import of plant and machinery.
- Imports made under short-term credit facility extended by overseas seller.

Credit support to imports is usually extended in the form of:

a. Opening of import Letter of Credit.

b. Financing imports in the form of cash, credit, and loans mostly against import trust receipt, effecting payment in foreign exchange directly to overseas sellers.

c. Issuing deferred payment guarantees favoring overseas sellers on behalf of an importer who is importing capital goods on long-term credit.

As a general rule, any credit facility extended to an importer is basically appraised like any other domestic credit proposal, to ascertain that the business has scope to generate cash flows that are sufficient to serve the debt besides leaving a reasonable profit with the borrowers. In addition to these normal credit appraisal techniques, banks are expected to assess the loan requirement for compliance with trade and exchange regulations that are applicable to the respective import activity. It is in fact incumbent upon everyone concerned with imports to comply with these regulations. In view of this, we shall now discuss about opening of import LCs or financing an importer against import trust receipt, etc., and compliance with regulations in detail.

Scrutiny of Application for Opening an Import Letter of Credit

Whenever an importer approaches a bank for opening an import LC, the banks usually subjects the request for scrutiny under the premises of:

i. Trade Control Requirements.

ii. Exchange Control Requirements.

iii. Credit Norms of the RBI.

iv. U.C.P.D.C Provisions and the FEDAI.

v. Bank's Internal Procedures.

According to the exchange control guidelines, banks are required to open Letters of Credit for their own customers known to be participating in the trade. The opening of a Letter of Credit involves two stages wherein the importer is first required to make an application in the required format to the bank for opening the LC. Along with the application, the applicant is also required to submit certain important documents like:

– The exchange control copy of the import license/open general license declaration form, in case the items to be imported are covered under OGL.

– Letter of authority signed by the licenser in favor of the applicant, in case the applicant is not the holder of the license.

– Pro forma invoice/indent/sale contract, etc., covering the goods to be imported.

– Board resolution in the case of limited companies authorizing the company to establish the Letter of Credit.

– Board resolution for availing of import loan wherever necessary.
– Evidence of the Import-Export Code Number allotted by the Director General of Foreign Trade (DGFT) to the importer.

While submitting the application, the importer should take care to ensure that:

a. The application form is duly stamped according to the law of the concerned state and dated.
b. The application form is signed on all pages by the authorized signatory.
c. The application is filled in completely and any corrections or alterations are duly authenticated.
d. Particulars furnished conform to the pro forma invoice/contract/indent backing the Letter of Credit.
e. The tenor of the bill of exchange does not exceed from that provided by the exchange control regulations in force.
f. Currency in which the payment is to be made is in conformance with the permitted methods of payment.
g. Goods are consigned only in the name of the LC opening bank. Similarly, documents of title to goods are in the name of the LC issuing bank and never directly to the importer.
h. The LC application clearly mentions the origin of the goods.
i. The indent/contract continues to be valid.
j. Terms and conditions mentioned are compatible with each other.
k. The rate of interest if any for the usance period does not exceed the prime rate of interest in the country of the currency in which goods are invoiced.

In order to assess the creditworthiness of an importer, banks obtain information relating to the following:

i. Whether the importer is in possession of an importer-exporter code issued by the Director General of Foreign Trade.
ii. Whether the exchange control copy of the import license is submitted to the Authorized Dealer.

The import license should be:

- Valid.
- Issued on a security paper and should have a printed number and date.
- Having a security seal.
- In the name of the importer or properly transferred in his name with proper transfer letters authorizing him to effect import and open Letter of Credit, etc., by the licensee as per provisions of the ITC policy.
- Commodity specified in the license should be the same as that indicated in the application. Similarly, quantity or amount limits specified in the license should be in agreement with that mentioned in the application. Also, irrespective of the sale terms for which the Letter of Credit is proposed to be opened, the import license should have adequate value to cover CIF value plus agency commission and interest, if any.
- Country of origin of goods authorized in the license and country of shipment as authorized should be in agreement with that which is stated in the Letter of Credit agreement.
- The license should be valid for shipment at least up to the last shipment date requested for in the Letter of Credit application.

- If the license is issued under any bilateral or multilateral agreement, the conditions stated in the concerned agreements and the relative ITC notification are complied with.
- If the license stipulates placement of order within a specified time limit, the sale contract submitted must confirm compliance of the condition.

Similarly, an import Letter of Credit will have to comply with certain exchange control aspects and hence the importer should be aware that:

a. LCs will be opened by bankers only in favor of their customers who are known to be participating in the trade.

b. LCs will be opened for those goods which are covered under the negative list of imports; an LC will be opened only if the importer submits a license marked "For Exchange Control Purposes".

c. Where goods are imported from Nepal or Bhutan, payment will be made in rupees and such an LC would be treated as a domestic LC.

d. If the beneficiary is from an ACU country, the LC should be denominated in ACU dollar which is value-wise equivalent to one US dollar.

e. If import is made under a foreign loan or credit agreement and payment is authorized under letter of commitment method, the Letter of Credit should not envisage any remittance from India. In the case of import licenses where reimbursement method applies, Authorized Dealers will make appropriate stipulations to ensure that the prescribed documents are submitted to them without fail.

f. In case of import of technology and drawings, the applicant will be required to pay Research and Development Cess, before allowing remittance. An undertaking to this effect is required to be given by the importer at the time of opening the LC.

g. In case of imports on cash basis, remittance should be completed within six months from the date of shipment. However, in a situation where there is undrawn balance, payment for such amount can exceed six months, but no interest will be paid on such amount withheld.

h. If a Letter of Credit is to be opened for transaction of merchanting or intermediary trade, a Letter of Credit for the other leg of the transaction on back to back terms will have to be opened or full advance payment should be made. Moreover, banks will open LCs only in favor of their clients who are genuine traders in goods and not mere financial intermediaries.

If the Letter of Credit application is found to be in order after scrutiny from all angles, the bank will open the LC in favor of the supplier of goods. The LC will be advised to the beneficiary by an advising bank based in the beneficiary's country. The mode of transmission of the LC is normally indicated by the applicant. However, in situations where such a request cannot be acceded to, the bank will inform the applicant and seek alternate instructions. The documents which are presented to the issuing bank are the same documents which are presented by the exporter. On receipt of documents from the exporter's bank, the importer's bank will examine the documents with the terms and conditions of the LC already issued and if found in order it will debit the importer's account for the amount in rupees equivalent to the bill amount plus its own charges and charges of the overseas bank and hand over the same to the importer.

The procedure for scrutiny of the said documents will be the same as that made by the exporter's banker. As payments under a Letter of Credit depend on the correctness and completeness of the documents submitted, both importers and exporters are required to follow certain safeguards while submitting the same.

Customs Procedure for Clearance of Imports into India

A person in charge of the conveyance carrying imported goods should submit an import manifest within 24 hours of the arrival of the conveyance to the customs department. The manifest includes details of all the goods that are on board the vessel, including those which are to be transshipped and those to be carried to subsequent ports of call. When the importer receives information about the arrival of goods, he or his agent is required to file a bill of entry in the prescribed form with the Imports department of the customs house. The date of presentation of the bill of entry is important as the goods will be assessed to duty based on the rate prevailing on the date of presentation. After the bill of entry is noted in the imports department, the same should be presented at the appraising counters accompanied by the following documents:

- Import License, if necessary.
- Exporter's Invoice.
- Copy of the Letter of Credit.
- Original Bill of Lading and its Non-negotiable Copy.
- Two Copies of Packing List.
- Weight Specifications.
- Manufacturer's Test Certificate.
- Certificate of Origin.
- Delivery Order Issued by the Shipping Company or its Agent.
- Freight and Insurance Amount Certificate if the Import is on FOB terms.
- A declaration from the importer that he has not paid any commission to agents in India.
- Customs declaration.
- Catalogue/drawings, etc., for machinery imported.

After verification and completion of the bill of entry by the appraiser, the bill is countersigned by the Assistant Collector and sent to the license section with an order to the dock staff for examination of the goods before clearance.

The appraising procedure may be either the first check procedure or the second check procedure. Under the first check procedure, the appraiser after initial scrutiny of the documents submitted, returns the bill of entry with an order for examination of goods prior to assessment of duty.

Under the second check procedure, after payment of duty, the importer or his agent is required to obtain the duplicate copy of the bill of entry from the customs on which the order for examination of goods is given. (The original copy of the bill of entry is retained by the customs department.) If the description of goods is found to be the same as declared, then permission for clearance is given by the appraiser. It should be noted that under the second check procedure, the assessment of duty is made prior to examination of the goods.

Box 1: BEF Statements
Importers are required to submit the exchange control copy of the bill of entry for home consumption/postal wrappers to the Authorized Dealers as evidence that the goods against which payment has been made are actually brought into the country. Authorized Dealers acknowledge evidence of import by issuing acknowledgement slips containing details like importer's full name, address, code number, import license number and date, bank's reference number (LC number, etc.), number and date of the exchange control copy of the bill of entry/postal wrapper, value and particulars of the imported goods.

In case the importer fails to furnish evidence of import within three months from the date of remittance, the AD will issue a reminder to the importer insisting him to produce the evidence. On failure to respond to this reminder by the importer, a second reminder by registered post acknowledgement due will be sent to the importer not later than one month from the date of the first reminder. If the importer fails to furnish evidence within a period of 21 days from the date of the second reminder, the AD will include details of the defaulting importer as well as the import transaction in the BEF statement to be forwarded to the Reserve Bank of India.

The BEF Statement is a half-yearly statement prepared at the end of June and December every year, in a prescribed format, furnishing details of import transactions exceeding USD 1,00,000 in respect of which importers have defaulted in submission of appropriate document evidencing the import. The BEF statement should be submitted to the Regional Office of the RBI under whose jurisdiction the AD is functioning within 15 days from the close of the half year to which the statement relates to. The Reserve Bank of India may initiate penal proceedings against the defaulting importer based on the details given in the BEF Statement.

Source: Icfai Research Team.

SOURCES OF FOREX FLOWS

Forex funds or external funds are required to:

a. Bridge the gap between current external receipts and payments, and

b. Meet the shortfall between domestic investments and savings.

Normally, developing countries have poor or inadequate savings, which results in shortage of funds required for development of infrastructure, industries, etc. Therefore there arises a need for depending on external funds. The various sources of forex funds are supplier's credit, buyer's credit and commercial borrowings.

Supplier's Credit

It is a credit facility arranged at the instance of the supplier to enable the buyer to procure goods on credit terms. Thus, supplier's credit is a source of funds for the buyer. In international trade, supplier's credit becomes the source of foreign funds from the point of view of the importer. It is arranged by the exporter's country to promote exports and to assist the exporter. It could be a short, medium or long-term debt. In case of capital goods, supplier's credit may extend for periods up to 10 years. Many countries offer supplier's credit at competitive interest rates. If an importer arranges credit in his own country, he may not get the credit terms as competitive as the one's offered by the supplier's credit.

Examples of Supplier's Credit:

i. If Dr. Reddy's Lab is supplied chemicals by a Taiwanese firm on 180 days DA basis. This is a supplier's credit of short-term nature.

ii. When a manufacturer of aircrafts in New York sells aeroplanes to say Indian Airlines, such vendor may stipulate that a down payment of 10-15% may be made and the balance amount may be paid in a certain number of equal installments at competitive rates of interest. Here, it's a supplier's credit of medium-term nature.

Buyer's Credit

In this case, the buyer raises loan from a financial institution in the exporter's country. The loan is utilized to pay the exporter the full amount. Thus, from the point of view of the exporter, it is cash sale transaction. Buyer's credit is generally covered under the export credit insurance scheme. Buyer's credit may also be of short, medium, or long-term in nature.

Example of Buyer's Credit:

In the earlier example of Indian Airlines, if Indian Airlines arranges a loan from a bank in New York to pay the supplier in full and thereafter repays the loan as per stipulated installments, then this would be a buyer's credit.

Commercial Borrowings

In the above-mentioned forms of forex flows, the borrowings have to be repaid in foreign currency and thus there exist foreign currency risks to the borrower. There are certain instruments like equities, which do not pose any exchange risks to the borrower company. American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) are two such instruments.

EXPORT-IMPORT BANK OF INDIA

The Export-Import Bank of India (Exim Bank) is a fully owned bank of the Government of India and is managed by the Board of Directors with representation from the government, financial institutions, banks and business community. It provides financial assistance to promote Indian exports through direct assistance, overseas investment finance, term finance for export production and export development, pre-shipping credit, buyer's credit, lines of credit, re-lending facility, export bills rediscounting, refinance to commercial banks etc. The Exim Bank also extends non-funded facility to Indian exporters in the form of guarantees. The diversified lending program of the Exim Bank now covers various stages of exports, i.e., from the development of expand makers to expansion of production capacity for exports and post-shipment financing. The Exim Bank focuses more on the export of manufactured goods, project exports, export of technology services and computer software.

Financing Programs

Loans to Indian Companies and Deferred Payment Exports: Term finance is provided to Indian exporters of eligible goods and services which enables them to offer deferred credit to overseas buyers. Deferred credit can also cover Indian consultancy, technology and other services. Commercial banks participate in this program directly or under risk syndication arrangements.

Pre-shipment Credit: Finance is available from the Exim Bank for companies executing export contracts involving a time period exceeding six months. The facility also enables provision of rupee mobilization expenses for construction/turnkey project exporters.

Term Loans for Export Production: The Exim Bank provides term loans/ deferred payment guarantees to 100% export oriented units, units in free trade zones and computer software exporters. In collaboration with International Finance Corporation, Washington, the Exim Bank provides loans to enable small and medium enterprises upgrade their export production capability.

Facilities for Deemed Exports: Deemed exports are eligible for funded and non-funded facilities from the Exim Bank.

Overseas Investment Finance: Indian companies establishing joint ventures overseas are provided finance towards their equity contribution in the joint venture.

Finance for Export Marketing: This program, which is a component of World Bank loan, helps exporters implement their export market development plans.

Buyer's Credit: Credit is directly offered to foreign entities for import of eligible goods and related services, on deferred payment.

Lines of Credit: Besides foreign governments, finance is available to foreign financial institutions and government agencies to on-lend in the respective country for import of goods and services from India.

Relending Facility to Banks Overseas: Relending facility is extended to overseas banks to enable them to provide term finance to their clients' imports from India.

Export Bills Rediscounting: Commercial Banks in India which are authorized to deal in foreign exchange can rediscount their short-term export bills with Exim Banks, for an unexpired usance period of not more than 90 days.

Refinance of Export Credit: Authorized dealers in foreign exchange can obtain from Exim Bank 100% refinance of deferred payment loans extended for export of eligible Indian goods.

Guaranteeing of Obligations: Exim Bank participates with commercial banks in India in the issue of guarantees required by Indian companies for the export contracts and for execution of overseas construction and turnkey projects.

Export Marketing Finance Program

The Exim Bank seeks to create and enhance export capabilities and international competitiveness of Indian companies. Under the lending program for Export Marketing Finance, banks extend the term finance requirements for structured and strategic export marketing and development effort of companies.

Companies having a strategic international marketing plan are eligible to participate in this program. The company should have established presence in the domestic market and satisfactory financials.

Activities associated with export marketing and export capability creation are financed under the program. Typical activities eligible for finance under this program are desk and field research, minor product adaptation, overseas travel, training, quality certification, product launch, investment in machinery and equipment, testing or quality control equipment and factory premises. Loans in rupees or any other international currency are available from the Exim Bank. The interest rates of rupee term loans are linked to Exim Bank's minimum lending rate, and foreign currency term loans are linked to floating or fixed interest rates. A service fee of 1% is charged on the loan amount sanctioned, and is payable upfront. The loan has to be repaid in five years inclusive of the moratorium period, and a margin of 20% is allowed.

The Exim Bank requires hypothecation of movable fixed assets of the company, or mortgage of immoveable fixed assets of the company as security from the exporters.

The Role of Exim Bank in Trade Finance

The Exim Bank was established to finance and promote foreign trade. It extends finance to exporters of capital and manufactured goods, software and consultancy services and to overseas joint ventures and turnkey/construction projects abroad. Term loans are also extended to projects located in export zones.

Exim Bank's financing can, if required, supplement working capital finance extended by commercial banks at the pre-shipment stage. The functions of the Exim Bank are lending, guaranteeing, promotional services and advisory services.

LENDING

To Indian Companies.		To Foreign Govt., Foreign Companies	To Indian Banks
i. Direct Assistance.	i.	Buyers' Credit.	i. Bill Rediscounting.
ii. Consultancy and Technology Services.	ii.	Lines of Credit.	ii. Refinance.
iii. Overseas Investment Finance.	iii.	Relending Facility.	
iv. Pre-shipment Credit.			
v. Deemed Exports.			
vi. 100% Export Oriented Units and Free Trade Zones.			
vii. Forfaiting.			

Lending to Indian Companies

Direct Assistance: Funds are provided on deferred payment terms to Indian exporters of plant, equipment and related services, which enable them to extend deferred credit to the overseas buyer. Credit is provided by the Exim Bank in participation with commercial banks. Banks provide the credit and they can avail of refinance from the Exim Bank. The exporter is expected to obtain an advance and a down payment of at least 15 percent of the contract value.

Consultancy and Technology Services: Indian companies executing overseas contracts involving consultancy and technology services, can avail of Exim Bank's financing program, to offer deferred payment terms to their clients. The credit may be extended to the Indian company either by the Exim Bank in participation with commercial banks, or directly by commercial banks who could in turn seek refinance from the Exim Bank. The exporters in turn could offer deferred payment terms to their clients.

The credit normally given in Indian rupees is repayable in half-yearly installments over a period not exceeding five years. Guarantee of foreign government or a guarantee/irrevocable LC of an acceptable bank would need to be obtained. The Indian company also has to obtain ECGC insurance cover and assign it in favor of the bank.

Overseas Investment Finance: The Exim Bank provides export credits to Indian promoters for their equity contribution to overseas joint ventures. The funds are in the form of long-term credit not exceeding ten years. Exim bank's finance will be made available to Indian promoters by way of:

a. Rupee term loans for financing equity contribution.

b. Foreign currency loans/guarantees, where the equity contribution is allowed by the Government of India out of foreign currency loan to be raised by the Indian promoter.

Equity contribution by Indian promoters can be in various forms such as:

i. Capitalization of proceeds of exports in the form of plant and machinery.

ii. Technical know-how.

iii. Capitalization of earnings such as royalty and management fees.

iv. Cash remittances.

Where cash remittances are allowed, Indian promoters are granted approvals to remit foreign exchange from India or raise foreign currency loans for the purpose of equity contribution.

The quantum of finance will be determined with reference to the Indian promoter's share in the equity structure of overseas joint ventures, subject to a maximum of 80 percent of the Indian promoter's equity contribution. Commercial banks may also opt to take up risk participation in term loans and guarantees extended by the Exim Bank.

Pre-shipment Credit: If the requirement of pre-shipment credit by exporters is for periods in excess of 180 days, the Exim Bank participates in the credit.

Financing Deemed Exports: Deemed exports occur in case of specified transactions within India, which result in foreign exchange earnings or savings as given below:

i. Supplies made in India to World Bank\IDA-aided projects against international competitive bidding.

ii. Supplies to free-trade zones/100 percent export oriented units.

iii. Sales to foreign shipping companies.

iv. Supplies to ONGC and Oil India Ltd., for off-shore and on-shore drilling operations.

Deemed exports can avail of Exim bank's deferred credit facility. The Exim Bank may participate with commercial banks in extending rupee loans for bridging cash flow deficits of projects/supply contracts; It also issues guarantees and provides bridge finance in foreign currency.

Capital and producer goods are eligible for medium-term credits. Long-term credits up to ten years are provided in exceptional cases. Credit is normally secured by a bank guarantee.

Assistance to Export-Oriented Units: Free-trade zones and export-oriented units are given finance for acquisition of land, building, plant and machinery, preliminary and pre-operative expenses and working capital (as margin money). The Exim Bank's assistance will be in the form of direct assistance given as rupee term loans or deferred payment guarantees or indirect assistance as refinance to commercial banks.

The export-oriented units seeking Exim Bank's finance will have to establish the technical, economic and financial feasibility of their projects.

Forfaiting: Students are advised to refer to the topic in the preceding section.

Lending to Foreign Governments and Foreign Companies

Buyers' Credit: Credit is given to buyers abroad to enable them to import engineering goods from India on deferred payment terms. The loan facility is to be secured by a Letter of Credit or a bank guarantee.

Lines of Credit: Exim Bank also 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 payment terms. Exporters can obtain payment from the Exim Bank against negotiation of shipping documents.

Relending Facility: An overseas bank can enter into a credit line agreement with the Exim Bank. The overseas bank would relend the funds to importers of capital goods, consumer durables and services from India. The borrowing bank may be a commercial bank, a Central Bank, or an investment/merchant bank with a good credit standing.

Specimen Copy of a Promissory Note

Per Aval
WELLINGTON BANK, MANCHESTER,
UNITED KINGDOM

MANCHESTER 31 MARCH, 1992 **US$ 850,000**

On 1 APRIL, 1993 for value received pay against this promissory note

to the order of MACHINERY EXPORTS (INDIA) LTD. the sum of

EIGHT HUNDRED FIFTY THOUSAND US DOLLARS

effective payment to be made in UNITED STATES DOLLARS without deduction for

and free of any taxes, impost, levies or duties present or future of any nature

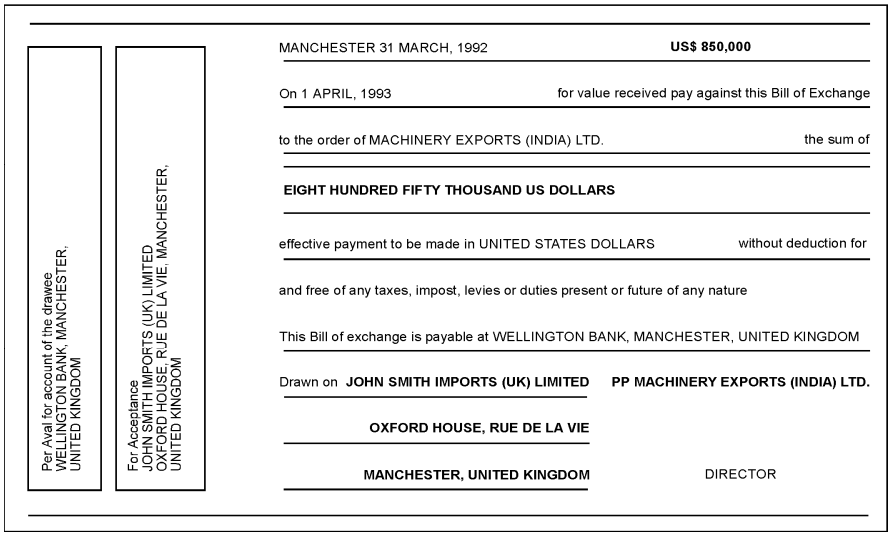
This promissory note is payable at WELLINGTON BANK, MANCHESTER, UNITED KINGDOM

Drawn on **JOHN SMITH IMPORTS (UK) LIMITED**

OXFORD HOUSE, RUE DE LA VIE

MANCHESTER, UNITED KINGDOM

Specimen Copy of a Bill of Exchange



Loans will be denominated in US dollars and repayment will also be in the same currency. Short-term loans extending from 180 days to one year are repayable by quarterly/half-yearly installments. Medium-term loans are also given.

The relending facility will operate as follows:

i. The borrowing bank, upon its approval of a sub-loan to an importer, opens irrevocable letters of credit in favor of the Indian exporter through the Exim Bank or banks designated by the latter.

ii. The Indian exporter ships goods and presents shipping documents to the Exim Bank or banks designated by the latter.

iii. Exim Bank pays to the Indian exporter the rupee equivalent.

iv. Exim Bank or the negotiating bank in India forwards shipping documents to the borrowing bank, together with the advice of having made disbursement to the supplier.

Lending to Indian Banks

Rediscounting of Export Bills: Commercial banks that are authorized dealers can rediscount their short-term usance export bills with the Exim Bank.

Refinance for Deferred Payment Exports: Deferred payment exports arise when export proceeds are to be received after six months from the date of shipment. Exim Bank offers hundred percent refinance facility to banks, which enables a bank to extend deferred credit to an Indian exporter against supplier's credit offered by the exporter to the overseas buyer. Capital goods, consumer durables and industrial manufactures can be considered for deferred credit.

Guarantees

OVERSEAS CONSTRUCTION PROJECTS

Guarantees are issued by the Exim Bank on behalf of exports of turnkey projects and construction contracts. Such guarantees include:

i. Bid bond guarantee.

ii. Advance payment guarantee.

iii. Performance guarantee.

iv. Retention money guarantee.

v. Guarantee for borrowing abroad.

Bid bond guarantee is issued for a maximum period of six months. For advance payment guarantee, exporters are expected to secure mobilization advance of 10-20 percent of contract value. Performance guarantee for 5-10 percent of the contract is issued and is valid up to one year after completion of the contract. Guarantee for release of retention money enables the exporter to obtain the release of full payments.

Bridge finance may be needed at the earlier phases of the contract; up to 10 percent of the contract value may be raised in foreign currency from a foreign bank against the Exim bank's guarantee for borrowing abroad.

SYNDICATION OF EXPORT CREDIT RISKS

Exim Bank and other banks participating in the funding of a loan would syndicate the respective credit risks to other eligible commercial banks, who would assume part of the total risk. Proposals valued at more than Rs.1 crore, entailing deferred credit exports of engineering goods and services, are forwarded by the sponsoring bank for consideration by an inter-institutional working group which meets at Mumbai, with the Exim Bank as the focal point. While clearing the proposal, the participation arrangement for the funding of export credit is also determined.

SOFTWARE EXPORTS

The new policy of the government on computer software exports and development has rationalized the system of facilities and incentives for exports. Under the new policy, the Exim Bank has been designated as an agency for facilitating speedy clearances and meeting foreign exchange requirements towards imports for computer software export where export obligation of 350 percent of foreign exchange used is undertaken. The Exim Bank will undertake financial and technical analysis of software export proposals and monitor the progress.

The Exim Bank extends advisory services to exporters in several areas and undertakes promotional activities like techno-economic surveys, collecting and disseminating market information, etc.

It offers an integrated package covering foreign currency and rupee term finance for acquisition of imported and indigenous computer/computer-based systems for export purposes. The bank welcomes the association of commercial banks for providing working capital finance for software export projects assisted by it. A rebate of 50 percent on customs duty payable on import of computer systems is available to software exporters opting for 350 percent export obligation.

Export and import transactions are governed by the Exim Policy and the RBI exchange control regulations. While the Exim Policy regulates the movements of goods and services by prescribing the permissible exports and imports, the RBI regulations regulate the corresponding payments for these international transactions. While extending credit for any such trade, the banks need to make sure that the respective guidelines have been followed by the concerned parties.

EXCHANGE CONTROL REGULATIONS RELATED TO MERCHANT TRANSACTIONS

Exchange controls were introduced in India in 1939, during the World War II, to conserve foreign exchange, particularly the US dollar, for meeting essential defence expenditure. The main purpose of exchange controls is to conserve foreign exchange and ensure its effective utilization.

After the World War II, the exchange control regulations framed under the Defence of India Rules were replaced by the Foreign Exchange Regulation Act, 1947, which was revised and replaced by the Foreign Exchange Regulation Act, 1973. With a view to create conducive climate for attracting foreign direct investment to increase production and promote exports, FERA 1973, has been substantially amended by the FERA [Amendment] Act, 1993. FERA was replaced

with the Foreign Exchange Management Act (FEMA) in 1999 to consolidate and amend the laws relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.

Exchange controls also cover foreign capital and activities financed by it. The administrative authority of foreign exchange regulation is vested with the Reserve Bank of India (RBI) and the routine work of exchange control is delegated to banks authorized to deal in foreign exchange. Exchange controls and procedures are set out in the Exchange Control Manual published by the RBI.

Transactions Subject to Control

i. Purchase, sale, and other dealings in foreign exchange and maintenance of balance at foreign centers.

ii. Realization of export proceeds and payment for imports.

iii. Payments to non-residents or to their accounts in India.

iv. Transfer of securities between residents and non-residents and acquisition and holding of foreign securities.

v. Foreign travel with foreign exchange.

vi. Export and import of currency, cheques, travelers cheques, securities, etc.

vii. Activities in India of foreign nationals and branches of foreign firms and companies.

viii. Foreign direct investment and portfolio investment in India including investment by non-resident Indians, persons of Indian origin and corporate bodies predominantly owned by such persons.

ix. Appointment of non-residents and foreign nationals and foreign companies, etc., as agents in India.

x. Setting up of joint ventures/subsidiaries outside India by Indian companies.

xi. Acquisition, holding and disposal of immovable property in India by foreign nationals/companies.

xii. Acquisition, holding and disposal of immovable property outside India by residents in India.

DEPARTMENT OF SCIENTIFIC AND INDUSTRIAL RESEARCH

The Department of Scientific and Industrial Research (DSIR) operates a scheme called International Technology Transfer Program (ITTP) under which it can grant assistance for technology exports. Apart from financial assistance, the prospective technology or service exporters can also identify the possible export opportunities by studying the technology profiles of various developing countries, which have been prepared with the support of DSIR to identify the technology needs of those countries.

Scheme of International Technology Transfer Program (ITTP)

Under this scheme, the DSIR provides support by way of grant, to finance efforts for technology exports. The quantum of grant and eligibility is determined case to case, but can extend to 100% of the eligible expense. The main activities are:

i. Preparation of reports/films regarding capabilities and experience of Indian industrial units and other concerned organizations in exports of technologies and services.

ii. Preparation of technological profiles having export potential.

iii. Training programs for potential foreign clients.

iv. Preparation and dissemination of publicity and market promotion materials like technology catalogues, brochures, video films, audio-visuals, etc.

v. Participation in technology trade fairs, exhibitions, etc. (including participation fee, cost of display, etc.).

vi. Setting up demonstration plants/pilot plants projecting Indian technology, either in India or abroad (in such cases, the grant is usually restricted to about 20% of the cost of the pilot plant).

vii. Documentation expenses for delegations (for example, brochures, pamphlets, advertisement materials, etc.) provided in the delegation also include technology exports.

Table 3: On-going/Completed Projects under International Technology Transfer Program As on July 1, 2006

Sl. No.	Title of the Project and Name of the Executing Agency	Amount Sanctioned, Date & Project Duration	Amount Released So far	Further Release by
1.	Exportable Technologies from SMEs in Andhra Pradesh and Karnataka – APITCO.	Rs.8 lakh 13.2.2004 12 months.	Rs.5.0 lakh	Aug. 2006
2.	Profiles of Exportable Technologies from SMEs in West Bengal and NE States – WEBCON.	Rs.10.0 lakh 12.4.05 12 months.	Rs.3.0 lakh	Sept. 2006
3.	Profiles of Exportable Technologies from SMEs in Haryana, Punjab, Himachal Pradesh and J&K – NAFEN.	Rs.10.0 lakh 31.3.05 12 months.	Rs.7.0 lakh	July. 2006
4.	Exportable Techno-logies from SMEs in Gujarat and Rajastan – GITCO.	Rs.8.6 lakh 5.10.2005 12 months.	Rs.1.8 lakh	Sept. 2006
5.	Exportable Technologies from SMEs in Tamilnadu & Kerala – Pixel Networks.	Rs.8.6 lakh 5.10.2005 6 months.	Rs.4.8 lakh	Aug. 2006
6.	Exportable Technologies from SMEs in UP Uttaranchal, Bihar & Jharkhand – Sycom Consultants.	Rs.9.7 lakh 27.3.2006 11 months.	Rs.3.0 lakh	Oct. 2006
7.	Exportable Technologies from SMEs in M.P. Chattisgarh & Orissa – MPCON.	Rs.10.0 lakh 27.3.2006 10 months.	Rs.3.0 lakh	Oct. 2006
8.	Technology Export Development Organization (TEDO) Phase II–CII.	Rs.100 lakh 25.4.05 24 months.	Rs.45.0 lakh	Dec. 2006
9.	Center for International Trade in Technology- Phase II–IIFT	Rs.21.0lakh28.3.2005 24 months	Rs.6.0 lakh	Sep. 2006
10.	Survey on Export Capability Assessment of Indian Tooling Industry – NPC.	Rs.4.26 lakh 25.11.04 12 months.	Rs.2.0 lakh	Sep. 2005
11.	DSIR – Commerce Project to Promote High Technology Cooperation with CIS Countries – MITCON.	Rs.37.26 lakh (DSIR Share:20 l) 31.3.05 18 months.	Rs.13.0 lakh (DSIR) Rs.12 lakh (Commerce)	Dec. 2006

Sl. No.	Title of the Project and Name of the Executing Agency	Amount Sanctioned, Date & Project Duration	Amount Released So far	Further Release by
12.	Technology Trade Facilitation Center – NRDC.	Rs.39.0 lakh 31.3.03 36 months.	Rs.28.0 lakh	Sep 2006
13.	Compendium on Technology Exports and Exportable Technologies – IIFT.	Rs.21.0 lakh 31.1.05 36 months.	Rs.3.5 lakh	Aug 2006
14.	Newsletter on Technology Exports – IIFT.	Rs.10.20 lakh 12.5.06 12 months.	Rs.3.40 lakh	Dec 2006
15.	Four Design Clinic- cum – Awareness Programs – NID.	Rs.20 lakh 16.3.05 12 months.	Rs.6.5 lakh	Aug 2006
16.	Workshops on IPR Awareness – WITT.	Rs.3.0 lakh 6.12.04 12 months.	Rs.1.0 lakh	Jul 2006
	Completed Projects			
17.	INDIATECH 2005: 9th Technology Trade Pavilion – ITPO.	Rs.27 lakh 16.9.05 6 months.	Rs.24.66 lakh	-----
18.	International Awareness Programme on Packaging Conversion Technologies – SIES School, Mumbai.	Rs.5.0 lakh 28.3.05 12 months.	Rs.3.8 lakh	----
19.	Third International Design awareness-cum-Training Program – NID.	Rs.6 lakh 7.10.05 6 months.	Rs.6 lakh	----

Source: Dept. of Scientific and Industrial Research, Govt. of India.

EXPORT CREDIT GUARANTEE CORPORATION OF INDIA LIMITED (ECGC)

The Government of India established the Exports Risks Insurance Corporation (ERIC) in July, 1957 in order to provide export credit insurance support to Indian exporters. It was transformed into Export Credit and Guarantee Corporation Limited in 1964. To bring the Indian identity into sharper focus, the Corporation's name was once again changed to the present Export Credit Guarantee Corporation of India (ECGC) Limited in 1983. The ECGC is a wholly-owned company of the Government of India functioning under the administrative control of the Ministry of Commerce and is managed by a Board of Directors with representatives from the government, banks, industry, trade, etc. Its major functions are:

- To provide a range of credit risk insurance covers to exporters against loss in export of goods and services.
- To offer guarantees to banks and financial institutions to enable exporters obtain better facilities from them.
- To provide insurance protection to exporters against payment risks.
- To provide guidance in export related activities.
- To provide information on credit-worthiness of overseas buyers.
- To provide information on about 180 countries with its own credit ratings.
- To guide exporters to obtain export finance from banks/financial institutions.
- To assist exporters in recovering bad debts.

The covers issued by the ECGC can be divided broadly into four groups:

Standard Policies

Shipments (Comprehensive Risks) Policy, which is commonly known as the Standard Policy, is the one ideally suited to cover risks in respect of goods exported on short-term credit, i.e., credit not exceeding 180 days. The policy covers both commercial and political risks from the date of shipment.

Specific Policies

Specific Policies are designed to protect Indian firms against payment risks involved in:

i. Exports on deferred terms of payment.

ii. Services rendered to foreign parties.

iii. Construction works and turnkey projects undertaken abroad.

These policies are issued separately for each specific contract, and cover risks normally from the date of contract.

Financial Guarantees

Financial Guarantees are issued to banks in India to protect them from risks of loss involved in their extending financial support at pre-shipment and post-shipment stages. These also cover a host of non-fund based facilities that are extended to exporters. The features of a financial guarantee are:

- This scheme protects the banks extending Buyers' Credit and Line of Credit to overseas buyers or overseas banks, institutions or governments.
- Buyer's Credit is a credit extended by a bank in India to an overseas buyer enabling the buyer to pay for machinery and equipment that he may be importing from India for a specific project.
- A Line of Credit is a credit extended by a bank in India to an overseas bank, institution or government for the purpose of facilitating import of a variety of listed goods from India into the overseas country. A number of importers in the overseas countries may be importing the goods under one Line of Credit.
- These covers are issued on a case-to-case basis.
- Policy covers both political and commercial risks.
- Policy covers up to 85% of the loss.

Small Exporter's Policy

This policy is specifically designed keeping in view the requirements of small exporters whose annual turn over does not exceed Rs.50 lakh. Its salient features are:

- The Small Exporter's Policy is basically the Standard Policy, incorporating certain improvements in terms of cover, in order to encourage small exporters to obtain and operate the policy.
- It will be issued to exporters whose anticipated export turnover for the next 12 months does not exceed Rs.50 lakh.
- Period of Policy: Small Exporter's Policy is issued for a period of 12 months, as against 24 months in the case of Standard Policy.
- Minimum premium: Minimum premium payable for a Small Exporter's Policy is equal to Rs.2,000 as against Rs.10,000 for the Standard Policy.
- No-claim bonus in the premium rate is granted every year at the rate of 5% (as against once in two years for Standard Policy at the rate of 10%).

Special Schemes

Some special schemes include:

- Transfer Guarantee meant to protect banks that add confirmation to Letters of Credit opened by foreign banks.
- Insurance cover for Buyers Credit and Lines of Credit.
- Exchange Fluctuation Risk Insurance.

OVERSEAS INVESTMENT INSURANCE

The ECGC has evolved a scheme to provide protection for Indian investments abroad. Any investment 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 investments may be either in cash or in the form of export of Indian capital goods and services. The cover will be available for the original investment together with annual dividends or interest receivable.

The period of insurance cover would not normally exceed 15 years. In case of projects involving long construction periods, 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 the investment. Amounts insured shall be reduced progressively in the last five years of the insurance period.

EXPORT CREDIT INSURANCE

Payments for exports are open to risks even at the best of times. Export credit insurance is designed to protect exporters from the consequences of the payment risks, both political and commercial, and to enable them to expand their overseas business without fear of loss. It also seeks to create a favorable climate in which exporters can hope to get timely and liberal credit facilities from banks at home. For this purpose, the export credit insurer provides guarantees to banks to protect them from the risk of loss inherent in granting various types of finance facilities to exporters.

Guarantees to Banks

Timely and adequate credit facilities, at the pre-shipment as well as post-shipment stage, are essential for exporters to realize their full export potential. Exporters may not, however, be able to obtain such facilities from their bankers for several reasons. ECGC has designed a scheme of guarantees to banks with a view to enhancing the creditworthiness of the exporters so that they would be able to secure better and large facilities from their bankers. The guarantees assure the banks, that in the event of an exporter failing to discharge his liabilities to the bank, and thereby making the bank incur a loss, the ECGC would make good a major portion of the bank's loss. The bank is required to be co-insurer to the extent of the remaining loss. Any amount recovered from the exporter subsequent to payment of claims shall be shared between the corporation and the bank in the same ratio in which the loss was borne by them at the time of settlement of claim. Recovery expenses shall be first charged on the amounts recovered.

To meet the varying needs of exporters, ECGC has evolved the following types of guarantees:

Packing Credit Guarantee: It helps the exporter to obtain better and adequate facilities from their bankers. The Guarantees assure the banks that, in the event of an exporter failing to discharge his liabilities to the bank, ECGC would make good a major portion of the bank's loss. Bank is required to be co-insurer to the extent of the remaining loss. Features of this guarantee are:

- Any loan given to an exporter for the manufacture, processing, purchasing or packing of goods meant for export against a firm order or Letter of Credit qualifies for Packing Credit Guarantee.

- Pre-shipment advances given by banks to parties who enter into contracts for export of services or for construction works abroad to meet preliminary expenses in connection with such contracts are also eligible for cover under the Guarantee.
- The Guarantee, issued for a period of 12 months based on a proposal from the bank, covers all the advances that may be made by the bank during the period to an individual exporter within an approved limit.
- Approval of ECGC has to be obtained if the period for repayment of any advance is to be extended beyond 360 days from the date of advance.
- Whole-turnover Packing Credit Guarantee (WTPCG) can be issued to banks which wish to obtain cover for packing credit advances granted to all their customers on all-India basis. Premiums are lower and higher percentage of cover is offered under this option.

Export Production Finance Guarantee: The purpose of this Guarantee is to enable banks to sanction advances the pre-shipment stage to the full extent of the cost of production when it exceeds the f.o.b. value of the contract/order, the differences representing incentives receivable. The extent of cover and the premium rate are the same as Packing Credit Guarantee.

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 qualify for this guarantee. It is necessary, however, that the exporter concerned should hold a suitable policy of the ECGC to cover the overseas credit risks. Features of this guarantee are:

- Individual Post-Shipment Credit Guarantee can also be obtained for finance granted against L/C bills, even where an exporter does not hold an ECGC Policy, provided that the exporter makes shipments solely against Letters of Credit.
- This guarantee can also be issued on whole turnover basis wherein the percentage of cover shall be 90% for advances granted to exporters holding ECGC policy. Advances to non-policyholders are also covered with the percentage of cover being 65.

Export Performance Guarantee: Exporters are often called upon to execute bonds duly guaranteed by an Indian Bank at various stages of export business. An exporter who desires to quote for a foreign tender may have to furnish a bank guarantee for the bid bond, if he wins the contract, he may have to furnish bank guarantees to foreign buyers to ensure due performance or against advance payment or in lieu of retention money or to a foreign bank in case he has to raise overseas finance for his contract. Further, for obtaining import licences for raw materials of capital goods, exporters may have to execute an undertaking to export goods of a specified value within a stipulated time, duly supported by bank guarantees.

Export Finance Guarantee: This guarantee covers post-shipment advances granted by banks to exporters against export incentives receivable in the form of cash assistance, duty drawback, etc.

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.

SUMMARY

- Export finance is considered by banks on priority basis. While granting export finance, banks have to follow the procedures relating to guidelines issued by the Reserve Bank of India, Trade Promotion Authorities, ECGC, FEDAI guidelines, etc.

- Export credit is granted on a concessional rate of interest. The advances granted by the banks are secured by ECGC guarantee.
- Export finance is broadly classified into pre-shipment and post-shipment finance depending upon the stage at which it is disbursed.
- ECGC was established to support and strengthen the export promotion drive in India. It provides a wide range of credit insurance covers to exports against loss in export of goods and services. To enable the exporters to obtain better facilities from the banks, it offers guarantees to banks and financial institutions.
- The Exim Bank is set up as a specialized institution to provide finance for export of capital goods, engineering goods, manufactured products and for setting up joint ventures abroad; apart from these, forfaiting is a trade finance extended by a forfeiter to an exporter/seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount.

Chapter VII

Documentary Credits

After reading this chapter, you will be conversant with:

- Basics of Letter of Credit
- Types of Credit
- Documents under a Letter of Credit
- Incoterms

Introduction

International trade involves various complexities and problems. This may be due to various reasons. The parties to a sale contract are located in different countries and are governed by different legal systems. Also, the currencies of the two countries are different. Further, the trade and exchange regulations applicable to both the parties may differ. In such a situation, a seller who ships goods will be apprehensive whether he will receive payment from the buyer. The buyer, on the other hand, will be concerned whether the seller will ship the goods ordered for, and deliver them in time. Given these complexities, a need for an ideal method of settling international trade payments was felt and hence, the usage of documentary credits commonly known as Letter of Credit came into practice.

Originally, a letter of credit was quite literally, a letter addressed by the buyer's bank to the seller's bank stating that they could vouch for their good customer, the buyer and then they would pay the seller in case of the buyer's default. They were thus used for any transaction wherein one or more parties to the transaction require the comfort zone of a guarantee of payment by a reputable bank. One may request a letter of credit for a transaction involving goods or services where the parties are on the other side of the world.

Now-a-days Letters of Credit are more popularly used to provide the fill-in spaces for the various documentary requirements of international or domestic business. An LC is issued by a bank on behalf of one of its creditworthy customers, whose application for the credit has been approved by that bank.

UCPDC Guidelines: As parties involved in the transactions relating to letters of credit have been using different terminologies/interpreting the arrangement in different ways, the International Chamber of Commerce (ICC) came up with a set of guidelines in the name of Uniform Customs and Practice for Documentary Credits (UCPDC) to facilitate uniform interpretation of terminology used under documentary credit by all the parties concerned. The UCP first appeared in 1933 and since then it has been periodically revised with the experiences gained from time to time. The latest revision was approved by the Banking Commission of the ICC at its meeting in Paris on October 25, 2006. This latest version of guidelines on documentary credit is referred to as UCP 600. The guidelines came into force formally from July 1, 2007.

BASICS OF LETTER OF CREDIT

What is a Letter of Credit?

A letter of credit is a banking mechanism which allows importers to offer secure terms to exporters.

A documentary Letter of Credit may be defined as "an arrangement by means of which a bank (issuing bank) acting at the request of a customer (applicant), undertakes to pay to a third party (beneficiary) a predetermined amount by a given date according to agreed stipulations and against presentation of stipulated documents". In simple terms an LC may be defined as an arrangement where payment is made against documents. Under documentary credits, all the parties concerned deal with documents and not with goods, services or performances to which the documents may relate to.

The Uniform Customs and Practice for Documentary Credits (UCPDC) guidelines which govern the operations of letters of credit defines documentary credit as "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 ('draft'(s) drawn by the beneficiary).

or

ii. authorizes another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s)).

or

iii. authorizes another bank to negotiate against stipulated documents, provided that the terms and conditions of the credit are complied with.

A specimen letter of credit is presented in Annexure 1 at the end of the chapter.

What a Letter of Credit Contains?

All letters of credit contain these elements:

- a payment undertaking given by the bank (issuing bank);
- on behalf of the buyer (applicant);
- to pay a seller (beneficiary);
- a given amount of money;
- on presentation of specified documents representing the supply of goods;
- within specific time limits;
- these documents conforming to terms and conditions set out in the letter of credit; and
- documents to be presented at a specified place.

From the definition given above it can be deduced that the principal parties to a Letter of Credit are:

- The Applicant (Opener of the LC/Importer).
- The Issuing Bank (The bank which opens the LC).
- The Beneficiary (Who is the Seller/ Exporter) of the underlying LC.
- The Advising Bank.
- Confirming Bank.
- Nominated Bank.
- Reimbursement Bank.

APPLICANT

The applicant of an LC is normally the buyer of the goods who is to make payment to the seller. It is at his request and instructions that the issuing bank opens the LC. Incidentally, an LC issuing bank could itself be an applicant (For its own use, it can be an applicant, as well as an issuer).

ISSUING BANK

The Issuing bank is the bank, which opens the LC in favor of the beneficiary. By opening the LC, the issuing bank undertakes the responsibility to make payment to the seller on compliance of required terms and conditions.

BENEFICIARY

The Beneficiary is the seller of goods who is to receive payment from the buyer. The LC is opened in his favor to enable him to receive payment on submission of the stipulated documents.

ADVISING BANK

The Advising Bank advises the credit to the beneficiary. Advising of credit is done only after verifying the authenticity of the credit. When a bank advises a credit, it implies that it authenticates the signatures of the issuing bank. The advising bank is usually situated in the country of the beneficiary.

CONFIRMING BANK

The advising bank or any other bank so authorized by the issuing bank may assume the role of a confirming bank and add its confirmation to the LC opened by an issuing bank. The bank which has been asked to confirm an LC is under no

obligation to confirm it. It can independently choose either to confirm or not, but it should advise its decision to the issuing bank immediately. A confirming bank, for all practical purposes enters into the shoes of the issuing bank and assumes primary responsibility of effecting payment under the LC to the beneficiary, upon his complying with the terms of the LC.

NOMINATED BANK

Nominated bank is the bank that is nominated and authorized by the issuing bank to

a. Pay if the LC is a payment LC.

b. Incur a deferred payment undertaking.

c. Accept drafts, if the credit so stipulates.

d. Negotiate.

Where a credit is specified as freely negotiable, any bank can negotiate the documents under such an LC. However, where credit is restricted for negotiation, the issuing bank specifies the banks which are the nominated banks and to whom documents have to be presented for negotiation, etc. Bills under an LC with "restricted for negotiation" clause cannot be negotiated by any bank other than Nominated Bank in the LC.

REIMBURSEMENT BANK

Reimbursement Bank is the bank, which is authorized to honor the reimbursement claim in settlement of negotiation/acceptance/payment lodged with it by the paying, negotiating or accepting bank. It is normally the bank with which the issuing bank has account, from which payment is to be made.

Rights and Responsibilities of Parties to an LC

The rights and responsibilities of every party associated with an LC have been defined in the UCPDC 500. It is necessary that every party dealing with an LC should keep himself informed about these responsibilities. A brief summary of these rights is as under:

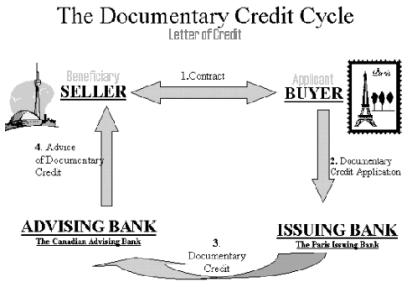
- All parties dealing with an LC are dealing only with documents and not with goods/services, or performances to which the documents may relate.
- Exporter/Beneficiary of LC has a right to receive payment against submission of prescribed documents under the LC. It is the exporter's duty to ship the goods as per the LC and submit the documents within the stipulated time for negotiation.
- **Negotiating Bank:** Once documents under the LC are submitted, the negotiating bank has to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit and if found agreeable, should effect payment as per the LC terms and dispatch documents to the opening bank as instructed. Once the amount under the LC is paid to the beneficiary, the negotiating bank is entitled to get reimbursement from the opening bank for the payment, provided documents are in conformity with LC terms.
- **Opening Bank:** Once documents under the LC are received from the negotiating bank, it should scrutinize them, within 7 days from the date of receipt. If it finds any discrepancy in the documents, it must convey the same to the negotiating bank through the fastest means available advising that it is holding documents in want of disposal instructions.
- **Advising Bank:** Once LC opening instructions are received from the opening bank, the advising bank should, if it so desires to act as advising bank, verify the veracity of the LC and advise the beneficiary about the LC and its terms. It is entitled to receive advising charges for having advised the LC from the LC opening bank.

- **Confirming Bank:** If, at the request of the issuing bank, the advising bank chooses to add its confirmation to the LC, it is taking upon itself, the responsibility of paying the beneficiary against presentation of stipulated documents. Upon payment, it is entitled to receive reimbursement from the issuing bank. It is also entitled to receive confirmation charges.
- **Applicant to the LC:** The importer is responsible for making payment under the LC, against release of stipulated documents, to the opening bank.

How a Letter of Credit Operates?

In order to make payment to the overseas supplier, the buyer of goods approaches his bank for opening a Letter of Credit in favor of the supplier.

Figure : The Operational Cycle of a Letter of Credit



Source:www.creditguru.com.

After considering the request of the buyer and fulfillment of the necessary formalities, the issuing bank (i.e., the buyer's bank) opens the Letter of Credit in favor of the supplier.

The Letter of Credit is transmitted to the advising bank (usually an intermediary bank located in supplier's country) with a request to advise the credit to the beneficiary. After being satisfied with the authenticity of the credit, the advising bank advises the credit to the beneficiary (i.e., the supplier).

The beneficiary verifies the Letter of Credit and checks for any discrepancies vis-à-vis, the sale contract. If any discrepancies are noticed, the buyer is asked to incorporate the necessary changes/amendments to the LC. The supplier then proceeds to ship the goods.

Shipment of goods is followed by submission of necessary documents by the supplier to the negotiating bank in order to obtain payment for the goods. The negotiating bank, upon the receipt of commercial documents and the bill of lading from the exporter, scrutinizes the documents in relation to the LC and if found to be in order, negotiates the bill and makes payment to the supplier.

The negotiating bank then claims reimbursement from the issuing bank by mailing the documents to it or any other bank authorized for the said purpose.

The commercial invoice and other documents are presented by the issuing bank to the buyer of goods, who, on receipt of the same, checks the documents and accepts/pays the bill. On acceptance/payment, the shipping documents covering the goods purchased are handed over to him. The operations of a letter of credit is depicted in figure above.

Characteristics of a Letter of Credit

The following are the characteristic features of a Letter of Credit:

Negotiability

Letters of Credit are usually negotiable. The issuing bank is obligated to pay not only the beneficiary, but also any bank nominated by the beneficiary. Negotiable instruments are passed freely from one party to another almost in the same way as money. To be negotiable, the letter of credit must include an unconditional promise to pay, on demand or at a definite time. The nominated bank becomes a holder in due course.

Revocability

Letters of credit may be either revocable or irrevocable. A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. A revocable letter of credit cannot be confirmed. If a correspondent bank is engaged in a transaction that involves a revocable letter of credit, it serves as the advising bank.

Transfer and Assignment

The beneficiary has the right to transfer or assign the right to draw, under a credit only when the credit states that it is transferable or assignable. Credits governed by UCC may be transferred on unlimited number of times. Under the UCPDC the credit can be transferred only once.

TYPES OF LETTERS OF CREDIT

Various types of LCs are in operation depending upon the need. Based on the nature and function, LCs may be categorized as under:

Based on Scope for Cancelation

REVOCABLE LETTER OF CREDIT

A revocable Letter of Credit is the one which can be revoked (either canceled or amended) by the issuing bank without giving notice to any of the parties concerned. Here the issuing bank reserves the right of revocation. A revocable Letter of Credit is disadvantageous from the exporter's point of view. By opening a revocable Letter of Credit, the issuing bank does not make a definite undertaking to effect payment to the exporter. However, if a nominated bank has made payment to the beneficiary, prior to receipt of the notice of cancelation or amendment, then the issuing bank will be responsible to reimburse the claim that has been presented to it.

Every Letter of Credit should clearly specify whether it is revocable or irrevocable. According to the UCPDC guidelines, if no such indication is observed, the credit will be deemed to be an irrevocable Letter of Credit.

IRREVOCABLE LETTER OF CREDIT

Almost all LCs opened in the course of international trade are irrevocable letters of credit. Cancelation or any amendment to such an LC cannot be made without the prior acceptance of all the parties to the said LC like the applicant, the confirming bank, if any and the beneficiary. It is important to note that cancelation or amendment can be made only if all the parties consent to the same. An irrevocable Letter of Credit is more desirable from the exporter's point of view.

CONFIRMED LETTER OF CREDIT

Here, in addition to the issuing bank, another bank will add its confirmation to the LC. In other words, a confirmed Letter of Credit will have the guarantee of not only the issuing bank but also of the confirming bank. It should be noted that only irrevocable letters of credit can be confirmed. The confirming bank will add its confirmation only if requested by the issuing bank. Confirming banks are usually located in the country of the beneficiary.

This works to the convenience of the beneficiary, as he will have to deal with a local bank rather than a bank situated in another country. A confirmed Letter of Credit is slightly costlier, owing to the charges that will have to be paid to the confirming bank for confirmation.

Based on Mode of Payment

PAYMENT CREDIT

Under this credit, payment will be made to the beneficiary on submission of the required documents provided they are in compliance with the LC terms. Payment credits do not usually call for drawing of bills. Under payment credit, the issuing bank, nominates a bank in the exporter's country to effect payment on its behalf if the documents are in conformity with the LC. The bank which paid the amount under the LC gets reimbursement from the issuing bank.

DEFERRED PAYMENT CREDIT

This type of credit is a usance credit, where payment is made on the due dates specified in the credit. The beneficiary may or may not be required to draw drafts. However, under this credit, the maturity dates at which payment has to be made and how such maturity should be determined should be clearly indicated. The drawee bank itself may draw promissory notes and pass on to the beneficiary for claiming payments on the due date.

ACCEPTANCE CREDIT

This credit is a usance credit, where it is mandatory for the beneficiary to draw a draft on the drawee/specified bank for a specified tenor. The drawee bank will accept such drafts and make payment on the respective due dates on presentation of the relevant bill of exchange.

NEGOTIATION CREDIT

This credit may be a sight credit or a usance credit. Under a sight credit, payment is made immediately, while under a usance credit payment is made after a specified tenor. A negotiation credit may be freely negotiable in which case the beneficiary may approach any bank for presentation of documents. This implies that when a credit is freely negotiable, any bank is a nominated bank.

On the other hand, when a credit is restricted for negotiation, the issuing bank authorizes certain specified banks as the nominated banks. In such case, the beneficiary is required to present the stipulated documents only to such banks as they alone are authorized to negotiate the documents under LC.

When a bank nominated to make payment refuses to do so, and then it is the responsibility of the issuing bank to make such payment. Hence, in a negotiation credit, under all circumstances, it is the responsibility of the issuing bank to pay, and it cannot avoid its responsibility by stating that the negotiating bank is required to pay. A nominated bank, which effectively negotiates documents, buys the same from the beneficiary, thus becoming a holder in due course.

Based on Tenor

SIGHT CREDIT

Where payment is made on sight (either on demand or presentation), such credit is called a sight credit. Drawing of drafts is not compulsory under sight credit. Under a sight payment credit (if drawing a draft is not required) payment can be made against submission of stipulated documents.

USANCE CREDIT

Also referred to as term credit, this credit requires drafts to be drawn on the drawee/specified bank indicating the tenor. Such drafts will be accepted by the drawee and paid at the end of the usance period.

Based on Availability Style

REVOLVING CREDIT

A Letter of Credit whereby the credit available to the beneficiary gets reinstated to the original amount once a drawing is made is called revolving credit. The amount under this credit may revolve in relation to time or value. Revolving credit may be of two types. In the first type, the amount gets reinstated immediately when the beneficiary makes a drawing. In the second type, the amount will be revived only when the issuing bank gives a confirmation. This may take place after the issuing bank receives documents and payment is made, or the issuing bank confirms the fact of receipt of documents. Bankers should be cautious while opening revolving credits, as there is a tendency to lose track of the amount, which they are committing under this credit.

INSTALLMENT CREDIT

It stipulates that shipments may be made in installments at specified periods of time. Installment credit differs from simple credit, which permits partial shipments in the sense that under installment credit, the time as well as the quantity is stipulated. On the other hand, under a simple credit, which permits partial shipments, there is no stipulation as to time and quantity.

While availing credit under an installment Letter of Credit, the exporter should be aware of the implications of Article 41 of the UCPDC guidelines. As per this article, if for any reason, the beneficiary is not able to ship the goods within the stipulated period and does not draw the installment on time, then the LC ceases to be available not only for that installment but also for any subsequent installments. This can be prevented only if the beneficiary sees to it that a provision specifically stipulating that credit will be available for subsequent installments despite any failure of earlier shipment or drawings is incorporated in the text of the LC. This credit calls for shipment of full value of goods.

DEFERRED CREDIT

This credit is mostly used in those trades where a portion of goods is paid for by the buyer after verification of goods or after assessing the value of the goods taking into account the quality, shortages, etc. Date for payment of the undrawn balance may or may not be specified. Hence such type of credit is called as deferred credit.

TRANSIT CREDIT

Normally, when an LC is opened, it will be advised to the beneficiary by a bank that is based in the beneficiary's country. However, in a transit credit, the services of a bank situated in a third country will be used. In such credit, the advising bank will be situated in a country other than the beneficiary's. Such a requirement may be called for, in cases where the opening bank has no correspondent relations with any bank in the beneficiary's country. Transit credit may also be opened by countries whose credit may not be readily accepted in the beneficiary's country. In such a case, a bank in a third country may be requested to open the LC.

REIMBURSEMENT CREDIT

When a credit is denominated in the currency of a third country, such credit is termed reimbursement credit. This is in contrast to the normal letters of credit, which are denominated in the currency of either the applicant's country or the beneficiary's country. Sometimes, credits where a paying/accepting/negotiating bank is reimbursed in a manner other than by debit to the Vostro Account of the opening bank or by credit to the Nostro Account of the paying/accepting/negotiating bank held with the opening bank are also referred to as reimbursement credits.

ANTICIPATORY CREDIT

Payment under a Letter of Credit is usually made at the post shipment stage (i.e., on submission of relevant shipping documents). However, under anticipatory credit, payment is made to the exporter at the pre-shipment stage in anticipation of export of goods and submission of bills at a later stage. The advances so made will be recovered from the proceeds of bills to be submitted under the Letter of Credit. Where the bills are not presented, recovery will be made from the opening bank.

Anticipatory credits are of two types:

a. Red clause credit.

b. Green clause credit.

Under the red clause credit, advance payment is made to the beneficiary for purchasing raw materials/processing and/or packing the goods.

In addition to the purpose specified under the red clause credit, the green clause credit provides for payment of advance towards warehousing and insurance charges at the port where the goods are stored pending availability of ship/shipping space. These two types are, as of now, outdated and are rarely being used.

Others

STAND BY LETTER OF CREDIT

In a standby Letter of Credit, the credit is payable upon certification of a party's nonperformance of the agreement, of course upon adducing evidence to the effect that payment has indeed been defaulted. Standby LCs are mostly used in countries, where financial guarantees are prohibited by law, like in the USA.

TRANSFERABLE CREDIT

A transferable credit is one, which can be transferred (i.e., from the first Beneficiary to a second Beneficiary). It should be noted that such credit can be transferred only once i.e., the second beneficiary cannot in turn transfer the same to a third beneficiary. A transferable credit will be subject to the original terms and conditions of the credit, excepting the amount of credit, unit prices, percentage of insurance terms, period of validity and shipment.

According to Article 48(b) of the UCPDC, a credit will be rendered as transferable, only if it is specifically stipulated as such in the credit.

BACK-TO-BACK CREDIT

This credit is one that is opened against the security of another credit called the main credit. Under this credit, when an LC is opened by the buyer in favor of the first beneficiary (who is usually not the actual supplier or manufacturer), such a beneficiary will open another identical LC in favor of his actual supplier/manufacturer against the security of the main credit. By doing so, the first beneficiary can obtain reimbursement by presenting documents received under back-to-back credit under the main LC.

Situations where the need for back-to-back letters of credit arises are:

i. Where the buyer is not willing to open a transferable Letter of Credit.

ii. Where the beneficiary does not want to reveal the source of supply to the buyer.

iii. Where the actual supplier wants payment against documents for goods but the beneficiary of credit is short of funds.

Bankers may not find a back-to-back credit as safe as a transferable credit. This is because there is likelihood that once payment is made against the documents received under the back-to-back LC, the opener of the back-to-back LC may not be able to submit the same documents under the main LC to obtain reimbursement leading to credit risk to the opening bank of the back to back LC. Hence, bankers should exercise due caution while opening a back-to-back Letter of Credit.

DOCUMENTS UNDER A LETTER OF CREDIT

In case of shipment under Letter of Credit, the supplier should prepare documents strictly in accordance with the terms and conditions of the Letter of Credit and submit them to his bank for negotiation. The negotiating bank will examine these documents and if found in order, negotiate the same.

If there are any discrepancies in the documents presented by the exporter, the negotiating bank:

- May return the documents to the exporters for rectification of defects.
- May refuse to negotiate the documents and advise the exporter to send them on collection basis.
- Contact the issuing bank for authorization for negotiation in case of minor discrepancies.
- Make payment 'under' reserve against exporter's indemnity and send the bills to the issuing bank.

The documents to be submitted by the exporter to his banker would include a commercial invoice, transport document which is usually the bill of lading (or seaway bill or airway bill), insurance document, certificate of inspection, packing list and in some cases a certificate of origin of goods as well.

Before submitting the documents to the bank, the exporter should follow certain safeguards, which are indicated below:

a. Documents called for should be submitted in the requisite number.

b. Documents should be issued by persons required to issue.

c. Documents should be dated wherever required.

d. Documents should be manually signed wherever stipulated.

e. Any material alterations to the documents should be properly authenticated.

f. Documents should be consistent with each other.

g. Shipment should take place within the time stipulated in the LC. In case of installment credit, the requisite quantity should be shipped within the stipulated time.

h. If partial shipment is effected, the same should be permitted under the LC.

i. Documents should be presented at the place stipulated.

j. Documents should be presented within the expiry date of the LC.

k. Documents should be presented within the time stipulation indicated in the LC or the provisions of the UCPDC.

Guidelines to be kept in mind with respect to individual documents are enumerated below:

Invoice

A commercial invoice is prima facie evidence of the contract of sale and purchase. It is a document made by the exporter on the importer indicating details like description of the goods consigned, consignor's name, consignee's name, name of the steamer, number and date of bill of lading, country of origin, price, terms of payment, amount of freight, etc.

The invoice should be made out in the name of the applicant.

- It should be signed by the maker. Description of goods specified in the invoice should correspond to the description given in the Letter of Credit. Similarly, other conditions like quantity of goods, unit price, delivery terms, etc., should conform to those stipulated in the Letter of Credit.
- The invoice should be drawn in the same currency of LC unless otherwise specified.
- The invoice should not include any charges not stipulated in the LC. Also, the gross value of invoice should not exceed the credit amount.
- The invoice should show deductions towards advance payment made, agency commission payable, etc., as applicable.
- Final amount of invoice or the percentage of drawing as permitted in the LC should correspond with the draft amount.
- If partial shipments are effected, amount of drawings should preferably correspond to proportionate quantities shipped (where only quantity is mentioned without unit price).
- If invoice is issued for an amount in excess of the amount permitted by the credit, the drawings should not exceed the amount of credit.
- Details stated on the invoice should correspond to details specified in all other documents. Also, the invoice should certify to facts like origin of goods, etc., as stipulated in the LC.

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.

There is a close relationship between bills of lading and the Letter of Credit. The possession of the original bill of lading enables the holder to claim the goods from the carrier.

The bill of lading must satisfy certain requirements. Every bill of lading must:

i. Show the name of the carrier and must be issued by a named carrier or his agent. The bill of lading must also be signed by the named carrier or his agent.

ii. Bear a distinct number.

iii. Indicate the date and place of issuance.

iv. Indicate the name of consignor and consignee.

v. Indicate a brief description of goods being carried.

vi. Indicate port of loading or taking in-charge (in case of marine bill of lading it must show a definite port of loading and in other cases it can be shown as an 'intended' port).

vii. Indicate port of discharge (in case of a marine bill of lading it must indicate a definite port of discharge and in other cases it can be shown as an intended port).

viii. Be presented in full set of originals (full set comprises of two or more originals issued to consignor of goods, all of which are made as 'originals' and signed. The number of copies of originals is indicated on the bill of lading itself).

ix. Meet all other stipulations of the credit.

x. Must indicate whether freight is prepaid or is payable.

A bill of lading should not unless otherwise specified by the terms of the LC:

a. Be a chartered party bill of lading.

b. Indicate that the carrying vessel is propelled by sail only.

c. Be issued by a freight forwarder (unless he himself is acting as a carrier or agent).

d. Indicate that the goods are/will be loaded on 'DECK'.

e. Be a claused bill of lading.

A bill of lading can (unless otherwise prohibited):

- Bear title such as "Combined Transport B/L" "Combined Transport document or Combined Transport B/L" or "Port to Port B/L".
- Be a short form or blank backed bill of lading.
- Indicate a place of taking in-charge different from the port of loading and or place of final destination as different from the port of discharge.
- Indicate that the goods are carried in containers, pallets, etc.
- Be a FIATA Combined Transport B/L known as FIATA FBL approved by ICC issued by the freight forwarder.
- Be issued by a freight forwarder provided it is issued in his capacity as a carrier or his agent.
- Contain a notation that the goods may be carried on deck provided it does not specifically state that they are or will be loaded on deck.
- Indicate that the goods will be transhipped provided the same B/L covers the entire carriage.

- Be a "freight payable" bill of lading.
- Evidence freight prepayment by a stamp or otherwise on bill of lading to that effect like "Freight Prepaid".
- Bear a reference by stamp or otherwise to cost additional to freight charges.
- Show clauses such as "shippers load and count" or "said by shipper to contain" etc., with reference to goods covered by bill of lading.
- Show shipper as third party other than the beneficiary.
- Be deemed as "clean on board" if it is an on board bill of lading without any super imposed clauses or notations expressed in declaring the defective conditions of the goods and or the packaging.

OTHER ASPECTS OF BILL OF LADING

– If a bill of lading is issued as an "on board" bill of lading it must indicate the name of the carrying vessel.

– A charter party bill of lading need not show the name of the carrier.

– A FIATA FBL can be accepted as a "Marine Bill of Lading" provided it meets with all the requirements of a marine bill of lading.

– A bill of lading issued by even a Non-Vessel Owning Common Carrier (NVOCC) can be accepted as "Marine B/L" provided NVOCC has issued the B/L in his capacity as a carrier or his agent and all other requirements of "Marine B/L" are met with.

– Bill of lading received for shipment can be treated as an "on board" bill of lading; if received for shipment. Bill of Lading is affixed with "on board" notation duly signed or initialed and dated by the carrier or his agent.

– If LC calls for a "marine B/L" without specifying whether it should be "on board" or "received for shipment" only "on board B/L" will be accepted.

– Date of issue of B/L or "on board" notation should be dated prior to the shipment date permitted under the LC.

– Shipping marks, gross/net weight, etc., specified on bill of lading must correspond to those specified in other documents.

Insurance Document

In international trade when goods are in-transit they are exposed to marine perils. Insurance is affected to protect the insured against the risk of loss or damage to goods due to marine perils. The following aspects have to be considered in an insurance document:

a. Insurance documents should be issued and signed only by insurance companies or underwriters or their agents.

b. Cover notes issued by brokers will not be accepted unless specifically authorized by the credit.

c. It should be signed by the issuer and dated. Date of the issuance must be on or before the date of shipment or it must be evidence by specific notation that the cover is effective from the date of shipment.

d. The insurance document must be expressed in the same currency as the Letter of Credit.

e. The insurance document must indicate the name of the assured and also give brief details of the goods insured.

f. The mode of conveyance of goods should also be indicated. Further, it should also indicate the nature of risks covered which should be those specified in the LC.

g. The insurance document should be in a negotiable form.

Unless otherwise specified, it should be issued for an amount of 110% of CIF/CIP value of the goods. If such value is not determinable from the documents on their face it should be for a minimum amount of negotiation requested for or the amount of invoice value whichever is higher:

i. If the insurance document is issued in more than one negotiable copy, all copies must be submitted.

ii. The document should be endorsed in blank by the assured if required as per the terms of the LC.

iii. It should indicate the port of shipment and destination or point of insurance coverage and point of termination of insurance coverage.

iv. It should not contain any clause affecting the interest of the assured/assignees.

v. It must cover all the additional risks as specified in the LC.

vi. If the goods are on 'DECK', deck-shipment should be covered.

Other Documents

In addition to the above-mentioned documents, a Letter of Credit may call for additional documents like bill of exchange, health certificate, pre-shipment inspection certificate, packing list, shipping company's certificate, beneficiary's declaration/undertaking, etc. Whenever such documents are called for under LC the following aspects should be taken care of:

- The documents called for should be issued by the person or authority specified in the credit. If no such person is specified or authorized, the banker may accept documents issued by any person.
- The documents should be dated and signed by the person/authority concerned.
- The documents should certify the facts required as per the LC.
- It should be checked whether the documents contain wordings or data content as specified in the LC or not.
- Bankers should check whether the details mentioned in such certificates/documents are consistent with other documents.

Certificate of Origin

Many countries require a certificate from the supplier of goods stating the origin of the goods and certified by the Chamber of Commerce or any other recognized authority in the exporter's country. Certificate of origin is an important document in case of imports into India to determine the origin of goods for methods of payment purpose as required by the Exchange Control Authorities.

a. It must be issued and signed by an independent authority such as chamber of commerce, etc., indicating the origin of goods.

b. The country of origin certified must be as per the LC requirement and consistent with the declaration given by the beneficiary in his invoice/other documents.

c. It must indicate the description of goods and should be consistent with other documents.

d. It must indicate the name of the consignor/seller and the name of consignee/buyer.

Details appearing in the documents must be consistent with the details in other documents.

INCOTERMS

Incoterms – An acronym for International Commercial Terms are standard trade definitions most commonly used in international sales contracts. They are derived and published by the International Chamber of Commerce (ICC). ICC introduced the first version of Incoterms for 'International Commercial Terms' in 1936. Since then, the ICC experts have updated them six times to keep pace with the development of international trade. The latest edition of Incoterms came into force from January 1, 2000. These are referred to as 'Incoterms 2000.'

Incoterms 2000 provides preambles explaining the function of each Incoterm. It contains totally 13 terms for standardized global trade, defining the most important responsibilities of buyers and sellers in international sales contracts. Table shows the 13 terms along with their main functions:

Table: Incoterms 2000

Serial no.	Incoterm	Function
1.	EXW – EX WORKS	• Carriage to be arranged by the buyer. • Risk transfer from the seller to the buyer when the goods are at the disposal of the buyer. • Cost transfer from the seller to the buyer when the goods are at the disposal of the buyer.
2.	FCA – FREE CARRIER	• Carriage to be arranged by the buyer or by the seller at the buyer's request. • Risk transfer from the seller to the buyer when the goods have been delivered to the carrier at the named place. • Cost transfer from the seller to the buyer when the goods have been delivered to the carrier at the named place.
3.	FAS – FREE ALONGSIDE SHIP	• Carriage to be arranged by the buyer. • Risk transfer from the seller to the buyer when the goods have been placed alongside the ship. • Cost transfer from the seller to the buyer when the goods have been placed alongside the ship.
4.	FOB – FREE ON BOARD	• Carriage to be arranged by the buyer. • Risk transfer from the seller to the buyer when the goods pass the ship's rail. • Cost transfer from the seller to the buyer when the goods pass the ship's rail.

5.	CFR – COST AND FREIGHT	• Carriage to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods pass the ship's rail. • Cost transfer at port of destination, buyer paying such costs as are not for the seller's account under the contract of carriage.
6.	CIF – COST, INSURANCE AND FREIGHT	• Carriage and insurance to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods pass the ship's rail. • Cost transfer at port of destination, buyer paying such costs as are not for the seller's account under the contract of carriage.
7.	CPT – CARRIAGE PAID TO	• Carriage to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods have been delivered to the carrier. • Cost transfer at place of destination, buyer paying such costs as are not for the seller's account under the contract carriage.
8.	CIP – CARRIAGE AND INSURANCE PAID TO	• Carriage and insurance to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods have been delivered to the carrier. • Cost transfer at place of destination, buyer paying such costs as are not for the seller's account under the contract of carriage.
9.	DAR – DELIVERED AT FRONTIER	• Carriage to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods have been delivered at the frontier. • Cost transfer from the seller to the buyer when the goods have been delivered at the frontier.

10.	DES – DELIVERED EX SHIP	• Carriage to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods are placed at the disposal of the buyer on board the ship. • Cost transfer from the seller to the buyer when the goods are placed at the disposal of the buyer on board the ship.
11.	DEQ – DELIVERED EX QUAY	• Carriage to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods are placed at the disposal of the buyer on the quay. • Cost transfer from the seller to the buyer when the goods are placed at the disposal of the buyer on the quay.
12.	DDU – DELIVERED DUTY UNPAID	• Carriage to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods are placed at the disposal of the buyer. • Cost transfer from the seller to the buyer when the goods are placed at the disposal of the buyer.
13.	DDP – DELIVERED DUTY PAID	• Carriage to be arranged by the seller. • Risk transfer from the seller to the buyer when the goods are placed at the disposal of the buyer. • Cost transfer from the seller to the buyer when the goods are placed at the disposal of the buyer.

Source: http://www.agilfreight.co.in/incoterms.html#top.

Incoterms make international trade easier and help traders in different countries to understand one another. The specification of Incoterms, 2000 on all contracts allow buyers and sellers to ensure the new Incoterms are being applied and clearly identify source of reference for the definition. Variations in local trades, ports and customs are possible.

SUMMARY

- International Chamber of Commerce (ICC) has taken upon itself the responsibility of designing bylaws governing these transactions so as to ensure uniformity across the trading partners. The guidelines issued by the ICC are commonly known as Uniform Customs and Practice for Documentary Credits and the regulations that are currently in force are prescribed in the booklet UCPDC-500.
- To remove the hurdles and irregularities in International trade, and to ensure that an exporter, upon his shipping the goods gets his payment from middlemen like a bank against his submitting the title to goods to the bank a mechanism called Letter of Credit is in practice.
- A Letter of Credit is a payment term generally used for international sales transactions. It is basically a mechanism, which allows importers/buyers to offer secure terms of payment to exporters/sellers in which a bank (or more than one bank) gets involved. The technical term for Letter of credit is 'Documentary Credit'.
- Letters of credit deal in documents, not goods.
- An LC (as it is commonly referred to) is a payment undertaking given by a bank to the seller and is issued on behalf of the applicant, i.e., the buyer. The Buyer is the Applicant and the Seller is the Beneficiary. The Bank that issues the LC is referred to as the Issuing Bank which is generally in the country of the Buyer. The Bank that Advises the LC to the Seller is called the Advising Bank which is generally in the country of the Seller.
- The LC could be 'irrevocable' or 'revocable'. An irrevocable LC cannot be changed unless both the buyer and seller agree. Whereas in a revocable LC changes to the LC can be made without the consent of the beneficiary.
- LCs are opened by the buyer's bank and advised to the beneficiary (exporter) through a bank located in the exporter's country, commonly known as the advising bank. Documents under the LC can be negotiated by a bank located in the exporter's country if it is not restricted and reimbursement can be claimed from the issuing bank.
- There are different kinds of LCs that are used for achieving different objectives of importer/exporter. All the parties associated with a LC deal only in documents, but not with the underlying goods. Documents like commercial invoice, bill of lading, insurance documents are the prime documents under LC. These documents have to comply with the specifications mentioned against each item in the LC.
- Incoterms – an acronym for International Commercial Terms – are a series of 13 trade terms used in international sales contracts to clearly divide the risks and responsibilities of buyers and sellers with regard to the movement of goods between both parties.

Annexure I

Format of a Letter of Credit

Application to Open Irrevocable Documentary Credit

L/C Ref No.

Applicant: Beneficiary:

IMPORTER-EXPORTER CODE NO.

Advising Bank	Amount not exceeding: In figures: currency _____ Amount _____ In words:
	Expiry Date For Shipment For Negotiation At the Counters of Negotiation Bank

To

The Manager,
Republic Bank,
S.R. Road Branch.

Please open by $\frac{\text{Full telex/Airmail/Fax}}{\text{Cable at urgent/Ordinary rate}}$ an irrevocable confirmed documentary credit available to the aggregate sum not exceeding _____ by negotiation of beneficiary's sight/_____days usance drafts drawn on us covering _____ and accompanied by (Description of goods).

1. Signed commercial invoices for a value not exceeding the draft amount quoting import licence No._____ and certifying goods are as per order/Indent _____. The gross FOB/CIF/C&F value of the goods before deduction of agent's commission, if any, must not exceed the credit amount.
2. Certificate of _____ origin issued by a Chamber of Commerce.
3. Full set, signed. "Clean", "On Board", Ocean Bills of Lading of a Conference Line Vessel made out to order and blank endorsed marked "Freight prepaid/Freight payable at destination" and

   notify_____

   and_____

L/C No. and date evidencing current shipment of merchandise stated above.

and

Short form bill of lading and Third Party Bill of Lading are not acceptable.

3a. Airway Bills/Air Consignment notes addressed to _____ account openers indicating Letter of Credit number and market freight/prepaid/payable at destination. Airway Bills/Air Consignment notes must indicate flight number and date.

4. Lloyds Certificate that carrying steamer is seaworthy and not more than 15 years old.

5. Marine Insurance Policies/Certificate dated not later than the date of bill of lading and blank endorsed for 10% over invoice value covering institute Cargo Clause (A), Institute War Clause (Cargo) and Institute Strikes Clause (Cargo) Warehouse to Warehouse Clauses with claims payable in India irrespective of percentage. Transhipment risks must be covered if goods are subject to transhipment.

6. Test Certificate/Inspection Certificate/Preshipment Certificate of a reputed agency current dated or issued by _____ specifying _____.

7. Packing List with the same details as in No. 6 above.

Shipment/Despatch should be affected from _____ to _____.
Bill of lading/Airway Bill must be dated not later than _____ nor prior to the date of this credit. (We confirm that this date is within the date stipulated in the Import Licence).

Transhipment is ~~permitted~~/prohibited. Markings:RSPL
Patancheru, Dist. Medak A.P.
Part-Shipment is ~~permitted~~/prohibited.

Additional Conditions:

1. All bank charges outside India are for beneficiary/opener's account.
2. The transport document:
   a. Must contain all the conditions of carriage on the original document.
   b. Must not indicate the place of final destination as being different from the port of discharge.
   c. Must not contain the indication "intended" or similar qualification in relation to the vessel or other means of transport or port of loading or port of discharge.
   d. Must be issued by carrier or his agent and not by any freight forwarder.
   e. Must not contain a provision that goods may be carried on deck.
3. "LASH" transport documents are not acceptable.
4. Transport documents bearing reference by stamp or otherwise to costs additional to the freight charges are not acceptable.
5. Short form or blank-back transport documents are not acceptable.
6. A transport document bearing a date of issuance prior to that of the credit is not acceptable.

IN CONSIDERATION of your opening the above credit, I/We hereby agree and undertake as follows:

1. I/We, hereby agree and undertake to accept and pay all bills of exchange drawn or purported to be drawn pursuant to the terms of the credit and take up and pay for all the documents negotiated thereunder in accordance with the terms thereof, as also for any disbursement made or liability incurred by you for my/our account under the credit, together with interest, costs, charges, and expenses due to you in respect thereof as hereinafter mentioned.
2. (i) I/We further agree to pay to you interest on the amount(s) payable in respect of my/our liability under the Credit, at the rate of _____ percent per annum over the Prime Lending Rate subject to a minimum of _____ percent per annum or at such other rate as may be prescribed by Bank from time to time for advances to non-priority sectors.
   (ii) The aforesaid rate of interest shall however be applicable only during the period from the date of negotiation of the bill/documents under the Credit up to and inclusive of the date immediately preceding the date of payment by me/us or the date of crystallization of my/our liability on the foreign currency bill pursuant to Clause 5(i) below, whichever is earlier, after which interest shall be payable at the rate stipulated in the said Clause 5(i).
3. I/We further agree to pay to you on demand (i) the charges that may be levied as per the Foreign Exchange Dealer's Association of India Rules in force from time to time for any early/late delivery of the relevant foreign exchange/currency under the Forward Exchange Contract, if any, booked by me/us, and (ii) the commission or handling charges at the rate of 0.15% on the amount of the bill(s) drawn under the credit.
4. I/We also agree to Pay you on demand, all costs (legal costs on full indemnity basis) customs duty, penalty, demurrage, storage charges, clearing and forwarding charges and all other charges and expenses which you may be put to or suffer or incur in connection with the goods and or the documents of title to goods covered by the credit including for re-shipment thereof for any reason whatsoever, or in the exercise or enforcement of any right or power hereby conferred or otherwise howsoever, and further agree and undertake to hold you safe and harmless and keep you indemnified against any claim, action or proceeding made or brought against you, your correspondents or agents against any liability or loss incurred or suffered by you, your correspondents or agents as also by reason of your having established the credit pursuant to my/our application or otherwise howsoever in the premises.
5. (i) If I/We fail to make due payment to you of a sight bill on its presentation or a usance bill on the date of its maturity, which is drawn or purported to be drawn under the Credit and expressed to be payable in a foreign currency, then you shall be at liberty without prejudice to your rights hereunder, to crystallize my/our liability on the foreign currency amount into Indian Rupees on the 10th day after the date of receipt of documents by you under the credit in the case of a sight bill remaining unpaid till then, or on the date of maturity in the case of a usance bill, whereupon I/We shall be liable to pay to you the Indian Rupee equivalent of such foreign currency amount as calculated at the rate of _____ percent per annum with quarterly rests, or at such other rate

and/or with such other rests as may be notified by you from time to time, until payment or realization, and all costs, charges and expenses payable by me/us hereunder.

(ii) The rate of exchange applicable to such conversion of the foreign currency amount into Indian Rupees shall be

(a) Your applicable bill selling rate prevailing on the date filling on the 10th day after the date of receipt of documents by you under the credit in case of a sight bill or on the date of maturity in the case of a usance bill provided however that if the relevant rate of exchange is not quoted or available for any reason on such 10th day in the case of a sight bill or on the date of maturity in the case of a usance bill, then the rate prevailing on the immediately next working day when such rate shall be quoted or be available, shall be the applicable rate of exchange, or

(b) The forward exchange contract rate in case a forward exchange contract has been booked by me/us with you.

(iii) The date of receipt of documents by you under the Credit as registered in your record shall be conclusive and binding on me/us.

(iv) I/We confirm that crystallization of my/our liability on the foreign currency bill by you and the charging/payment of interest at a higher rate as aforesaid shall not be deemed to create any right in me/us to keep any bill unpaid when due.

6. I/We further agree that you shall have a pledge upon all goods and documents of title to goods and other documents covered under the Credit which may have been already delivered or shall be hereafter delivered into your possession or into the possession of your agents by me/us or by any person, firm or company or my/our behalf as a result of your opening the Credit or in connection with the transaction thereunder. The said goods and the documents shall be deemed to be so delivered in pursuance of my/our this agreement to pledge them to you as security for all payments which may be made by you or your correspondents or agents under the credit for my/our account as also for any liability whatsoever incurred or which may be hereafter incurred by you or your correspondents or agents as a result of the opening of this Credit, together with interest, costs charges and expenses as herein above mentioned.

7. In the event of my/our committing a default in making due payment of any bill drawn or purported to be drawn under the Credit or in making reimbursement on demand of any payment made by you for my/our account in respect of any liability that may be suffered or incurred by you or your correspondents or agents under or in connection with the Credit then you shall be entitled without prejudice to any of your rights and without Credit (the said "goods") whether before or after their arrival, either by public auction or tender or by private contract and subject to such conditions as you may deem fit to impose or otherwise dispose of or deal with the said goods or any part thereof and or with the relative documents of title to goods in any manner whatsoever, without being bound to exercise any of these powers or liable for any loss in the exercise or non-exercise thereof. The net proceeds realized from sale of the said goods or transfer of any document of title, remaining after deducting there from the costs and expenses of and incidental to such sale or transfer, shall be applied in or towards payment or satisfaction of the amount(s) due to you in respect of any payment or disbursement made by you under the Credit for my/our account, and interest thereon and all costs, charges and expenses as herein above mentioned. I/We agree to accept Bank's account of sale or realization as conclusive evidence both in and out of court as to the amount(s) realized and expenses incurred, and to pay forthwith any shortfall or deficiency remaining after such application. I/We further agree that you shall not be liable to me/us for any loss which may occur pending sale or disposal of the goods and/or documents of title to goods, whether by reason of theft, damage, deterioration or decay of the goods or depreciation in the value thereof or otherwise whatsoever be the cause.

8. I/We agree to keep the said goods further insured from the time of expiry of insurance cover under the initial policy or policies of insurance, against all risks which are normally covered for goods of the nature purchased under the Credit as also against such other risk(s) as may be required by you, and in the event of my/our failing to do so, you shall be at liberty to insure the said goods at my/our cost and expense without prejudice to your rights hereunder. Until all your dues in respect of the credit are paid in full, I/We agree to pay to you forthwith all moneys if received by me/us under any policy or policies of insurance and until payment to you of such insurance moneys, I/We undertake to hold the same in trust for you.

9. I/We further agree and undertake to sign, execute and deliver to you from time to time on demand made by you, such further or other deeds, documents and writings, and do all such acts, matters and things as may be required by you for better perfecting your title to the said goods and the documents covered under the credit and are to render the same readily saleable or transferable by you to any purchaser(s) at all times.
10. Shipping documents and goods thereunder is entirely at my/our risk. You and your correspondents shall not be responsible for any error or delay in such transmission or loss or delay in delivery of the documents or the goods nor shall you or your correspondents or agents be liable in any respect beyond ensuring that bill(s) drawn under the credit and the relative documents covered thereunder purport to comply with the terms and conditions of the credit.
11. I/We have made adequate arrangements for retiring the bills under the Credit and do not contemplate to seek any financial assistance from you for the purpose.
12. I/We agree to the negotiations of the drafts drawn under the Credit being confined to your branches or agencies or to any bank acceptable to you.
13. I/We confirm that the goods described above are covered under my/our below mentioned import license.
14. I/We enclose for your perusal:
    (i) Order together with the order confirmation of overseas supplier

    Or

    (ii) Pro forma invoice of overseas supplier duly countersigned by us

    Or

    (iii) Indent/Offer from overseas supplier or his authorized agent together with the Exchange control copy of the relative import licence.
15. This application shall be deemed to have been accepted and the Credit deemed to have been established when written advice thereof has been sent to the beneficiary.
16. I/We agree and confirm that this Credit may be amended and/or modified by you in your absolute discretion, including for an increased limit, on our giving you written instructions for the same and in such an event, such amendment/modification will be deemed to form part of this credit application and will be governed by the terms hereof and I/We agree, covenant, record and confirm that I/We shall be bound by the same as if such amendment/modification including the increased limit had originally constituted the term of this credit.
17. This Agreement shall be binding upon me/us, my/our heirs, executors and administrators/ successors and shall ensure to be of and be enforceable by you, your successors, transferees and assigns.

    EXCEPT AS OTHERWISE EXPRESSLY STATED TO THIS CREDIT IS TO BE OPENED SUBJECT TO THE UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1993 REVISION) AS CONTAINED IN THE INTERNATIONAL CHAMBER OF COMMERCE PUBLICATION NO.500 AS AMENDED FROM TIME TO TIME.
18. I/We confirm that the goods/items to be imported are not in the negative list of current import policy of the Government of India.

Licence No. **Date**
For Rs. **Valid up to**
Date **Signature**
HO Limit Rs. _____ **Number _____**
Outstanding L/C Rs. _____
L/C Amount Rs. _____ **Date of issue**
Margin held Rs. _____ **Date of expiry _____**
_____ **Goods _____**
Value Rs. _____
Limiting factor _____ **____Value/Quantity/Both**

Signature of Manager **Signature of Officer**

NO: 00270

REPUBLIC BANK, S.R. ROAD, AUTO SEND
APR 04 2000 13:25:16

FROM: REPUBLIC BANK, S.R ROAD, SECUNDERABAD, A.P., INDIA

TO: LLOYDS BANK, LONDON, UK

TEST 29-870 FOR USD 19000 DATED 4TH APRIL, 2000.

WE ESTABLISH OUR IRREVOCABLE/CONFIRMED DOCUMENTARY LETTER OF CREDIT AS FOLLOWS:

L/C NO. 505/RP/010/2000 DATED 4TH APRIL, 2000.

APPLICANT

M/S RADIANT SYSTEMS PRIVATE LIMITED
25, RADIANT HOUSE
COLABA, MUMBAI-400 005.
INDIA

BENEFICIARY

M/S STARGOLD LIMITED
RIDGEWAY INDUSTRIAL ESTATE
IVER,
BUCKINGHAMSHIRE, UNITED KINGDOM.

VALUE: NOT EXCEEDING USD 19000 (US DOLLARS NINETEEN THOUSAND ONLY)

TERMS: FOB

COVERING SHIPMENT OF

1 NO. OF LD 1080 SINGLE PLANE 200 MM, 1 NO. OF CI900-1C AND 1.NO. OF CABLE LD TO CI900 AS PER PROFORMA INVOICE NO.23548 DATED 21ST MARCH, 2000 OF BENEFICIARY.

SHIPMENT

LATEST BY 25TH JUNE, 2000 FROM ANY UK AIRPORT TO HYDERABAD AIRPORT.

NEGOTIATION

LATEST BY 30TH JUNE, 2000 AT THE COUNTERS OF ADVISING BANK AGAINST THE FOLLOWING DOCUMENTS IN TRIPLICATE UNLESS OTHERWISE SPECIFIED.

1. DRAFTS DRAWN BY THE BENEFICIARY ON THE US IN DUPLICATE FOR 100 PERCENT INVOICE VALUE AT SIGHT AND MARKED DRAWN UNDER DOCUMENTARY CREDIT NO. 505/RP/010/2000 OF REPUBLIC BANK, FOREX DEPARTMENT, 2-2-18, S.R ROAD BRANCH, SECUNDERABAD, AP, INDIA.
2. SIX COPIES OF SIGNED COMMERCIAL INVOICES FOR A VALUE NOT EXCEEDING THE DRAFT AMOUNT QUOTING IMPORT UNDER OGL OF EXPORT AND IMPORT POLICY 1997-2002 AND CERTIFYING THAT THE GOODS ARE AS PER PROFORMA INVOICE NO.23548 DATED 21ST MARCH, 2000 OF BENEFICIARY.

   THE GROSS FOB VALUE OF GOODS BEFORE DEDUCTION OF AGENTS COMMISSION, IF ANY, MUST NOT EXCEED THE CREDIT AMOUNT.

3. AIRWAY BILLS/AIR CONSIGNMENT NOTES ADDRESSED TO REPUBLIC BANK, FOREX DEPT., 2-2-18, S.R., ROAD BRANCH, SECUNDERABAD-500003, A.P INDIA, FOR ACCOUNT OPENERS INDICATING LETTER OF CREDIT NUMBER AND MARKED FREIGHT PAYABLE AT DESTINATION.

   AIRWAY BILLS/AIR CONSIGNMENTS NOTES MUST INDICATE FLIGHT NUMBER AND DATE.

4. PACKING LIST.
5. INSURANCE WILL BE ARRANGED BY THE OPENERS. BENEFICIARY SHOULD FAX THE DETAILS OF AIRWAY BILL IMMEDIATELY AFTER SHIPMENT TO THE OPENERS FAX NO. 22-217843 TO ENABLE THEM TO ARRANGE INSURANCE COVER.
6. TEST/INSPECTION CERTIFICATE ISSUED BY MANUFACTURER.
7. CERTIFICATE OF THE UK ORIGIN ISSUED BY A CHAMBER OF COMMERCE.

ADDITIONAL CONDITIONS

1. ALL BANK CHARGES OUTSIDE INDIA ARE FOR BENEFICIARY'S ACCOUNT.
2. TRANSHIPMENT PROHIBITED.
3. PARTSHIPMENT PROHIBITED.
4. ALL CASES/PACKINGS SHOULD BEAR THE FOLLOWING MARKINGS. RSPL, PATANCHERU, DIST.MEDAK, A.P.
5. DIRECTIONS TO NEGOTIATING BANK
   1. FORWARD DOCUMENTS IN TWO CONSECUTIVE REGISTERED AIRMAIL/COURIER.

   2. NEGOTIATE DOCUMENTS WITHIN 5 DAYS OF SHIPMENT, BUT WITHIN THE VALIDITY OF THE DOCUMENTARY CREDIT.

   3. IF THE DOCUMENTS ARE IN STRICT CONFORMITY WITH THE TERMS AND CONDITIONS OF THE LETTER OF CREDIT CLAIM REIMBURSEMENT FROM OUR IBD, MUMBAI A/C NO. 7800054325 WITH BANK OF NEW YORK, NEW YORK, USA.

DIRECTIONS TO ADVISING BANK

1. PLEASE ADD YOUR CONFIRMATION AND ADVISE THE BENEFICIARY THROUGH

   NATIONAL WESTMINISTER BANK PLC,
   P.O BOX NO. 34, 15 BISHOPGATE,
   LONDON, EC2P 2AP
   SORT CODE 50-00-00
   A/C NO. 30078256.

2. THIS TELEX IS THE OPERATIVE CREDIT INSTRUMENT AND NO MAIL CONFIRMATION FOLLOWS. THIS LETTER OF CREDIT IS SUBJECT TO UCPDC 500 (1993).

REGARDS
MANAGER.
888301 LOYDLN G
4256595
MMMM
DURATION 010.3 MIN

Lloyds TSB

International Services Center
Two Brindleyplace
P.O Box 63
Birmingham B1 2AB.

Telephone:	Telex	Telegraphic Address
0121 643 9840	888301 & 883474	Overloyd Birmingham.

Mail To:
Republic Bank
FOREX DEPT.,
2-2-18, S.R ROAD
SECUNDERABAD 500 003
AP.
INDIA.

Our Reference:	Documentary Letter of Credit:	Date:
XQSTM253831P001	505/RP/010/2000	23rd June, 2000

PLEASE FOLLOW INSTRUCTIONS MARKED (X) BELOW:

THESE DOCUMENTS ARE SENT TO YOU "IN TRUST" UNDER THE PROTECTION OF YOU ABOVE MENTIONED DOCUMENTARY CREDIT AND ON THE STRICT UNDERSTANDING THAT THEY ARE TO BE RELEASED ONLY AGAINST:

(X) Payment.

	Draft	Inv.	Fax/Conf	Test/Cert	Pkg./List	Cert./Orig	Move/Doc.	Cert	
ORIGINALS ENCLOSED	[1x1]	[1x5]	[1x2]	[2x2]	[1x2]	[1x2]	[1x2]	[1x1]	[ ]
DUPLICATES TO FOLLOW	[1x1]	[1x1]	[1x1]	[2x1]	[1x1]	[1x1]	[1x1]	[ ]	[ ]

Bill of Exchange Amount USD 19,000.00

Drawn on Yourselves Tenor SIGHT

(X) Discrepancies if any are to be advised to us by Teletransmission.
(X) On your taking up documents.
(X) Credit our account held with BANK OF NEW YORK, NEW YORK, under telex advice to us quoting our reference.
the sum of USD 19,000.00.

Subject to Uniform Customs and Practice for Documentary Credits 1993 revision International Chamber of Commerce Publication No. 500.

AUTHORIZED SIGNATORY

Chapter VIII

Export Import Policy

After reading this chapter, you will be conversant with:

- Historical Perspective and the Rationale behind Trade Regulations in India
- Objectives of the Foreign Trade Policy (2004-2009)
- Trade Regulations Governing Imports/Exports

Introduction

Till a decade back, imposition of trade barriers for one reason or the other has been the trend all over the globe. This was affected in two ways viz. Tariff and Non-Tariff measures. Tariff, being a revenue source for the Government was the most preferred measure to discourage imports in order to increase demand for domestic goods or to restrict export of goods that is in short supply locally. Non-tariff measures include all kinds of rules and regulations in the form of quotas, embargos, etc., restricting free movement of goods from and into the country. Various theories have been proposed for and against these measures. However, with the advent of liberalization process all over the globe, there was a sudden shift in this stance and countries have started opening their markets to outside goods and India is no exception to this phenomenon. Countries have started realizing the benefits of free trade and are slowly moving away from quotas and embargos towards positive and growth oriented economic policies to encash one's own unique potential/competency vis-à-vis the trading partners. Our recent Exim policy is a pointer in that direction. To have a better appreciation of this fast changing scenario, let us take a look at the genesis of trade restrictions as they evolved in the last five to six decades in our country.

HISTORICAL PERSPECTIVE AND THE RATIONALE BEHIND TRADE REGULATIONS IN INDIA

The origin of import trade control in India dates back to the Second World War, when for the first time restrictions under the Defense of India Rules (DIR), were imposed on imports into India. However, at that time the main aim was to reduce the pressure on the limitedly available shipping space. Starting with consumer goods, the restrictions were gradually extended to cover unmanufactured as well as semi-finished goods. In September 1946, with the lapse of the DIR, import trade control continued under the Emergency Provisions (Continuance) Ordinance, 1946. The ordinance was replaced by the Imports and Export (Control) Act, 1947 that was also replaced by the Foreign Trade (Development and Regulation) Act, 1992. Presently, import trade control is administered in India under the purview of the Foreign Trade (Development and Regulation) Act, 1992, the Foreign Trade (Regulations) Rules, 1993 and the Foreign Trade (Exemption from application of rules in certain cases) Order, 1993.

For many years the accent of trade policies was on maintaining the level of imports within the available foreign exchange. This was done with the intention of protecting domestic industry and achieving price stability. However, these measures were not successful in containing the trade deficit. It was then that the Government of India realized the importance of export promotion.

The import export policy of 1985 can be considered as the first bold and dynamic policy initiative in this direction. Keeping in mind the importance of exports, the 1985 policy was announced incorporating the objectives of export promotion, import substitution and technological upgradation.

In the year 1990-91, drastic measures (like pledging of gold by the RBI to borrow foreign exchange) were introduced to tide over the severe balance of payments crisis, which had reached dangerous levels because of the Gulf crisis. Even though the crisis was resolved, a need was felt to be better equipped for any such future recurrences. As a corollary, the Liberalized Exchange Rate Management System (LERMS) was introduced. The scheme came into effect on 1st March, 1992. As per this scheme, 40% of current account receipts were required to be converted/ surrendered to the RBI at official rate prescribed by the RBI and the balance at market determined exchange rates. The success of this scheme led to the introduction of Unified Exchange Rate System that came into effect from 1st March, 1993. Since then, all foreign exchange transactions are being put through by authorized dealers at market-determined rates.

The other notable fall out of this crisis was the launching of economic and financial reforms by the Government of India. The main objective of the liberalization process was to increase the wealth of the nation by higher economic growth that would bring about better income and living standards to the population. In the interdependent world of the 90s, it was felt that economic growth could only be achieved by integrating the Indian economy with global economy in terms of free movement of goods, services and capital.

The liberalization process was aimed at:

- Freeing Industry from Licenses, Permits and Government Control.
- Reforming Fiscal and Monetary Policies.
- Reforming the Banking and Financial Sectors and the Capital Market.
- Creating vital infrastructure such as telecommunication, power and roads to facilitate economic growth.
- Removing foreign exchange control barriers to the movement of Investment and Capital.
- Removing quantitative and tariff barriers on International Trade and rationalizing Tariffs.

As a sequence to the liberalization process, the Government of India had introduced significant changes in the import export policy also. The export-import policy 1992-1997 was born in this context where an attempt was made to align India's international trade policies and practices to the overall liberalization process and getting closer to free international trade. The trade policy that was hitherto called import export policy was rechristened as export import policy. The long-term export import policy for a period of five years was announced synchronizing with the 8th Five-year plan. The Exim policy 1992-1997 saw the introduction of numerous changes and modifications.

Previously, the policy was being announced on an annual basis. However, in order to bring about continuity and stability in the policy, there was a shift from the usual annual policy to a three-year policy from April, 1985. Beginning from 1st April, 1992 the policy is being announced on a five-year basis and the policy currently in effect is the export and import policy 1st April, 2002 to 31st March, 2007. Revisions during the five-year period generally are published on 1st April of subsequent years during the five-year period, although changes may be made and announced by means of public notices/amendment orders at any time.

On 31st August, 2004, government announced a new policy, i.e., Foreign Trade Policy (2004-2009) which replaced the existing policy, i.e., Exim Policy 2002-2007.

FOREIGN TRADE POLICY (2004-2009)

OBJECTIVES

For India to become a major player in the world trade, an all encompassing, comprehensive view needs to be taken for the overall development of the country's foreign trade. While increase in exports is of vital importance, imports also to be facilitated to stimulate Indian economy. Coherence and consistency among trade and other economic policies is important for maximizing the contribution of such policies to development. Thus, while incorporating the existing practice of enunciating an annual Exim policy, it is necessary to go much beyond and take an integrated approach to the developmental requirements of India's foreign trade. Thus, the new concept of a five year Exim policy was born. As already pointed out, a five year policy was announced for the period 2004-2009. The principal objectives of the policy are:

i. To double our percentage share of global merchandise trade within the next five years.

ii. To stimulate sustained economic growth by providing access to essential raw materials, intermediates, components, consumables and capital goods required for augmenting production and providing services.

iii. To enhance the technological strength and efficiency of Indian agriculture, industry and services, there by improving their competitive strength while generating new employment opportunities and to encourage the attainment of internationally accepted standards of quality.

iv. To provide consumers with good quality goods and services at internationally competitive prices while at the same time creating a level playing field for the domestic producers.

v. To act as an effective instrument of economic growth by giving a thrust to employee generation.

The key strategies to be adopted to achieve the above objectives are:

i. Unshackling of controls;

i. Creating an atmosphere of trust and transparency;

iii. Simplifying procedures and bringing down transaction costs;

iv. Adopting the fundamental principle that duties and levies should not be exported; and

v. Identifying and nurturing different special focus areas to facilitate development of India as a global hub for manufacturing, trading and services.

Highlights of Foreign Trade Policy (2004-2009)

In exercise of the powers confirmed under section 5 of the Foreign Trade (Development and Regulation) Act, 1992 the central government has notified on 31st August, 2004 the first National Foreign Trade Policy for the period 2004-09 incorporating the export and import policy for the period 2002-07. This policy came into force w.e.f. 1st September, 2004 and shall remain in force up to 31st August, 2009. The Policy has for the first time tried to integrate the trade policy with the process of Country's Economic development.

The new trade policy replaces the five-year Export Import Policy of 2002-07. The most important factor that proves the similarity between the new and the existing policy is the implication of WTO agreement and the Free Trade Agreement between India and other countries.

The new initiatives announced for agriculture and other thrust areas such as handicrafts, handlooms, gems and jewellery, and leather and footwear are appreciable.

Further in the new trade policy, export-oriented units will be exempted from the service tax and biotechnology parks in the country would get all the facilities of 100% Export Oriented Units.

In addition to the above, the government has liberalized the EPCG benefits, the permission to transfer capital equipment to group companies, the extension of duty-free entitlement benefits to some more sectors, duty relief on fuel consumed by exporting units, and determination to double exports and keep a special focus on agriculture, all as a part of focusing on the new policy.

It is for the first time that a comprehensive Foreign Trade Policy is being notified. The Foreign Trade Policy takes an integrated view of the overall development of India's foreign trade.

The main highlights of the Policy are:

1. **Special Focus Initiatives:**
    - Sectors with significant export prospects coupled with potential for employment generation in semi-urban and rural areas have been identified as thrust sectors, and *specific sectoral strategies* have been prepared.

- Further sectoral initiatives in other sectors will be announced from time to time. For the present, *Special Focus Initiatives* have been prepared for Agriculture, Handicrafts, Handlooms, Gems & Jewellery and Leather & Footwear sectors.
- The threshold limit of designated Towns *of Export Excellence* is reduced from Rs.1,000 crore to Rs.250 crore in these thrust sectors.

2. **Package for Agriculture:**

The Special Focus Initiative for Agriculture includes:

- A new scheme called *Vishesh Krishi Upaj Yojana* has been introduced to boost exports of fruits, vegetables, flowers, minor forest produce and their value added products.
- Duty-free import of capital goods under EPCG scheme.
- Capital goods imported under EPCG for agriculture permitted to be installed anywhere in the Agri Export Zone.
- ASIDE funds to be utilized for development for Agri Export Zones also.
- Units in Agri Export Zone exempt from bank guarantee under the EPCG scheme.
- Import of seeds, bulbs, tubes and planting material has been liberalized.
- Export of plant portions, derivatives and extracts has been liberalized with a view to promote export of medicinal plants and herbal products.

3. **Gems & Jewellery:**

- Duty-free import of consumables for metals other than gold and platinum allowed up to 2% of FOB value of exports.
- Duty-free re-import entitlement for rejected jewellery allowed up to 2% of FOB value of exports.
- Duty-free import of commercial samples of jewellery increased to Rs.1 lakh.
- Import of gold of 18 carat and above shall be allowed under the replenishment scheme.
- Cutting and polishing of Gems and Jewellery shall be treated as manufacturing for the purposes of exemption under Section 10A of the Income Tax Act.

4. **Handlooms & Handicrafts:**

- Duty-free import of trimmings and embellishments for Handlooms & Handicrafts sectors increased to 5% of FOB value of exports.
- Import of trimmings and embellishments and samples shall be exempt from CVD.
- Handicraft Export Promotion Council authorized to import trimmings, embellishments and samples for small manufacturers.
- A new Handicraft Special Economic Zone shall be established.

5. **Leather & Footwear:**

- Duty-free entitlements of import trimmings, embellishments and footwear components for leather industry increased to 3% of FOB value of exports.
- Duty-free import of specified items for leather sector increased to 5% of FOB value of exports.
- Machinery and equipment for Effluent Treatment Plants for leather industry shall be exempt from Customs Duty.

6. **Export Promotion Schemes:**

i. **Target Plus:** A new scheme to accelerate growth of exports called *Target Plus* has been introduced. Exporters who have achieved a quantum growth in exports would be entitled to duty-free credit based on incremental exports substantially higher than the general actual export target fixed. (Since the target fixed for 2004-05 is 16%, the lower limit of performance for qualifying for rewards is pegged at 20% for the current year). Rewards will be granted based on a tiered approach. For incremental growth of over 20%, 25% and 100%, the Duty-free credits would be 5%, 10% and 15% of FOB value of incremental exports.

ii. **Vishesh Krishi Upaj Yojana:** Another new scheme called *Vishesh Krishi Upaj Yojana* (Special Agricultural Produce Scheme) has been introduced to boost exports of fruits, vegetables, flowers, minor forest produce and their value added products. Export of these products shall qualify for Duty-free credit entitlement equivalent to 5% of FOB value of exports. The entitlement is freely transferable and can be used for import of a variety of inputs and goods.

iii. **Served from India Scheme:** To accelerate growth in export of services so as to create a powerful and unique "*Served from India*" brand instantly recognized and respected the world over, the earlier DFEC scheme for services has been revamped and re-cast into the *Served from India* scheme. Individual service providers who earn foreign exchange of at least Rs.5 lakh, and other service providers who earn foreign exchange of at least Rs.10 lakh will be eligible for a duty credit entitlement of 10% of the total foreign exchange earned by them. In the case of stand-alone restaurants, the entitlement shall be 20%, whereas in the case of hotels, it shall be 5%. Hotels and Restaurants can use their duty credit entitlement for import of food items and alcoholic beverages.

iv. **EPCG:**

- Additional flexibility for fulfillment of export obligation under EPCG scheme in order to reduce difficulties of exporters of goods and services.
- Technological upgradation under EPCG scheme has been facilitated and incentivised.
- Transfer of capital goods to group companies and managed hotels now permitted under EPCG.
- In case of movable capital goods in the service sector, the requirement of installation certificate from Central Excise has been done away with.
- Export obligation for specified projects shall be calculated based on concessional duty permitted to them. This would improve the viability of such projects.

v. **DFRC:** Import of fuel under DFRC entitlement shall be allowed to transfer to marketing agencies authorized by the Ministry of Petroleum and Natural Gas.

vi. **DEPB:** The DEPB scheme would be continued until replaced by a new scheme to be drawn up in consultation with exporters.

7. **New Status Holder Categorization:**

- A new rationalized scheme of categorization of status holders as Star Export Houses. The applicant shall be categorized depending on his total FOB/FOR export performance during the current plus the previous three years. This scheme has categorized the performance as follows:
  - One Star Export House – 15 crore
  - Two Star Export House – 100 crore
  - Three Star Export House – 500 crore
  - Four Star Export House – 1,500 crore
  - Five Star Export House – 5,000 crore

A Star Export House shall be eligible for the following facilities:

i. Licence/certificate/permissions and Customs clearances for both imports and exports on self-declaration basis;

ii. Fixation of Input-Output norms on priority within 60 days;

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;

vi. Entitlement for consideration under the Target Plus Scheme; and

vii. Exemption from furnishing of Bank Guarantee in Schemes under this Policy.

8. **Export Oriented Units (EOUs) :**

- EOUs shall be exempted from Service Tax in proportion to their exported goods and services.
- EOUs shall be permitted to retain 100% of export earnings in EEFC accounts.
- Income Tax benefits on plant and machinery shall be extended to DTA units, which convert to EOUs.
- Import of capital goods shall be on self-certification basis for EOUs.
- For EOUs engaged in Textile & Garments manufacture leftover materials and fabrics up to 2% of CIF value or quantity of import shall be allowed to be disposed of on payment of duty on transaction value only.
- Minimum investment criteria shall not apply to Brass Hardware and Hand-made Jewellery EOUs (this facility already exists for Handicrafts, Agriculture, Floriculture, Aquaculture, Animal Husbandry, IT and Services).

9. **Free Trade and Warehousing Zone:**

- A new scheme to establish Free Trade and Warehousing Zone has been introduced to create trade-related infrastructure to facilitate the import and export of goods and services with freedom to carry out trade transactions in free currency. This is aimed at making India into a global trading-hub.
- FDI would be permitted up to 100% in the development and establishment of the zones and their infrastructural facilities.

- Each zone would have minimum outlay of Rs.100 crore and five lakh sq. mts. built up area.
- Units in the FTWZs would qualify for all other benefits as applicable for SEZ units.

10. **Services Export Promotion Council:** An exclusive Services Export Promotion Council shall be set up in order to map opportunities for key services in key markets, and develop strategic market access programs, including brand building, in co-ordination with sectoral players and recognized nodal bodies of the services industry.

11. **Common Facilities Center:** Government shall promote the establishment of Common Facility Centers for use by home-based service providers, particularly in areas like Engineering & Architectural design, Multi-media operations, software developers etc., in State and District-level towns, to draw in a vast multitude of home-based professionals into the services export arena.

12. **Procedural Simplification & Rationalization Measures:**

- Import of second-hand capital goods shall be permitted without any age restrictions.
- Minimum depreciated value for plant and machinery to be re-located into India has been reduced from Rs.50 crore to Rs.25 crore.
- All exporters with minimum turnover of Rs.5 crore and good track record shall be exempt from furnishing Bank Guarantee in any of the schemes, so as to reduce their transactional costs.
- All goods and services exported, including those from DTA units, shall be exempt from Service Tax.
- Validity of all licenses/entitlements issued under various schemes has been increased to a uniform 24 months.
- Number of returns and forms to be filed has been reduced. This process shall be continued in consultation with Customs & Excise.
- Enhanced delegation of powers to Zonal and Regional offices of DGFT for speedy and less cumbersome disposal of matters.
- Time bound introduction of Electronic Data Interface (EDI) for export transactions. 75% of all export transactions to be on EDI within six months.

13. **Pragati Maidan:** In order to showcase our industrial and trade prowess to its best advantage and leverage the existing facilities, Pragati Maidan will be transformed into a world-class complex. There shall be state-of-the-art, environmentally controlled, visitor-friendly exhibition areas and marts. A huge Convention Center to accommodate 10,000 delegates with flexible hall spaces, auditoria and meeting rooms with high-tech equipment, as well as multi-level car parking for 9,000 vehicles will be developed within the envelope of Pragati Maidan.

14. **Legal Aid:** Financial assistance would be provided to deserving exporters, on the recommendation of Export Promotion Councils, for meeting the costs of legal expenses connected with trade-related matters.

15. **Grievance Redressal:** A new mechanism for grievance redressal has been formulated and put into place by a Government Resolution to facilitate speedy redressal of grievances of trade and industry.

16. **Quality Policy:**

- DGFT shall be a business-driven, transparent, corporate-oriented organization.
- Exporters can file digitally signed applications and use Electronic Fund Transfer Mechanism for paying application fees.
- All DGFT offices shall be connected via a central server making application processing faster. DGFT HQ has obtained ISO 9000 certification by standardizing and automating procedures.

17. **Board of Trade:** The Board of Trade shall be revamped and given a clear and dynamic role. An eminent person or expert on trade policy shall be nominated as President of the Board of Trade, which shall have a Secretariat and separate Budget Head, and will be serviced by the Department of Commerce. The functions of the Board of Trade are as follows:

i. To review export performance of various sectors, identify constraints and suggest industry specific measures to optimize export earnings;

ii. To examine the existing institutional framework for imports and exports and suggest practical measures for further streamlining;

iii. To review the policy instruments and procedures for imports and exports and suggest steps to rationalize and channelize such schemes for optimum use; and

iv. To examine issues which are considered relevant for promotion of India's foreign trade, and to strengthen the international competitive ness of Indian goods and services.

18. **Assistance to States for Infrastructure Development of Exports (ASIDE):** The State Government shall be encouraged to participate in promoting exports from their respective states. For this purpose, Department of Commerce has formulated a scheme called ASIDE. Suitable provision has been made in the Annual Plan of the Department of Commerce for allocation of funds to the states on the twin criteria of gross exports and rate of growth of exports. The states are to utilize this amount for developing infrastructure.

19. **Market Access Initiative (MAI)** – The Market Access Initiative is intended to provide financial assistance for medium term export promotion efforts with a sharp focus on a country and a product. A whole range of activities can be funded under the MAI scheme including market studies, setting up of showroom / warehouse, sales promotion campaigns, international department stores, publicity campaigns etc. Each of these schemes can receive financial assistance from 25% to 100% of the total cost depending upon the activity and the implementing agency.

20. **Marketing Development Assistance (MDA)** – This scheme is intended to provide financial assistance for a range of export promotion activities implemented by export promotion councils, industry and trade associations on a regular basis every year.

21. **Special Economic Zones (SEZ)** – SEZs are the growth engines that can boost manufacturing, augment exports and generate employment. The SEZs require special fiscal and regulatory regime in order to impart a hassle free operational regime encompassing the state of the art infrastructure and support services. SEZ units may export goods and services including agro-products, partly – processed products, sub-assemblies and component parts except prohibited items of export. SEZs can produce goods required by it without payment of duty.

TRADE REGULATIONS GOVERNING IMPORTS/ EXPORTS

The Exim policy announced by the Commerce Minister lays down various trade regulations governing exports and imports. These regulations have to be mandatorily complied with, by exporters, importers, authorized dealers and all other market players engaged in the business of exports/imports transactions. Hence, it is necessary for these players to familiarize themselves with the trade regulations. Furthermore, they are also required to keep a constant watch on any modifications/amendments to trade regulations effected by the concerned authorities from time to time in order to ensure strict compliance.

Given this fact, we shall now discuss trade regulations governing both exports and imports in detail.

Trade Regulations Governing Imports

FEMA defines 'import' as bringing into India, any goods or services. Imports to India can be classified into two categories:

a. **Freely Importable Items or the Open General License (OGL):** The OGL includes those items, which are freely importable, and do not require import licenses.

   For instance the following items does not require import license:

   - Microfilm Camera,
   - Paraffin Wax,
   - Video Echo Sounder,
   - Collator Machine, and
   - Asbestos Fiber, etc.

b. **Negative List:** Import of those items, which are not regulated by the OGL fall under the negative list category. These categories of items are broadly grouped under 3 heads: Prohibited, Restricted and Canalized.

   i. Banned or prohibited items have not permitted to be imported at all. They include tallow fat, animal rennet and unprocessed ivory.

   ii. Restricted items are generally those for which demand can be adequately satisfied, in normal circumstances, by local production in India. These are permitted to be imported only against a license, and include certain categories of consumer goods, precious stones, seeds, animals, insecticides, certain electronic items, drugs and chemicals.

   iii. Canalized items are those items, which are importable only by government trading monopolies. They are mostly commodity imports and any import of these items must be channeled through these agencies. Some of the canalized items include petroleum products to be imported only by the Indian Oil Corporation, Nitrogenous Phosphatic, potassic and complex chemical fertilizers by the Minerals and Metals Trading Corporation and cereals by the Food Corporation of India.

Import trade control is exercised by the director general of foreign trade functioning under the ministry of commerce. Some of the trade regulations governing imports are discussed below:

IMPORT LICENSES

Import license means a license granted specifically for import of goods, which are subject to import control. Items, which require a license, can be imported only by an actual user, unless the actual user condition is specifically dispensed with by the licensing authority.

The Export-Import Policy defines "Actual User" as an actual user who may be either industrial or non-industrial user. "Actual User (Industrial)" is defined as "a person who utilizes the imported goods for manufacturing in his own unit or manufacturing for his own use in another unit including a jobbing unit." "Actual User (Non-Industrial)" is defined as "a person who utilizes the imported goods for his own use in (i) any commercial establishment carrying on any business, trade, or profession; or (ii) any laboratory, Scientific or Research and Development (R&D) institution, university or other educational institution or hospital; or (iii) any service industry."

Every license has a validity period, which is specified therein. For example, the validity of the Export Promotion Capital Goods license (EPCG) is 24 months. Only those items or category of items mentioned on the license can be imported under that license. A license is issued subject to the provisions of the policy applicable as on date of issue of the license. Every license bears the security seal of the office of issue as well as the signature of the issuing authority. As per the present rules import licenses issued under various provisions of the policy indicate the value in Indian rupees and in foreign currency at the exchange rate prevailing on the date of issue of the license.

CATEGORIES OF LICENSE

There are different categories of licenses:

Regular License

These are licenses issued for the import of goods, which fall under the normal import policy. These can be issued to anybody entitled for issuance as per the policy provision.

Advance License

Advance licenses are issued under the duty exemption scheme. Under advance licenses, Duty-free imports of inputs are permitted on fulfillment of value addition and export obligation within a certain time frame. Such licenses (other than those for deemed exports) are exempted from payment of basic customs duty, surcharge, additional customs duty, anti-dumping duty and safeguard duty, if any.

Under a value based advance license, any of the inputs specified in the license may be imported within the total CIF value indicated for those inputs, except inputs specified as sensitive items. Under such a license, both the quantity and the FOB value of the exports to be achieved shall be specified. It shall be obligatory on the part of the license holder to achieve both the quantity and the FOB value of the exports specified in the license.

In case of quantity-based license, each item of inputs for import will be restricted in terms of quantity (or value where restrictions cannot be put in quantity terms).

The Exim policy 1997-2002 has done away with value-based advance licenses. However, quantity-based advance licenses will continue to remain in force. Quantity-based advance licenses indicate the individual item, along with quantity and the aggregate CIF value of imports.

Licenses with Export Obligations

Certain licenses are issued with a rider, like 'export obligation' which means importers of capital goods are required to export to a place outside India, a certain proportion of goods manufactured by the use of imported capital goods. In case of importers rendering services, export obligation means receiving payments in freely convertible foreign currency for services, rendered through the use of such capital goods. License where export obligation is imposed, indicates value of export obligation both in free convertible currency and Indian Rupees equivalent thereof at the exchange rate prevailing on the date of issue of the license. It also indicates exchange rate used for arriving at the rupee value of license. Value indicated on import licenses is always for CIF (Cost, Insurance and Freight) value of goods authorized to be imported.

Special Import License

A Special Import License (SIL) may be used to import, among other items, certain consumer goods. The SIL is like an import permit and is traded in the market, at a premium on its value. It is issued to Indian exporters as an export incentive, and its value is tied to export earnings. SIL licenses are freely transferable and thus can be easily procured in the market by any prospective importer. The Special Import License shall be valid for import of items appearing in the ITC (HS) classification of Export and Import items. ITC (HS) refers to Indian Trade Classification (Harmonized System). The ITC (HS) classification of export and import items contains 99 chapters and each chapter covers information in five columns: the 8-digit code i.e. the Exim code, the item description, the applicable policy (prohibited, restricted, canalized or free); any conditions relating to the Export and Import Policy (these conditions appear either indicated with the particular item or in licensing notes at the end of the HS Chapter or section thereof); and an indication of whether the product can be imported under a Special Import License. The eight digit code can be interpreted as follows: the first two digits represent the chapter number, the next two digits the heading of goods in that chapter, and the last four digits refers to the sub heading. Each chapter is divided into various headings depending on different types of goods belonging to the same class of products. For instance, raw cotton has a code of 5201, while soft cotton waste/hard cotton waste has a code of 5202 and cotton yarn has a code of 5205. This means, the said items are in chapter 52 and occupy the first, second and fifth place respectively in that particular group. Similarly, the code for exotic birds is 0106 indicating that it falls under chapter one and occupies the sixth place in that chapter. The policy applicable to exotic birds is "Prohibited" and the nature of restriction is "Not permitted to be exported". Another example would be calcium ammonium nitrate. The code for calcium ammonium nitrate is 31029009. The first two digits represent the chapter number, the next two digits the place it occupies in the chapter and the remaining four digits the sub classification under that chapter.

Import licenses are issued in duplicate. One copy is marked for "Customs Purposes" and has to be presented to the customs authorities at the time of clearance of goods. The other copy is marked for "Exchange Control Purposes" and has to be presented by the importer to the authorized dealer while opening a Letter of Credit (L/C) or making payment for import of goods.

TRANSFERABILITY OF LICENSES

After the fulfillment of export obligation and other conditions laid down, the holder of a transferable license may transfer it to a third party. However, a request for endorsement of transferability should be made to the licensing authority within 36 months of the date of issuance of license. When the import license is so endorsed, the license holder may transfer the license in full in case he has not made any imports or where imports have already been made, the license may be transferred in part excluding the value and quantity of imports already made or the materials or the balance already imported.

Issue of duplicate license, increase in the C.I.F value or any other amendments will not be permitted once the endorsement of transferability is made on the license.

The license transferred will be valid for the balance period of its validity or six months from the date of endorsement whichever is later.

ENDORSEMENT OF IMPORT LICENSE

Where a license is transferable, the fact of transferability will be indicated on the body of the license. In such case the license holder may affect part or full transfer of the license to other eligible importers in conformation with the various provisions of the policy.

VALIDITY OF IMPORT LICENSE/CERTIFICATES/PERMISSION/CCPS

The validity of import licence/certificate/permission from the date of issue of licence/ certificate/permission shall be as follows:

(i)	Advance Licence (including Advance Licence for Annual Requirement), DFRC and Replenishment licence for	4 months
(ii)	Gem&Jewellery	36 months
(iii)	EPCG licence (other than spares)	Co-terminus with the Export Obligation
(iv)	EPCG Licence for Spares, refractories, catalyst and consumables	Period of the EPCG Licence.
(v)	Others including CCP and Duty Entitlement Passbook Scheme, unless otherwise specified Advance Licence for deemed export (including Advance Licence for Annual Requirement)	24 months 24 months or Co-terminus with the contracted duration of execution of the project whichever is later.

DUTY ENTITLEMENT PASS BOOK SCHEME (DEPB)

The objective of Duty Entitlement Passbook Scheme is to neutralize the incidence of customs duty on the import content of the export product. The neutralization shall be provided by way of grant of duty credit against the export product.

Under the Duty Entitlement Passbook Scheme (DEPB), an exporter may apply for credit, as a specified percentage of the FOB value of exports, made in freely convertible currency. DEPB credit is available on export of goods. However, only those goods specified in the list of goods notified by the Director General of Foreign Trade by way of a public notice issued in this behalf will be eligible for credit. It thus becomes clear that unless the item is specified in the list notified by the DGFT, no DEPB credit can be availed of. The exim policy 1997-02 had introduced a new duty entitlement pass book scheme in place of the old pass book scheme.

Under this scheme, the exporter is issued a passbook, which has validity for a period of 12 months from the date of its issue. The holder of DEPB shall have the option to pay additional custom duty, if any, in cash as well and the DEPB and/or the items imported against it are freely transferable.

DIAMOND, GEM AND JEWELLERY EXPORT PROMOTION SCHEME

To give a boost to exports of diamond, gem and jewellery for which India enjoys a special advantage of skilled labor, exporters under these sectors have been offered two special schemes viz:

- Replenishment (REP) licenses, and
- Diamond Imprest Licenses,

for importing their inputs like raw/cut and polished diamonds, gold, etc. A brief summary of the provisions under these schemes is discussed hereunder:

Replenishment License

Eligibility: The exporter of gem and jewellery products listed in Appendix-26 of the handbook (Vol. I) shall be eligible to import and replenish their input.

Procedure for Obtaining REP Licenses

- The Gem REP licenses are available as per the scale given in Appendix-26A.
- An application for the Gem REP license may be given to the license authority in Appendix 25 in the form given in Appendix-13A along with the documents prescribed therein.

- In case EP copy of the shipping bill and custom attested invoice is submitted to the nominated agencies, the exporter shall furnish a self certified photocopy of the same along with a certificate from the nominated agency certifying the carat/value of studdings in case of studded jewellery and excess the value addition achieved in the case of plain jewellery and articles.
- Such applications are to be made within 6 months following the month/ quarter in which export proceeds were realized.
- A consolidated application is to be made for all the exports realized in a month/quarter.
- To claim REP licenses against third party exports, the EP copy of the shipping bill must show the names of both i.e., the name of the manufacturer and the 3rd party through whom it was exported. Secondly, a disclaimer should be furnished from the third party.

Diamond Imprest License

Under this scheme, diamond exporters can obtain Diamond Imprest License in advance, for import of rough diamonds from any source. Such licenses, however, carry an export obligation, which the licensee has to fulfill.

- ***Eligibility:*** An exporter of cut and polished diamonds who is status holder may be issued a license for import of cut and polished diamonds up to 5% of the export performance of the preceding year of cut and polished diamonds.
- ***Procedure:*** Application has to be made in the prescribed format to the Regional licensing authority along with name and address of his banker and bankers certificate to the effect that there are no overdue export bills beyond a period of six months.
- ***Export Obligation:*** The export obligation against each consignment shall be fulfilled within a period of five months from the date of clearance of such consignment through customs.

BANK GUARANTEE AND LEGAL UNDERTAKING (LUT)

The licensee is required to execute a bank guarantee/legal undertaking before the first consignment of import is cleared. However, this requirement will be waived in case the export obligation is fulfilled before any imports are made. LUT/Joint LUT limits for different categories of exporters is indicated in the table below:

Type of Exporter	Limits
1. Super Star Trading House and Units within the same group/public sector undertaking and units within the same group.	Unlimited.
2. Export House/Trading House/Star Trading House and units within the same group.	Up to five times of the FOB value of exports effected in the preceding licensing year/current year.
3. Exporters having performance of past exports but not covered under S.No. 1 and 2 above.	Up to two times of the FOB value of exports made during the preceding licensing year.
4. Any overseas company with its branch office in India with an annual average turnover in diamonds during preceding three licensing years not less than Rs.150 crore.	Up to 50% of annual average turnover of the preceding three licensing years.

If a licensee does not have LUT limit he is required to execute Bank Guarantee for 50% of the CIF value of the license in the prescribed form.

Extension of Export Obligation Period

The licensing authority shall allow one extension for a period of six months from the date of expiry of the original export obligation period to the licensee subject to payment of composition fee of 1% of the unfulfilled FOB value of export obligation with reference to CIF value of imports made for which extension is being sought. The request for further extension may be considered by the authorities, subject to payment of composition fee of 5% of the unfulfilled FOB value of export obligation with reference to CIF value of imports made for which extension is being sought. Such extension shall however not exceeding a period of six months from the date of expiry of earlier extension.

Diamond Dollar Account

Diamond exporters enjoy several benefits including the right to open diamond dollar accounts, which was introduced in the Exim policy 1997-2002. Diamond dollar accounts allow exporters to retain their proceeds in dollars. However, opening of this account is optional, and diamond exporters can continue to use their rupee accounts if required.

The criteria specified by the RBI for operating diamond dollar accounts include:

- Firms/companies should be dealing in the purchase/sale of rough or cut and polished diamonds.
- A track record of at least 3 years in import or export of diamonds.
- An average annual turnover of Rs.5 crore or above during the preceding three licensing years.

Firms and companies maintaining foreign currency accounts, excluding Export Earners' Foreign Currency (EEFC) accounts, with banks in India or abroad, are not eligible to maintain Diamond Dollar Accounts. Eligible firms or companies may be allowed to open not more than 5 Diamond Dollar accounts with their banks.

Trade Regulations Governing Exports

FEMA defines 'export' as the taking or sending out of goods by land, sea or air, on consignment or by way of sale, lease, hire purchase, or under any other arrangement by whatever name called, and in the case of software, also includes transmission through any electronic media.

Exports may be of different types. They could be:

CASH EXPORTS

Cash Exports are those exports where the proceeds are realized within 6 months from the date of shipment or the due date for payment whichever is earlier. As per FEDAI rules, the normal transit period and the notional due date of the bill will be taken into consideration to determine the due date of payment.

PROJECT EXPORTS

Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as 'Project Exports'. These contracts are usually of very high value.

DEEMED EXPORTS

Goods under this kind of export do not leave the shore of the country. Any such supply to be eligible for labeling as deemed exports should comply with the following:

a. Supply of goods is to a project that funded by multilateral/bilateral agencies like IBRD/ADB/OPEC, etc. and any other such projects notified by the Government of India from time to time.

b. Goods are supplied against an order received under international competitive bidding and to this effect the supplier of goods should submit a certificate from his buyer.

The central idea of this arrangement is that supply of goods has indeed facilitated inflow/retention of forex into/within the country.

The current trade policy allows for the free exportation of all goods, except to the extent such exports are regulated by the ITC (HS) classification of export and import items or any other provision of the policy or any other law for the time being in force. Exports from India are categorized into two (i.e., the open general license and the negative list) on the same lines as imports. The negative list consists of those goods which are (a) Permitted for export under license (restricted) or (b) Canalized or (c) Prohibited.

Some of the goods which are included under the restricted list are cattle, deoiled groundnut cakes containing more than 1% oil, fur of domestic animals excluding lamb fur skin, fodder including wheat and rice straw, etc. Canalized exports include export of petroleum products, mica waste, mineral ores, onions, etc. The prohibited list includes all forms of wild life, exotic birds, human skeletons, etc.

The Director General of Foreign Trade lays down conditions according to which certain items may be exported without licenses. Such terms and conditions generally include minimum export price, registration with specific authorities, quantitative ceilings and compliance with other laws. A person wishing to export an item on the negative list of exports must have a registration and membership certificate from the relevant export promotion council. He should also be in possession of a license issued by the licensing authority for the said purpose. An export license contains all the terms and conditions laid down by the licensing authority. Some of the details which are included in an export license are the quantity, description and value of the goods, actual user condition, export obligation, value addition to be achieved by the exporter, and the minimum export price. It should be noted that an export license cannot be claimed as a right. The licensing authority has the power to refuse, grant or renew a license as per the provisions of the Act. All export contracts must be denominated in freely convertible currencies.

In addition to possessing an export license, exporters are also required to register themselves with any one of the Export Promotion Councils (EPC) and obtain Registration and Membership Certificate (RCMC). Export promotion councils help in promoting and developing the exports of the country. Each council is responsible for promotion of a particular group of products, projects and services. EPCs are non-profit organizations registered under the Indian Companies Act or the Societies Registration Act as the case may be and are supported by financial assistance from the Government of India. An exporter who wishes to avail of the various Exim benefits will have to register with the export promotion council which is mandatory. The RCMC issued by the Export Promotion Council is valid for a period of 5 licensing years.

Prior to any export, an exporter is required to give a declaration that the full export value of the goods or if the value is not ascertainable at the time of export, the value which the exporter expects to receive from the export has been or will be paid within the stipulated time and in the prescribed manner.

Also, the export of goods to countries other than Nepal and Bhutan can be made only if a declaration in the prescribed form is furnished to the prescribed authority.

However, declaration forms are not required in certain cases. Exports where declaration form is not required are:

a. Trade samples supplied free of payment.

b. Personal effects of travelers, whether accompanied or unaccompanied.

c. Ships stores, transshipment cargo and goods shipped under the orders of the Central Government or of such officers as may be appointed by the Central Government in this behalf or of the military, naval or air force authorities in India for military, naval or air force requirements.

d. Goods or software accompanied by a declaration by the exporter that they are not more than twenty five thousand rupees in value.

e. By way of gift of goods accompanied by a declaration by the exporter that they are not more than one lakh rupees in value.

f. Aircrafts or aircraft engines and spare parts for overhauling and/or repairs abroad subject to their re-import into India after overhauling/repairs within a period of six months from the date of their export.

g. Goods imported free of cost on re-export basis.

h. Goods not exceeding US$ 1000, or its equivalent in value per transaction exported to Myanmar under the Barter Trade Agreement between the Central Government and the Government of Myanmar.

i. The following goods which are permitted by the Development Commissioner of the Export Processing Zones or Free Trade Zones to be re-exported namely:

   i. Imported goods found defective for the purpose of their replacement by the foreign suppliers/collaborators.

   ii. Imported goods, which were imported from foreign collaborator on loan basis.

   iii. Surplus goods, which were earlier, imported from foreign suppliers or collaborators free of cost, after production operations.

j. Replacement goods exported free of charge in accordance with the provisions of the Exim policy in force, for the time being.

The Foreign Trade Policy is regularly monitored and any changes, if necessitated are introduced through annual policy statements. A brief summary of the Annual policy statement for 2007-08 is given in Annexure 1.

SUMMARY

- The Gulf crisis in the early 90s was the precursor for introduction of economic reforms in India.
- With the focus having shifted to opening up of the economy, a number of incentives aimed at giving a fillip to the export sector announced by the Government of India.
- The current Exim policy 2004-2009 has for the first time tried to integrate the trade policy with the process of Country's Economic development.
- The Exim policy also issues the trade regulations governing exports and imports. It lays down the trade procedures to be followed by exporters and importers.
- Every person/firm or organization engaged in this field should be aware of these regulations and strictly comply with the same. These trade regulations may be amended from time to time depending on the circumstances.

Annexure I

Annual Supplement 2007

To Foreign Trade Policy 2004-09

1. **SECTOR SPECIFIC INITIATIVES**

1.1 **Handloom and Handicraft Sector**

Absence of environmentally sustainable production process often works as a non-tariff barrier. To overcome this, exemption from duty on machinery and equipment for effluent treatment plants for handlooms and handicrafts has been allowed. As these sectors comprise of many small units and are located in geographically contiguous regions, these essential supports would strengthen their marketability.

A special focus initiative will provide for tools, machinery and equipments for handicrafts within present duty free entitlement ceiling.

1.2 **Gems and Jewelry Sector**

An initiative will provide for tools, machinery and equipments for gems and jewelry sector within present duty free entitlement limit. In the light of increase in global prices of precious metal, duty free entitlement for consumables for export of rhodium plated silver jewelry has been increased to 3%.

1.3 **Samples for all exporters**

Duty free import of samples up to Rs. 75,000/- (Presently Rs. 60,000/) would be allowed for all exporters.

2. **SERVICE TAX ON EXPORTS**

2.1 **Exemption from Service Tax on services (related to exports) rendered abroad**

Government has enunciated the principle that we should only export goods and not the taxes and duties thereon. In line with this, services rendered abroad and charged on exports from India would be exempted from Service Tax.

2.2 **Exemption/Remission of Service Tax on export of goods**

Service tax on services rendered in India and utilized by exporters would be exempted /remitted. Remission mechanism would be institutionalized after working out modalities with Department of Revenue (DoR).

3. **STATUS HOLDERS**

Categorization of exporters as One to Five Star Export Houses has been changed to Export Houses & Trading Houses, with rationalization and change in export performance parameters.

4. **VISHESH KRISHI AND GRAM UDYOG YOJANA (VKGUY): EXPANSION AND CHANGES**

4.1 **Forest based products**

Forest-based products are added to the existing list, which presently include Minor Forest Produce. This would benefit artisans, employed in manufacture of value added products like artistic wooden furniture, particularly in small scale, cottage and tiny sectors.

4.2 **Scope of VKGUY Scheme**

Scope of agricultural sector is enhanced to include many more products. Value added products have been included to ensure employment generation.

4.3 **Status Holders developing Agri-Infrastructure**

4.3.1 **Duty Credit Benefits**

Status Holders will be incentivised with duty credit scrip equal to 10% of the FOB value of agricultural exports which can be used for duty free import/procurement of capital goods related to infrastructure meant for agro-processing to promote agricultural exports. This would be in addition to the prevailing benefits in other schemes administered by the Ministry of Agriculture.

4.3.2 **Allocation Basis**

Allocation of funds will be on a first-cum-first-served basis. Assessment of applicants' proposal can be with respect to their past export performance. This would be within the additional allocation of Rs.200 crore for 2007-08.

4.4 **VKGUY extended to EOUs**

VKGUY benefits are extended to EOUs not availing direct tax benefits.

5. **FOCUS MARKET & PRODUCT SCHEMES**

5.1 **Expansion of Ceiling, Scope and Coverage**

Under Focus Market Scheme (FMS) and Focus Product Scheme (FPS) coverage/scope of eligible markets/items would be enhanced. Revised allocation for benefits is now Rs.1000 crore, for exports during 2007-08.

5.2 **New Markets and Products**

16 countries (including 10 from CIS block) are added as new Markets and several value-added low volume export products have been identified and would be entitled to benefits under FPS.

5.3 **FMS & FPS extended to EOUs**

Moreover, EOUs not availing direct tax benefits would also get benefits under FMS and FPS.

6. **PROMOTION OF HIGH TECH PRODUCTS**

Promotion of High Tech Products is essential to increase quantum of such products' manufacturing base in India for export purposes. An Export Promotion Scheme is launched with following salient features:

i. Duty credit of 10% on incremental export growth would be given as incentive for exporter.

ii. List of products would be notified in consultation with the concerned Scientific Ministries.

7. **DUTY ENTITLEMENT PASS BOOK (DEPB) SCHEME**

7.1 **Extension of DEPB Scheme**

DEPB Scheme stands extended upto 31.3.2008. It is proposed to introduce a new scheme instead of DEPB, soon.

7.2 **Modification in DEPB scheme**

While extending the scheme for another year, government has agreed to reimburse the cost of duty on fuel and special additional duty, on all export-related imported goods, to the extent it is not cenvatable. Benefit may be allowed by notifying Brand rate of DEPB for such products.

8. HIGHER EXPORT GROWTH THROUGH RATIONALIZATION OF EXPORT PROMOTION

CAPITAL GOODS (EPCG) SCHEME

8.1 Export Obligation (EO) for tiny and cottage sector

For tiny and cottage, sector export obligation period is raised to 12 years.

8.2 Spares, tools and spare refractory for Imported CG

Issue of EPCG for import of spares, tools and spare refractory would be allowed for the existing imported plant and machinery (though not imported under EPCG cover).

8.3 Waiver of EO due to Force Majeure

Waiver of outstanding export obligations can only be considered where, because of *force majeure* or other unforeseen circumstances/reasons, exporter is unable to fulfill export obligation.

8.4 Concurrent EPCG – Fixation of Average EO

Wherever more than one EPCG authorizations are issued concurrently, fresh EPCG authorization would build upon last required average export obligation only (incorporating the previous EPCG obligation), notwithstanding actual achievements. This removes anomaly whereby better performance is penalized presently.

8.5 Block wise EO abolished

Block-wise fulfillment of export obligation would be done away with. This will reduce unnecessary transaction cost and paper work. While doing so in case of the existing export obligations fresh EPCG would be issued only to such applicant who has fulfilled proportionate export obligation by that time. Simultaneously, services sector will have to maintain the average to avail new EPCG. This would be a supportive measure for export promotion and growth.

9. 100% EOU AND SEZ UNITS

9.1 Interest on delayed payments

Interest on delayed payments (refund of terminal excise duty/duty drawback on deemed exports and CST) would be payable in lines of provisions in Customs and Income Tax Acts. This facility would also apply to delayed payments for deemed exports.

9.2 Counting for NFE of EOU

Supplies of accessories such as buttons and hangers by EOUs to DTA units will be counted for NFE calculations.

9.3 Defining manufacture under Income Tax

Definition of manufacturing shall be incorporated in the Income Tax Act. This would remove uncertainty regarding taxation for EOU units.

9.4 EOU units extended benefits under VKGUY, FMS & FPS Schemes

EOUs not availing direct tax benefits would also get benefits under VKGUY, FMS and FPS schemes.

9.5 Co-Developer of SEZ

Developer and Co-developer of Special Economic Zone would be notified for benefits under all duty neutralization schemes like DEPB, DFIA and Advance Authorization Schemes.

Appendix

BASEL-II NORMS

Overview of the New Basel Capital Accord

Key Elements of the New Accord

The New Accord consists of three pillars:

1. Minimum capital requirements,
2. Supervisory review of capital adequacy, and
3. Public disclosure.

Pillar 1

Minimum Capital Requirements

While the proposed New Accord differs from the current Accord along a number of dimensions, it is important to begin with a description of elements that have not changed. The current Accord is based on the concept of a capital ratio where the numerator represents the amount of capital, a bank possesses and the denominator is a measure of the risks faced by the bank, and is referred to as risk-weighted assets. The resulting capital ratio may be no less than 8%.

Under the proposed New Accord, the regulations that define the numerator of the capital ratio (i.e., the definition of regulatory capital) remain unchanged. Similarly, the minimum required ratio of 8% is not changing. The modifications, therefore, are occurring in the definition of risk-weighted assets i.e., in the methods used to measure the risks faced by banks. The new approaches for calculating risk-weighted assets are intended to provide improved bank assessments of risk and thus to make the resulting capital ratios more meaningful.

The current Accord explicitly covers only two types of risks in the definition of risk-weighted assets: (1) credit risk, and (2) market risk. Other risks are presumed to be covered implicitly through the treatments of these two major risks. The treatment of market risk arising from trading activities was the subject of the Basel Committee's 1996 Amendment to the Capital Accord. The proposed New Accord envisions this treatment remaining unchanged.

The pillar one proposals to modify the definition of risk-weighted assets in the New Accord have two primary elements:

- substantive changes to the treatment of credit risk relative to the current Accord; and
- the introduction of an explicit treatment of operational risk that will result in a measure of operational risk being included in the denominator of a bank's capital ratio. The discussion below will focus on these two elements in turn:

In both cases, a major innovation of the proposed New Accord is the introduction of three distinct options for the calculation of credit risk and three others for operational risk. The Committee believes that it is not feasible or desirable to insist upon a one-size-fits-all approach to the measurement of either risk. Instead, for both credit and operational risk, there are three approaches of increasing risk sensitivity to allow banks and supervisors to select the approach or approaches that they believe are most appropriate to the stage of development of banks' operations and of the financial market infrastructure. The following table identifies the three primary approaches available by risk type:

Credit Risk	Operational Risk
(1) Standardized Approach	(1) Basic Indicator Approach
(2) Foundation IRB Approach	(2) Standardized Approach
(3) Advanced IRB Approach	(3) Advanced Measurement Approaches (AMA)

Standardized Approach to Credit Risk

The standardized approach is similar to the current Accord in that banks are required to slot their credit exposures into supervisory categories based on observable characteristics of the exposures (e.g. whether the exposure is a corporate loan or a residential mortgage loan). The standardized approach establishes fixed risk weights corresponding to each supervisory category and makes use of external credit assessments to enhance risk sensitivity compared to the current Accord. The risk weights for sovereign, interbank, and corporate exposures are differentiated based on external credit assessments. For sovereign exposures, these credit assessments may include those developed by OECD export credit agencies, as well as those published by private rating agencies.

The standardized approach contains guidance for use by national supervisors in determining whether a particular source of external ratings should be eligible for banks to use. The use of external ratings for the evaluation of corporate exposures, however, is considered to be an optional element of the framework, where no external rating is applied to an exposure, the standardized approach mandates that in most cases, a risk weighting of 100% be used, implying a capital requirement of 8% as in the current Accord. In such instances, supervisors are to ensure that the capital requirement is adequate given the default experience of the exposure type in question. An important innovation of the standardized approach is the requirement that loans considered past-due be risk-weighted at 150%, unless a threshold amount of specific provisions has already been set aside by the bank against that loan.

Another important development is the expanded range of collateral, guarantees, and credit derivatives that banks using the standardized approach may recognize. Collectively, Basel II refers to these instruments as credit risk mitigants. The standardized approach expands the range of eligible collateral beyond OECD sovereign issues to include most types of financial instruments, while setting out several approaches for assessing the degree of capital reduction based on the market risk of the collateral instrument. Similarly, the standardized approach expands the range of recognized guarantors to include all firms that meet a threshold external credit rating.

The standardized approach also includes a specific treatment for retail exposures. The risk weights for residential mortgage exposures are being reduced relative to the current Accord, as are those for other retail exposures, which will now receive a lower risk weight than that for unrated corporate exposures. In addition, some loans to Small- and Medium-sized Enterprises (SMEs) may be included within the retail treatment, subject to meeting various criteria.

By design, the standardized approach draws a number of distinctions between exposures and transactions in an effort to improve the risk sensitivity of the resulting capital ratios. The same can also be said of the IRB approaches to credit risk and those for assessing the capital requirement for operational risk where capital requirements are more closely linked to risk. In order to assist banks and national supervisors where circumstances may not warrant a broad range of options, the Committee has developed the ‘simplified standardized approach’ outlined in Annex 9 of CP3. The annex collects in one place the simplest options for calculating risk-weighted assets. Banks intending to adopt the simplified standardized methods are also expected to comply with the corresponding supervisory review and market discipline requirements of the New Accord.

Internal Ratings-based (IRB) Approaches

One of the most innovative aspects of the New Accord is the IRB approach to credit risk, which includes two variants: a foundation version and an advanced version. The IRB approach differs substantially from the standardized approach in that banks’ internal assessments of key risk drivers serve as primary inputs to the capital calculation. Since the approach is based on banks’ internal assessments, the

potential for more risk sensitive capital requirements is substantial. However, the IRB approach does not allow banks themselves to determine all of the elements needed to calculate their own capital requirements. Instead, the risk weights and thus capital charges are determined through the combination of quantitative inputs provided by banks and formulas specified by the Committee.

The formulas, or risk weight functions, translate a bank's inputs into a specific capital requirement. They are based on modern risk management techniques that involve a statistical and thus quantitative assessment of risk.

Ongoing Dialogue with Industry

The participants have confirmed that use of such methods represents an important step forward for developing a meaningful assessment of risk at the largest most complex banking organizations in today's market.

The IRB approaches cover a wide range of portfolios with the mechanics of the capital calculation varying somewhat across exposure types. The remainder of this section highlights the differences between the foundation and advanced IRB approaches by portfolio, where applicable.

Corporate, Bank and Sovereign Exposures

The IRB calculation of risk-weighted assets for exposures to sovereigns, banks, or corporate entities uses the same basic approach. It relies on four quantitative inputs:

1. **Probability of Default (PD)** which measures the likelihood that the borrower will default over a given time horizon;
2. **Loss Given Default (LGD),** which measures the proportion of the exposure that will be lost if a default occurs;
3. **Exposure at Default (EAD),** which for loan commitments measures the amount of the facility that is likely to be drawn if a default occurs; and
4. **Maturity (M),** which measures the remaining economic maturity of the exposure.

Given a value for each of these four inputs, the corporate IRB risk-weight function described in CP3 produces a specific capital requirement for each exposure. In addition, for exposures to SME borrowers defined as those with annual sales of less than 50 million of Euros, banks will be permitted to make use of a firm size adjustment to the corporate IRB risk weight formula.

The foundation and advanced IRB approaches differ primarily in terms of the inputs that are provided by the bank based on its own estimates and those that have been specified by the supervisor. The following table summarizes these differences.

Data Input	Foundation IRB	Advanced IRB
Probability of Default (PD)	Provided by the bank based on own estimates.	Provided by the bank based on own estimates.
Loss Given Default (LGD)	Supervisory values set by the Committee.	Provided by the bank based on own estimates.
Exposure at Default (EAD)	Supervisory values set by the Committee.	Provided by the bank based on own estimates.
Maturity (M)	Supervisory values set by the Committee or At national discretion, provided by bank based on own estimates (with an allowance to exclude certain exposures).	Provided by the bank based on own estimates (with an allowance to exclude certain exposures).

The table makes it clear that for corporate, sovereign, and interbank exposures, all IRB banks must provide internal estimates of PD. In addition, advanced IRB banks must provide internal estimates of LGD and EAD, while foundation IRB banks

will make use of supervisory values contained in CP3 that depend on the nature of the exposure. Advanced IRB banks will generally provide their own estimates of remaining maturity for these exposures, although there are some exceptions where supervisors can allow fixed maturity assumptions to be used instead. For foundation IRB banks, supervisors can choose on a national basis whether all such banks are to apply fixed maturity assumptions described in CP3 or to provide their own estimates of remaining maturity.

Another major element of the IRB framework pertains to the treatment of credit risk mitigants, namely, collateral, guarantees and credit derivatives. The IRB framework itself, particularly the LGD parameter, provides a great deal of flexibility to assess the potential value of credit risk mitigation techniques. For foundation IRB banks, therefore, the different supervisory LGD values provided in CP3 reflect the presence of different types of collateral. Advanced IRB banks have even greater flexibility to assess the value of different types of collateral. With respect to transactions involving financial collateral, the IRB approach seeks to ensure that banks are using a recognized approach to assess the risk that such collateral could change in value, and thus a specific set of methods is provided, as in the standardized approach.

Retail Exposures

For retail exposures, there is only a single, advanced IRB approach and no foundation IRB alternative. The key inputs to the IRB retail formulas are PD, LGD and EAD, all of which are to be provided by the bank based on its internal estimates. In contrast to the IRB approach for corporate exposures, these values would not be estimated for individual exposures, but instead for pools of similar exposures.

In light of the fact that retail exposures address a broad range of products with each exhibiting different historical loss experiences, the framework divides retail exposures into three primary categories:

1. Exposures secured by residential mortgages,
2. Qualifying Revolving Retail Exposures (QRRE), and
3. Other non-mortgage exposures also known as ‘other retail’.

Generally speaking, the QRRE category captures unsecured revolving credits that exhibit appropriate loss characteristics, which would include many credit card relationships. All other non-mortgage consumer lending including exposures to small businesses falls into the ‘other retail’ category. A separate risk-weight formula for each of the three categories is provided in CP3.

Specialized Lending

Basel II distinguishes several sub-categories of wholesale lending from other forms of corporate lending and refers to them as specialized lending. The term specialized lending is associated with the financing of individual projects where the repayment is highly dependent on the performance of the underlying pool or collateral. For all but one of the specialized lending sub-categories, if banks can meet the minimum criteria for the estimation of the relevant data inputs, they can simply use the corporate IRB framework to calculate the risk weights for these exposures. However, in recognition that the hurdles for meeting these criteria for this set of exposures may be more difficult in practice, CP3 also includes an additional option that only requires that a bank be able to classify such exposures into five distinct quality grades. CP3 provides a specific risk weight for each of these grades.

For one sub-category of specialized lending, ‘High Volatility Commercial Real Estate’ (HVCRE), IRB banks that can estimate the required data inputs will use a separate risk-weight formula that is more conservative than the general corporate risk-weight formula in light of the risk characteristics of this type of lending. Banks that cannot estimate the required inputs will classify their HVCRE exposures into five grades, for which CP3 also provides specific risk weights.

Equity Exposures

IRB banks will be required to separately treat their equity exposures. Two distinct approaches are described in CP3. One approach builds on the PD/LGD approach for corporate exposures and requires banks to provide own PD estimates for the associated equity exposures. This approach, however, mandates the use of a 90% LGD value and also imposes various other limitations, including a minimum risk weight of 100% in many circumstances. The other approach is intended to provide banks with the opportunity to model the potential decrease in the market value of their equity holdings over a quarterly holding period. A simplified version of this approach with fixed risk weights for public and private equities is also included.

Implementation of IRB

By relying on internally generated inputs to the Basel II risk weight functions, there is bound to be some variation in the way in which the IRB approach is carried out. To ensure significant comparability across banks, the Committee has established minimum qualifying criteria for use of the IRB approaches that cover the comprehensiveness and integrity of banks' internal credit risk assessment capabilities. While banks using the advanced IRB approach will have greater flexibility relative to those relying on the foundation IRB approach, at the same time they must also satisfy a more stringent set of minimum standards.

The Committee believes that banks' internal rating systems should accurately and consistently differentiate between different degrees of risk. The challenge is for banks to define clearly and objectively the criteria for their rating categories in order to provide meaningful assessments of both individual credit exposures and ultimately an overall risk profile. A strong control environment is another important factor for ensuring that banks' rating systems perform as intended and the resulting ratings are accurate. An independent ratings process, internal review and transparency are control concepts addressed in the minimum IRB standards.

Clearly, an internal rating system is only as good as its inputs. Accordingly, banks using the IRB approach will need to be able to measure the key statistical drivers of credit risk. The minimum Basel II standards provide banks with the flexibility to rely on data derived from their own experience, or from external sources as long as the bank can demonstrate the relevance of such data to its own exposures. In practical terms, banks will be expected to have in place, a process that enables them to collect, to store and to utilise loss statistics over time in a reliable manner.

Securitization

Basel II provides a specific treatment for securitization, a risk management technique that the current Accord does not fully contemplate. The Committee recognises that securitization by its very nature relates to the transfer of ownership and/or risks associated with the credit exposures of a bank to other parties. In this respect, securitization is important in helping to provide better risk diversification and to enhance financial stability.

The Committee believes that it is essential for the New Accord to include a robust treatment of securitization. Otherwise, the new framework would remain vulnerable to capital arbitrage, as some securitizations have enabled banks under the current Accord to avoid maintaining capital commensurate with the risks to which they are exposed. To address this concern, Basel II requires banks to look at the economic substance of a securitization transaction when determining the appropriate capital requirement in both the standardized and IRB treatments.

As elsewhere in the standardized approach to credit risk, banks must assign supervisory risk weights to securitization exposures based on various criteria. One noteworthy point is the difference in treatment of lower quality and unrated securitizations vis-à-vis comparable corporate exposures. In a securitization, such positions are generally designed to absorb all losses on the underlying pool of exposures up to a certain level. Accordingly, the Committee believes this concentration of risk warrants higher capital requirements. In particular, for banks using the standardized approach, unrated securitization positions must be deducted from capital.

For IRB banks that originate securitizations, a key element of the framework is the calculation of the amount of capital that the bank would have been required to hold on the underlying pool had it not securitized the exposures. This amount of capital is referred to as KIRB. If an IRB bank retains a position in a securitization that obligates it to absorb losses up to or less than KIRB before any other holders bear losses (i.e. a first loss position), then the bank must deduct this position from capital. The Committee believes that this requirement is warranted in order to provide strong incentives for originating banks to shed the risks associated with highly subordinated securitization positions that inherently contain the greatest risks. For IRB banks that invest in highly rated securitization exposures, a treatment based on the presence of an external rating, the granularity of the underlying pool, and the thickness of an exposure has been developed.

In view of their importance in ensuring the smooth functioning of commercial paper markets and their importance to corporate banking generally, the Basel II securitization framework includes an explicit treatment of liquidity facilities provided by banks. In the IRB framework, the capital requirement for a liquidity facility is dependent upon a number of factors including the asset quality of the underlying pool and the degree to which credit enhancements are available to absorb losses prior to use of the facility. Each is a critical input to the supervisory formula designed for use by originating banks to calculate capital requirements for unrated positions, such as liquidity facilities. A treatment of liquidity facilities in the standardized approach is also provided which sets out various criteria for ensuring that more preferential treatment is only provided to those liquidity facilities where the risks are lower.

Many securitizations of revolving retail exposures contain provisions that call for the securitization to be wound down if the quality of securitized assets begins to deteriorate. The Basel II proposals include a specific treatment of securitizations with these 'early amortization' features, given that such mechanisms can in effect partly shield investors from fully sharing in the losses of the underlying accounts. The Committee's approach is based on a measure of the quality of the underlying assets in the pool. When this is high, the approach implies a zero capital requirement associated with the securitized exposures. As the quality deteriorates, however, the bank must increasingly hold capital as if future draws on existing credit card lines would remain on its balance sheet.

Operational Risk

The Committee believes that operational risk is an important risk facing banks and that banks need to hold capital to protect against losses from it. Within the Basel II framework, operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people and systems, or external events. This is another area where the Committee has developed a new regulatory capital approach. As with credit risk, the Committee builds on banks' rapidly developing internal assessment techniques and seeks to provide incentives for banks to improve upon those techniques, and more broadly, their management of operational risk over time. This is particularly true of the Advanced Measurement Approaches (AMA) to operational risk described below:

Approaches to operational risk are continuing to evolve rapidly, but are not likely in the near term to attain the precision with which market and credit risk can be quantified. This situation has posed obvious challenges to the incorporation of a measure of operational risk within pillar one of the New Accord. Nevertheless, the Committee believes that such inclusion is essential to ensure that there are strong incentives for banks to continue to develop approaches to operational risk measurement and to ensure that banks are holding sufficient capital buffers for this risk. It is clear that a failure to establish a minimum capital requirement for operational risk within the New Accord would reduce these incentives and result in a reduction of industry resources devoted to operational risk.

The Committee is prepared to provide banks with an unprecedented amount of flexibility to develop an approach to calculate operational risk capital that they believe is consistent with their mix of activities and underlying risks. In the AMA, banks may use their own method for assessing their exposure to operational risk, so long as it is sufficiently comprehensive and systematic. The extent of detailed standards and criteria for use of the AMA is limited in order to accommodate the rapid evolution in operational risk management practices that the Committee expects to see over the coming years.

The Committee intends to review progress in regard to operational risk approaches on an ongoing basis. It has been strongly encouraged by the advances made at those banks that have been developing operational risk frameworks consistent with the spirit of the AMA. Management in these banking organizations has concluded that it is possible to develop a flexible and comprehensive approach to operational risk measurement within their firms.

Internationally active banks and banks with significant operational risk exposure (for example, specialized processing banks) are expected to adopt over time the more risk-sensitive AMA. Basel II contains two simpler approaches to operational risk: the basic indicator and the standardized approach, which are targeted at banks with less significant operational risk exposures. In general terms, the basic indicator and standardized approaches require banks to hold capital for operational risk equal to a fixed percentage of a specified risk measure.

In the basic indicator approach, the measure is a bank's average annual gross income over the previous three years. This average, multiplied by a factor of 0.15 set by the Committee, produces the capital requirement. As a point of entry for the capital calculation, there are no specific criteria for use of the basic indicator approach. Nevertheless banks using this approach are encouraged to comply with the Committee's guidance on sound practices for the management and supervision of operational risk, which was released in February, 2003.

In the standardized approach, gross income again serves as a proxy for the scale of a bank's business operations and thus the likely scale of the related operational risk exposure for a given business line. However, rather than calculate capital at the firm level as under the basic indicator approach, banks must calculate a capital requirement for each business line. This is determined by multiplying gross income by specific supervisory factors determined by the Committee. The total operational risk capital requirement for a banking organization is the summation of the regulatory capital requirements across all of its business lines. As a condition for use of the standardized approach, it is important for banks to have adequate operational risk systems that comply with the minimum criteria outlined in CP3.

Banks using the basic indicator or standardized approaches to operational risk are not permitted to recognize the risk mitigating impact of insurance. However, banks using the AMA are permitted to do so subject to certain conditions.

Pillar 2

Supervisory Review

The second pillar of the New Accord is based on a series of guiding principles, all of which point to the need for banks to assess their capital adequacy positions relative to their overall risks, and for supervisors to review and take appropriate actions in response to those assessments. These elements are increasingly seen as necessary for effective management of banking organizations and for effective banking supervision respectively.

Feedback received from the industry and the Committee's own work has emphasized the importance of the supervisory review process. Judgements of risk and capital adequacy must be based on more than an assessment of whether a bank complies with minimum capital requirements. The inclusion of a supervisory review element in the New Accord, therefore, provides benefits through its emphasis on the need for strong risk assessment capabilities by banks and

supervisors alike. Further, it is inevitable that a capital adequacy framework, even the more forward looking New Accord, will lag, to some extent, behind the changing risk profiles of complex banking organizations, particularly as they take advantage of newly available business opportunities. Accordingly, this heightens the importance of, and attention supervisors must pay to pillar two.

The Committee has been working to update the pillar two guidance as it finalizes other aspects of the new capital adequacy framework. One update is in relation to stress testing. The Committee believes it is important for banks adopting the IRB approach to credit risk to hold adequate capital to protect against adverse or uncertain economic conditions. Such banks will be required to perform a meaningfully conservative stress test of their own design with the aim of estimating the extent to which their IRB capital requirements could increase during a stress scenario. Banks and supervisors are to use the results of such tests as a means of ensuring that banks hold a sufficient capital buffer. To the extent there is a capital shortfall, supervisors may, for example, require a bank to reduce its risks so that existing capital resources are available to cover its minimum capital requirements plus the results of a recalculated stress test.

Other refinements focus on banks' review of concentration risks, and on the treatment of residual risks that arise from the use of collateral, guarantees and credit derivatives. Further to the pillar one treatment of securitization, a supervisory review component has been developed, which is intended to provide banks with some insight into supervisory expectations for specific securitization exposures. Some of the concepts addressed include significant risk transfer and considerations related to the use of call provisions and early amortization features. Further, possible supervisory responses are outlined to address instances when it is determined that a bank has provided implicit (non-contractual) support to a securitization structure.

Pillar 3

Market Discipline

The purpose of pillar three is to complement the minimum capital requirements of pillar one and the supervisory review process addressed in pillar two. The Committee has sought to encourage market discipline by developing a set of disclosure requirements that allow market participants to assess key information about a bank's risk profile and level of capitalization. The Committee believes that public disclosure is particularly important with respect to the New Accord where reliance on internal methodologies will provide banks with greater discretion in determining their capital needs. By bringing greater market discipline to bear through enhanced disclosures, pillar three of the new capital framework can produce significant benefits in helping banks and supervisors to manage risk and improve stability.

Over the past year, the Committee has engaged various market participants and supervisors in a dialogue regarding the extent and type of bank disclosures that would be most useful. The aim has been to avoid potentially flooding the market with information that would be hard to interpret or to use in understanding a bank's actual risk profile. After taking a hard look at the disclosures proposed in its second consultative package on the New Accord, the Committee has since scaled back considerably the requirements, particularly those relating to the IRB approaches and securitization.

The Committee is aware that supervisors may have different legal avenues available in having banks satisfy the disclosure requirements. The various means may include public disclosures deemed necessary on safety and supervision grounds or information that must be disclosed in regulatory reports. The Committee recognizes that the means by which banks will be expected to share information publicly will depend on the legal authority of supervisors.

Another important consideration has been the need for the Basel II disclosure framework to align with national accounting standards. Considerable efforts have been made to ensure that the disclosure requirements of the New Accord focus on bank capital adequacy and do not conflict with broader accounting disclosure standards with which banks must comply. This has been accomplished through a strong and co-operative dialogue with accounting authorities. Going forward, the Committee will look to strengthen these relationships given that the continuing work of accounting authorities may have implications for the disclosures required in the New Accord. With respect to potential future modifications to the capital framework itself, the Committee intends also to consider the impact of such changes on the amount of information, a bank should be required to disclose.

RBI's Approach for Implementation of BASEL II Accord

For the last two years, RBI has been looking ahead and preparing the ground for advance steps towards eventual implementation of Basel II accord by the Indian Banking System. In the Monetary and Credit Policy for the year 2003-04 announced by the Governor Dr.Bimal Jalan on 29th April, 2003 before the release of document CP3 by Basel Committee, this viewpoint of RBI is expressly stated under paragraphs 123 & 124 as reproduced hereunder:

"124. The New Capital Accord, presently under consideration of the Basel Committee, aims at capturing major risks inherent in a bank's operations and envisages enhancement of risk sensitivity. In order to equip banks to identify, measure, monitor and control the various types of risks assumed by them, RBI has, over a period, issued various guidelines and guidance notes taking into account the overall ability of banks to adopt them. The Reserve Bank has also taken a number of proactive steps and rationalized various prudential norms to prepare banks to understand the complexity and lessen the burden of costs involved in adhering to the international standards. These steps include phased provisioning, building up of Investment Fluctuation Reserve (IFR) to guard against interest rate risks, refining asset-liability management systems with tolerance levels, assessing the impact of the proposed New Capital Accord on banks by conducting Quantitative Impact Studies (QIS), relaxing exposure norms and permitting concessional risk weights in critical areas of importance and putting in place a sound 'Know Your Customer' (KYC) policy and adopting anti-money laundering measures.

"125. Taking into account the preliminary results of the QIS, the Basel Committee is fine-tuning risk weights assigned to banks' exposures to retail customers, Small and Medium Enterprises (SMEs), residential mortgages, securitization transactions, past due loans etc., reflecting the risk characteristics of these exposures. The Basel Committee is also considering entrusting the supervisors with discretion for estimating capital charge for operational risk appropriate to risk profile of the bank."

After publication of the document CP3, the third consultative document on 30.04.2003, RBI reviewed the different recommendations of the draft document in the background of their eventual implementation by the banking system in India and submitted its comments. This document titled "Comments of the Reserve Bank of India on the Third Consultative Document of the New Basel Capital Accord" can be viewed in the RBI's website.

The overall approach of RBI in formulating its comments is stated as under:

"The Reserve Bank of India (RBI) had forwarded its comments on the Second Consultative Paper (CP 2) of the New Basel Capital Accord to the Basel Committee on Banking Supervision (the Committee) in May, 2001 and had also placed it on its website. RBI recognizes that several of the concerns expressed and suggestions made by India and other emerging markets on the second consultative paper have been taken into account and addressed in the third Consultative Document (CP 3) after consultations and conducting a Quantitative Impact Study (QIS 3). Particularly, the provision of a Simplified Standardized Approach which provides for calculating risk-weighted assets, provision of preferential risk weights for retail exposures (75%) and residential mortgages (35%), aligning the capital requirements for credit risk in the trading book with the banking book and partial adoption of different approaches under the operational risk, reflect the Committee's endeavor in evolving a consensus which would facilitate adoption of the New Capital Accord in many jurisdictions.

"However, some of the issues relevant in the context of the emerging markets and developing countries are yet to be fully addressed. In its attempt to strive for more accurate measure of risks in banks, the simplicity of the present Capital Accord is proposed to be replaced, with a highly complex methodology which needs the support of highly sophisticated MIS/data processing capabilities. The complexity

and sophistication essential for banks for implementing the New Capital Accord restrict its universal application in the emerging markets. Banks in these emerging markets form a significant segment in financial intermediation and are likely to find implementation of the New Capital Accord a major challenge in the medium term. Besides banks, supervisors would be required to invest considerable resources in upgrading technology systems, and human resources to meet the minimum standards. Banks in emerging markets would, therefore, face serious implementation challenges due to lack of adequate technical skills, under development of financial markets, structural rigidities and less robust legal system.

"The QIS 3 results for the Standardized Approach show an increase in capital requirements for all country groupings in respect of both Group 1 and Group 2 banks. The QIS 3 results from the participating non-G-10 countries show that overall increase in risk weighted assets under the Standardized Approach was 19%, reflecting the impact of new operational risk charge (+ 15%) plus a credit risk contribution (+ 4%). These, average contributions fall to + 11% and + 2% respectively (or an overall increase of around 13%) after some recalibration to the risk weights attached to claims on retail portfolios, residential property and past due loans.

"The Reserve Bank of India is fully committed to implement the best international practices. However, the level of preparedness of the banking system and the supervisors would vary from country to country. In view of this, it will be desirable to assign greater flexibility to national supervisors to calibrate risk weights on different types of exposures under the Standardized Approach. For example, the CP 3 has recalibrated the risk weights on claims on retail portfolio to 75% and residential property to 35%. The CP 3 has also indicated reduction in risk weights on past due loans from 150% to 100% or 50%, depending on the level of provisions held against such loans and to encourage banks to make higher provisions for past due loans by providing capital relief. RBI welcomes such adaptability in the approach shown in CP 3. RBI also notes that the national supervisors can consider a higher risk weight on unrated claims on corporates if warranted in their jurisdictions. However, RBI feels that there are many other areas in which national supervisors can be allowed greater flexibility in assigning a lower risk weight if the country-specific situation so warrants than following a "one-size-fits-all" approach based on the external ratings under the Standardized Approach. RBI has examined the various aspects of the proposals contained in the CP 3 and conveyed its specific comments thereon in this document".

By way of summarizing its comments, RBI has stated under title "Conclusions" in the aforesaid document as under:

"6 Conclusion

6.1 RBI welcomes the adaptability in approach shown in CP 3. RBI also notes that the national supervisors can consider a higher risk weight on unrated claims on corporates if warranted in their jurisdictions. However, RBI feels that there are many other areas in which national supervisors can be allowed greater flexibility in assigning a lower risk weight if the country-specific situation so warrants than following a "one-size-fits-all" approach based on the external ratings under the Standardized Approach.

6.2 The Committee's proposal to apply the New Accord to all 'internationally active banks' within the G-10 countries by end-2006 and permit a longer lead time for banks in the non-G-10 countries acknowledges the need for adopting a flexible approach in the implementation of the New Accord. As the main objective of the New Accord is to ensure competitive equality and providing a reasonable degree of consistency in application, it is necessary that all supervisors across the world should have a common definition of 'internationally active banks'. Hence, the Committee may evolve this definition.

6.3 The QIS 3 results show that even under the Standardized Approach, which is likely to be adopted by most of banks in the emerging economies, there are:

- sizeable increases in credit risk charges for bank exposures as also for sovereign exposures.
- the impact of lower risk weights for retail exposures was on average less than expected.
- the increase in risk weight to 150% for past due loans was also significant.

In view of the above, it may be necessary to review the relevant provisions of CP 3 with respect to the Standardized Approach.

6.4 The proposal to allow banks to adopt an alternative exposure indicator for retail and commercial banking under the Alternative Standardized Approach for calculating operational risk capital charges should reckon only performing advances in these two business lines rather than the total portfolio of loans and advances, which would imply a substantial increase in capital charge for operational risk. The Committee may also like to review the beta factor proposed under the above approach where the banks are unable to disaggregate their gross income into the various business lines, with a view to incentivise banks to migrate from the Basic Indicator Approach to more advanced approaches for measuring operational risk.

6.5 RBI appreciates the Committee's efforts in evolving the New Accord containing proposals that are comprehensive in coverage. When implemented, these would go a long way in making the capital allocation more risk-sensitive and use of supervisory oversight with market discipline would reinforce the supervisory framework and ensure financial stability. However, the complexity and sophistication of the proposals restrict its universal application in emerging markets, where the banks continue to be the major segment in financial intermediation and would be facing considerable challenges in adopting all the proposals. Like the 1988 Capital Accord, the New Accord should also preserve the spirit of simplicity and flexibility to ensure universal applicability including emerging markets. The New Accord would involve shift in direct supervisory focus away to the implementation issues. Further, banks and the supervisors would be required to invest large resources in upgrading their technology and human resources to meet the minimum standards. The increasing reliance on external rating agencies in the regulatory process would undermine the initiatives of banks in enhancing their risk management policies and practices and internal control systems. The minimum standards set even for the IRB foundation approach are complex and beyond the reach of many banks."

It is of interest to point out that even in the US the perceived complexities in the New Accord is taken into consideration and US regulators have decided as under:

"US bank regulators issued an Advance Notice of Proposed Rule-making in July regarding implementation of Basel II in the United States. Under the proposal, only the top 10 largest, internationally active banks will have to comply with the new risk-based capital standard and its sophisticated internal ratings-based approach that is used to determine appropriate capital for credit risk. The regulators have suggested that other institutions may choose to opt-in if they can meet the requirements of the advanced approach and estimated another 10 to 15 banks will do just that. All other US banks and thrifts will remain subject to Basel I."

[Source: from an article titled "Basel II: A High-Risk Proposition" by Casey-Landry, Diane published in online journal "Community Banker"; Sep 2003, Vol. 12 Issue 9, p8, 2p].

In further elaboration of her viewpoint Ms.Diane Casey-Landry, president and chief executive officer of America Community Bankers, the author, has stated in the article as under:

"We believe that the new standard will raise significant competitive problems for community banks. The most recent Quantitative Impact Study shows that the main area of activity where minimum capital requirements will change substantially is the retail portfolio, where risk weights would be lowered significantly relative to the current accord. Even with an additional operational risk capital requirement, retail-oriented institutions will see a reduction in overall capital requirements under Basel II. This raises serious competitive issues for our members."

Specific comments of RBI conveyed to the Basel Committee for changes/modifications/clarifications in the accord are discussed in the succeeding articles.

RBI's Approach for Implementation of BASEL II – Specific Comments of RBI

RBI has appreciated the Committee's efforts in evolving the New Accord containing proposals that are comprehensive in coverage. These proposals when implemented, would go a long way in making the capital allocation more risk-sensitive and use of supervisory oversight with market discipline would reinforce the supervisory framework and ensure financial stability. However, RBI feels that there are many areas of the Draft Proposals in which national supervisors can be allowed greater flexibility in assigning a lower risk weight if the country-specific situation so warrants than following a "one-size-fits-all" approach based on the external ratings under the Standardized Approach. RBI has examined the various aspects of the proposals contained in the CP 3 and specific comments thereon are detailed hereunder:

Scope of Application (Paragraph 1)

The Committee has proposed that the New Accord will be applied to internationally active banks. However, it has been indicated in the Overview of the New Basel Capital Accord that the New Accord may be extended to include other significant banks as national supervisors deem appropriate. RBI reiterates that the focus of the New Accord should be primarily on the internationally active banks. As the main objective of the New Accord is to ensure competitive equality and providing a reasonable degree of consistency in application, it is necessary that all supervisors, across the world should have a common definition of internationally active banks. Basel Committee may, therefore, define what constitute internationally active banks.

RBI Comment

In this regard, RBI is of the view that all banks with cross-border business exceeding say 20% or 25% of their total business may be defined as internationally active banks.

Cross Holding of Capital (Paragraph 10)

RBI, while appreciating the Committee's proposal that reciprocal cross-holdings of bank capital artificially designed to inflate capital position of banks should be deducted, feels that cross-holdings of equity and other regulatory investments may be allowed in principle, but may also need to be moderated to preserve the integrity of the financial system and minimize the adverse effect of systemic risk and contagion.

RBI Comment

RBI, therefore, reiterates the view that the Basel Committee may consider prescribing a material limit (10% of the total capital) up to which cross-holdings of capital and other regulatory investments could be permitted and any excess investments above the limit would be deducted from total capital.

Claims on Sovereigns (Paragraph 29)

The Committee's proposal that the Export Credit Agencies (ECAs) qualify for recognition only if they publish their country risk scores and subscribe to the OECD agreed methodology is appreciated. However, the OECD methodology and ECAs' country risk classifications are still confidential.

RBI Comment

RBI, therefore, reiterates that the ratings of only those ECAs should be eligible for use in assigning preferential risk weights which

- disclose publicly their risk scores, rating process and procedure,
- subscribe to the publicly disclosed OECD methodology, and
- are recognised by national supervisors.

Claims on Banks

The flexibility to provide uniform risk weight i.e., one category less favorable than that assigned to claims on sovereign to all the banks (under first option) (Paragraph 35) militates the basic philosophy of aligning capital adequacy assessment more closely with the key elements of risk. The mere location may not necessarily be a good indicator of a bank's creditworthiness. This proposal provides competitive advantage to banks with weak financials by virtue of their having been incorporated in better-rated countries.

RBI Comment

RBI, therefore, reiterates its earlier view that the risk weighting of banks should be de-linked from the credit rating of sovereigns in which they are incorporated. Instead, preferential risk weights should be assigned on the basis of their underlying strength and creditworthiness.

The proposal to assign preferential risk weight to short-term claims (Paragraph 38) may lead to arbitrage of regulatory capital through roll-overs, concentration of short-term borrowings and serious asset-liability mismatches, which could trigger systemic crisis and contagion in the domestic inter-bank market. It would also be very difficult to monitor and control the rollovers of short-term claims, given the high volume of transactions in the inter-bank market.

RBI Comment

RBI, therefore, reiterates that preferential risk weights should not be linked to the maturity of the claims.

Banks are strongly regulated and supervised entities. Risks inherent in inter-bank exposures are not comparable to that of the corporates. There is, therefore, a need for a modified treatment for claims on banks. The Basel Committee has provided discretion to national supervisors in paragraph 28 to assign a lower risk weight to the exposures to the sovereign of incorporation, denominated in domestic currency and funded in that currency. A similar flexibility should be provided in respect of claims on banks as well under option 2.

RBI Comment

RBI, therefore, reiterates that on the lines of discretion provided in the case of claims on sovereigns, the national supervisors may be given discretion under option 2 to assign lower risk weight, to all claims on banks, which are denominated in domestic currency and funded in that currency, subject to a floor of 20%.

External Credit Assessments

The Committee has indicated that if banks are allowed to use unsolicited ratings in the same way as solicited ratings there may be the potential for ECAIs to use unsolicited ratings to put pressure on entities to obtain solicited ratings. Therefore, the Committee has proposed that such behavior, when identified, should cause supervisors to consider whether to continue recognizing such ECAIs as eligible for capital adequacy purpose.

RBI Comment

RBI feels that it would be very difficult for the supervisors to take a view as to whether the ECAIs are using unsolicited ratings to put pressure on entities to obtain solicited ratings. Supervisors are neither equipped nor competent to identify such behavior of rating agencies.

RBI appreciates the Committee's efforts in evolving a range of risk-sensitive options for assessing capital for credit risk. However, the reliance on External Credit Assessment Institutions (ECAIs) under the Standardized Approach for assigning preferential risk weights may not be a better option. First, the credibility of the rating agencies is at stake and there is no system of accountability for sharp deterioration in the credit quality of rated entities immediately after assigning a rating. Secondly, their access to information, especially in the absence of

transparency and good corporate governance principles is severely restricted; whereas, banks are privy to customer information and are less exposed to customer-related informational asymmetry. Thirdly, the population of rated entities, even in the advanced countries, and especially in the emerging markets, which have exposure to the banking system, is very few in number. Fourthly, the use of external credit rating agencies in the regulatory process may act as a disincentive for the banks to improve their credit risk rating systems.

It is appreciated that the expanded role envisioned for IRB Approach provides positive incentives to banks in improving their credit risk management techniques. However, the adoption of the IRB Approach, even under the foundation approach, requires considerable investments in IT/human resources and rigorous supervisory oversights. Thus, most of the banks may not be able to adopt, even in advanced markets, the IRB foundation approach and would initially adopt Standardized Approach.

With a view to encouraging the banks using Standardized Approach, to move over to the IRB Approach at the earliest, and also to equip them during the interregnum to adopt robust internal rating systems, they may be allowed to use the internal ratings for assigning preferential risk weights, on certain types of exposures, subject to compliance with the minimum standards prescribed by the Basel Committee for internal ratings under the IRB Approach.

This could be gradually extended to a larger portion of the banks' asset portfolio. This will encourage banks to refine their credit risk assessment and monitoring process, which would facilitate better management of their asset portfolio. This will also avoid the use of ECAIs in the regulatory process and reduce the burden of additional cost on this count. Besides, the scarce supervisory resources will be optimally utilized for validating the banks' internal rating systems rather than for approving ECAIs. This would also avoid conflict of jurisdiction over rating agencies.

RBI Comment

RBI, therefore, feels that while the internationally active banks in emerging economies may be initially required to follow the Standardized Approach, they may be allowed to use the internal ratings for assigning preferential risk weights, on certain types of exposures, after validation of the internal rating systems by the national supervisors.

Internal Rating-Based Approach

RBI appreciates the Basel Committee's proposal to offer a range of options of increasing sophistication for providing explicit capital charge for credit risk. RBI recognizes the inherent attractiveness of the IRB Approaches, which will result in better internal credit risk management. However, the minimum requirements stipulated even under the IRB foundation approach are difficult to be implemented, especially in the emerging markets. Most of the banks do not have robust rating systems and historical data on Probability of Default (PD), nor do the supervisory authorities maintain time series data for estimating Loss Given Default (LGD).

It is well recognized that the proposal to assign banking book exposures into six broad classes of exposures with different underlying credit risk characteristics – corporates, sovereigns, banks, retail, project finance and equity under IRB Approach would better discriminate the likely pattern of portfolio losses. However, a common framework for definition of these segments, without recognizing the institutional framework, value of accounts or geographical spread, may pose severe implementation problems to banks in the emerging markets.

RBI Comment

RBI, therefore, re-iterates that national supervisors may have discretion and flexibility in defining the exposure classes, such as corporate, retail, sovereign and project finance.

Operational Risk

In the context of increasing globalization, enhanced use of technology, product innovations and growing complexity in operations, RBI agrees, in principle, with the Committee's proposal to assign explicit capital charge for operational risk. RBI also acknowledges that the range of approaches of increasing sophistication – Basic Indicator, Standardized and Advanced Measurement – would set the basic framework for estimating capital for operational risk. Given the sophistication and database required for Standardized and Advanced Measurement Approaches, most of the banks, especially those domiciled in emerging markets would be adopting the Basic Indicator Approach.

The Committee has proposed that at national discretion, banks can use Alternative Standardized Approach (ASA) for calculating operational risk capital charges. This would serve as an intermediate stage for banks which are migrating from the Basic Indicator Approach to the Standardized Approach. It is observed that under the ASA, the beta will be 15% for retail and commercial banking if they are aggregated and the banks unable to disaggregate their gross income into the other six business lines can aggregate the total gross income for these six business lines using a beta of 18%. This suggests adoption of a higher beta under the ASA as compared to the beta applicable to the Basic Indicator Approach which is 15% and may not, therefore, effectively serve the intended purpose of serving as an intermediate stage for banks migrating from the Basic Indicator Approach to the Standardized Approach.

RBI Comment

RBI, therefore, is of the opinion that the Committee may review the beta applicable to the various lines of business under the ASA, especially when the banks are not able to disaggregate their income for some of the lines of business and keep the effective capital charge under the ASA at a stage between that required under the Basic Indicator Approach and the Standardized Approach.

It has been proposed that under the Alternative Standardized Approach, the exposure indicator for 'retail banking' and 'commercial banking' business lines may be the 'volume of advances multiplied by m (which is 0.035)' instead of 'gross income'. It is also proposed that loans and advances for the purpose would be taken gross of provisions. Since this measure is intended to serve as an alternative to the measurement of gross income of these two business lines, it would be in order to reckon the advances 'net of non-performing loans' under the Alternative Standardized Approach.

RBI Comment

RBI is of the view that the proposal to alternatively consider volume of advances (instead of gross income) would imply a substantial increase in capital charge for operational risk. Hence, RBI feels that the volume of performing advances may be considered under the Alternative Standardized Approach.

Approach of RBI for Implementation of BASEL II – Specific Comments of RBI

International lending to developing and emerging economies

Under the CP 3, banks have the choice to adopt any one of the following methods for measuring credit risk:

- Standardized Approach (SA).
- Foundation Internal Ratings-Based Approach (FIRB).
- Advanced Internal Ratings-Based Approach (AIRB). Under the SA, the risk weight for sovereign exposures would depend upon the rating assigned to such sovereign exposures by export credit agencies. Under the IRB (Internal Ratings Based) Approaches, the risk weight would depend upon the rating by the banks' internal ratings model, and is computed as a function of the following four factors – probability of default, loss given the default, exposure at default and maturity. While the risk weight for exposures with the lowest rating (Below B) under the SA is 150%, the same is likely to theoretically go up to 1250% under the IRB Approaches. This clearly illustrates the extent to which the IRB Approaches are more risk-sensitive than the Standardized Approach.

It is unlikely that a developing economy would receive the best of the ratings. It is also largely unlikely that an entity in a developing economy would attract a rating better than the sovereign rating of that economy. In the circumstances, a bank adopting the IRB Approach is likely to be more averse to exposures to developing economies both directly (to the sovereign) and indirectly (to entities in that economy). As has been brought out convincingly in the paper 'Basel II and Developing Countries: Diversification & Portfolio effects' by Stephany Griffith-Jones, Miguel Angel Segoviano and Stepphan Spratt - this aversion may translate into either avoidance of risk or appropriate pricing of the risk resulting in the following scenario:

RBI Comment

Widespread adoption of the IRB Approach by internationally active banks would lead to a significant increase in capital requirements for loans to lower rated borrowers. To the extent that the pricing and availability of international bank loans are influenced by the capital requirements that relate to them, this would imply a sharp increase in the cost and/or reduction in the quantity of international lending to developing and emerging economies. The expressed purpose of the Basle II norms is to better align regulatory capital with actual risk. Therefore, failure of the proposals to take account of the benefits of international diversification suggests that, risk has not been measured accurately. By excluding the possibility that banks' capital requirements should take account of portfolio and diversification effects, the proposals effectively impose an inaccurate measure of risk, at the portfolio level. The fact that the proposals under Basle II will not allow these diversification benefits to be taken into account, suggests that the regulatory capital associated with lending to developing countries will be higher than that which the banks would – and currently are – choosing to put aside on the basis of their own models.

The BCBS has modified the IRB formula to take account of variable asset correlation as related to Probability of default, and those relating to the SMEs. Under the proposed treatment, exposures to SMEs will be able to receive a lower capital requirement than exposures to larger firms. The reduction in the required amount of capital will be as high as twenty percent depending on the size of the borrower, and should result in an average reduction of approximately ten percent across the entire set of SME borrowers in the IRB framework for corporate loans. Since the BCBS has recognized the impact that differential asset correlation can have on the portfolio level risk, there is a strong need that a similar modification is justified with respect to internationally diversified lending.

RBI is of the view that there is a strong case for revisiting the risk weights assigned to sovereign exposures when the exposures are aggregated as a portfolio which enjoy the benefits of diversification similar to the approach adopted for retail exposures.

Trading Book Issues

The Basel Committee has indicated that the changes made in the trading book are consistent with the changes in the banking book capital requirements under the Standardized Approach. However, the Committee's proposal to provide explicit capital charge on the basis of ratings, is not consistent with the banking book capital requirements in respect of the 'other category' which attracts a uniform capital charge of 8% (risk weight of 100%) and does not compare with the risk weight of 150% being proposed for claims on sovereigns, banks and corporates that are rated below B. Unless, the capital charge or risk weights are uniform both in the trading and banking books, the New Accord may lead to banks resorting to regulatory arbitrage.

RBI Comment

RBI, therefore, reiterates that the capital charge for specific risk in the banking and trading books should be consistent to avoid regulatory arbitrages.

Market Discipline – Third Pillar

RBI shares the Committee's view that market discipline can contribute to a safe and sound banking environment. RBI also shares the Committee's view that too much information could blur the key signals to the market and agrees with the proposal to make a clear distinction between core and supplementary disclosures. Further, the proposals to mandate frequent disclosures on information, subject to rapid time decay, would facilitate market participants in taking informed decisions.

General Issues

Impact on Capital under Standardized Approach.

The Committee's views are apparently based on the assumption that capital discharge would be available on assigning preferential risk weights to claims on sovereigns, banks and corporates, on the basis of external assessments and recognition of more collaterals under credit risk mitigation techniques.

However, RBI feels that the adoption of the New Accord would definitely enhance the minimum regulatory capital, especially for banks domiciled in emerging markets on account of the following:

i. All claims on sovereign in India are currently assigned a uniform risk weight of 0%. The discretion to assign a lower risk weight would henceforth be available to claims on sovereign (or Central Bank) of incorporation, denominated in domestic currency and funded in that currency. Other sovereigns are required to be assigned risk weight in the range of 0% to 150% on the basis of external assessments;

ii. Similarly, under the Current Accord, all claims on banks are assigned a uniform risk weight of 20%. The 20% risk weight would become the floor under the proposed accord. Since most of the banks are not rated, they would have to be assigned a risk weight of 50%;

iii. The population of rated corporates is very small and hence most of them would have to be assigned a risk weight of 100%. The benefit of lower risk weight of 20% and 50% would, therefore, be available only to very few corporates;

iv. Past due loans, net of specific provisions, would have to be assigned a risk weight of 150%, if the specific provisions are less than 20% of the outstanding amount of the loan if it is not fully secured or 15% of the outstanding amount of the loan if it is fully secured;

v. Claims on certain high-risk exposures viz. venture capital and private equity, at national discretion, are also required to be assigned a higher risk weight of 150%;

vi. The deduction of significant investments in commercial entities; and

vii. Explicit capital charge requirement for operational risk.

The benefit of credit risk mitigation techniques also may not be available as most of the banks in emerging markets are not in a position to comply with the preconditions stipulated by the Basel Committee. These apprehensions were confirmed by the findings of the QIS 3 conducted by the Committee.

RBI Comment

The RBI therefore reiterates that unless suitably modified, the adoption of the New Accord in its present format would result in a significant increase in the capital charge for banks, especially in emerging markets.

Program of Further Steps by RBI towards Implementation

The Reserve Bank of India (RBI) has decided to convene a meeting of banks before this year-end to assess implications of implementing of the New Basel Capital Accord (Basel II) by 2006-07. Although the Basel document is still not final, the basic architecture is now set and the Reserve Bank of India (RBI) in consultation with banks will evaluate the new framework and plan for the transition of Indian banks to Basel II. The timing, approach, and sequencing of Basel II, which seeks to align capital requirements of banks with their actual risks, will have to be closely tailored to Indian circumstances. The reservations, if any, of RBI are based on the fact that Indian banks do not have the support of sophisticated MIS/data processing capabilities that can measure risks. Our Banks do not have robust rating systems and historical data on probability of default. Nor do the supervisory authorities maintain time series data for estimating loss given default to implement the foundation of internal ratings-based (IRB) approach. The complexity and sophistication essential for banks for implementing Basel II restrict its universal application in the emerging markets. In regard to the standardized approach, which builds on the existing Basel I, RBI's concerns are in regard to the use of external credit rating agencies.

[Source: Press Interview by RBI Executive Director Ms.Shyamala Gopinath.]

Commenting on the problem faced by the Banks in India, The Economic Times in an article titled "Moving in tandem" in its online issue dated Wednesday, June 18, 2003 observes that "There are 105 banks in the country with 55,000 branches – a majority of the public sector banks lack data due to late computerization. At the outset then, this means huge scale IT investments are being made to have the one critical element to implement Basel II successfully: Clean and reliable data-data that is accountable.

"Take for example credit risk-according to the New Basel Capital Accord, internal ratings must be 'grounded in the banks historical experience and empirical evidence'. This follows from the fact that data analysis and statistical modeling are the fundamental basis of any internal rating system - wherein the bank's own default and loss experience is the essential data source for the creation of the rating model."

"At this point, it is important to note that as per the Accord, even though the use of pooled data and mapping of internal rating grades to external data sources are explicitly allowed by the Accord, it is also stated that internal data must always be used, at least to complement these techniques. This is because a rating model that is built on internal data using internal resources is likely to be the superior choice for an internal rating system in most circumstances. It would optimally support banks in generation of disclosure reports, aggregation and decomposition of risk measures, generation of migration matrices, conducting vintage analysis for tracking realized default rates, quality control, rating system monitoring and assessing the model validity.

"More importantly, it establishes a solid foundation for a path towards Risk-Adjusted Performance Management from a strategy perspective. Thus, on an immediate basis, banks need to collect and store a minimum of 3-5 years worth of historical data, ensure data integrity and timeliness of figures, effectively integrate different risk types and guarantee accurate calculation of risk measures."

Focusing the problem faced by Indian Banks from a different perspective, Business Line, Financial Daily from Chennai in its online edition dated Wednesday, December 12, 2002 observes as under much-publicized and oft-debated Basel-II Capital accord has faced growing opposition and provoked concerns over issues such as systemic risk owing to "model-convergence" and "pro-cyclical lending". Notwithstanding such levels of criticism, the inordinate delays and inherent complexities of the proposals, major international banks have already started preparing the roadmap for taking full advantage of the new Basel-II regime. Most banks in India and other developing countries will face stiff competition from these large banks, as the opening up of the banking sector under WTO's General Agreement on Trade in Services (GATS) and the rolling out of Basel-II will be more or less coincidental and also because the business implications of the two are complementary in nature.

The Internal Ratings-Based (IRB) approach proposed by the Basel Committee on Banking Supervision seeks to make bank regulatory capital requirements for credit risk approximate the economic capital requirements. The new accord provides for a win-win situation for mostly large and sophisticated global banks. These banks will be able to function at the lower capital requirements at transaction levels and "cherry pick" the best of deals by aggressive pricing. This is particularly true for acquiring AAA type of assets, as these banks will be able to release substantial capital by using sophisticated risk measurement techniques in their IRB models.

On the other hand, small banks, particularly those outside G10, will be able to apply only simple risk measurement (or standardized) approaches. These banks will have a difficult time competing with their big and sophisticated counterparts, as the regulatory capital requirements for them will be far more than the economic capital they actually need and this regulatory overhead will prove to be a major cause of inefficiency. Unable to compete for quality assets in a market where banks are already price takers, these banks will be left with the lower bands of the rating spectrum which means a riskier balance-sheet, lower credit rating and higher cost of liabilities. The weak getting weaker in a vicious cycle.

Economic Capital-Based (ECB) models help banks in capital budgeting, deal pricing and performance measurement in a "risk-adjusted" framework. As against the traditional financial performance measure of absolute returns, banks can now evaluate performance across the business units using the same performance measure: Risk-adjusted returns. Two businesses that make the same amount of money may involve very different amounts of risk and hence economic capital. A bank may accordingly decide the capital allocation and form a business strategy with a target risk-return profile, which then gets reflected in its credit rating and share price."

To introduce economic capital models, banks will need to understand two elements of economic capital assessment. The first is calculating aggregate economic capital across all sources of risk (simultaneously capturing the underlying diversification that exists among them). The second is allocating that capital to individual business units or profit centers on a risk-efficient basis. Banks must realize that models based on economic capital framework will help in risk-adjusted capital allocation, risk-adjusted pricing and risk-adjusted performance measurement. Moreover, pillar three of the new Basel accord aims at setting a framework for bolstering market discipline, allowing shareholders to see their risk profile."

"Although the time line for Basel implementation seems to be far off (around 2006) and many areas of the accord have not yet been finalized, it will be prudent for banks in developing countries and local regulators to start initial work. The RBI has already communicated to commercial banks under its jurisdiction that they may upgrade their credit-risk management systems for optimizing capital if they wished to take advantage of inbuilt capital incentives available under the IRB models in the new accord."

"There is no doubt that most banks will benefit from the economic capital framework, which is in line with Basel-II discussions and proceedings and modern financial academics. It will provide them with a platform to develop models for managing their businesses efficiently and to compete with the large sophisticated players. It will also help them learn how to use their capital in the most efficient manner, which will be the key to survival in a global, unconstrained and ruthless market in financial services.

"Those banks which develop expertise as well as global standards of risk measurement and analysis, reporting and disclosure now will benefit from improved IRB models and find themselves equipped to face the "activist investor". Those who do not, will be targets for increased consolidation in this capital-starved sector. Some will be purchased and some will go bankrupt, unless there is a bailout package in the offing from taxpayers."

"Basel II represents a logical and appropriate successor to Basel I. Its basic message is that all parts of the international financial system – banks, supervisors and other market participants – can and must become more discriminating in their approaches to risk, and better equipped to anticipate problems before they turn into crisis. The events of the past few years in industrialized as well as developing economies have forcefully driven this lesson home to banks and supervisors alike. Basel II thus reflects both the lessons of the recent past and the direction in which private and official sectors must continue to move.

"It is a major, ambitious, and difficult effort, very much a work-in-progress. And it is in all our interests to continue improving it and help make it succeed."

Before beneficial implementation of Basel II standards accompanied by expert risk-management techniques suited to reap the optimum advantage of capital usage, Indian Banks need to implement total IT usage in their functioning and operations with inter-connectivity of their branches and administrative offices along with re-engineering of their functional systems & business process, as also human resource development policies at par with global standards. This process started with the Banking Sector Reforms in 1992, but subsequently there is a slowdown in recent years. However, when the transformation in all above mentioned areas comes through, Indian Banking can achieve not only global standards, but global leadership, together possessing knowledge superiority and cost advantage. Basel II is, thus, a challenge as well as an opportunity for Indian banks to achieve global standards.

Glossary

Arbitrage : The process of buying a product in one market and selling it in another, and thereby making a profit.

Airway Bill : A receipt from the airline confirming the receipt of goods from the shipper. It serves as a non-negotiable receipt for the shipper.

Ask Price : The price for which a seller is ready to sell a product.

Authorized Dealers : As per Section 2(c) of FEMA, "authorized person" means an authorized dealer, money changer, offshore banking unit or any other person who is authorized to deal in foreign exchange or foreign securities.

Back-to-Back Credit : A credit that is opened against the security of another credit is called the main credit.

Balance of Payments : The account showing movements of goods, services and capital between a country and the rest of the world.

Bank Agencies : These mostly deal in the local currency markets and in the foreign exchange markets, arrange loans, clear bank drafts and cheques, and channel foreign funds into financial markets. They also arrange long-term loans for customers and act on behalf of the home office to keep it directly involved in the important foreign financial markets.

Bank for International Settlements (BIS) : The bank for the industrial countries' Central Banks which helps them manage their reserves.

Beneficiary of LC : The beneficiary is the seller of goods, who is to receive payment from the buyer. The LC is opened in his favor to enable him to receive payment on submission of the stipulated documents.

Bid-Ask Spread : The difference between the bid and ask price.

Bid Price : The price, a buyer is ready to pay for a product.

Bill of Exchange : A written unconditional order for payment from a drawer to a drawee, directing the drawee to pay a specified amount of money in a given currency to the drawer or a named payee at a fixed or determinable future date.

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.

Blocked Currency : A currency that is not convertible into other currencies due to regulations.

Bonded Warehouse : A warehouse authorized by customs authorities for storage of goods where payment of duties on the goods is deferred until they are removed from the warehouse.

Canalized Goods : Goods which are importable only by government trading monopolies.

Capital Account Balance : A part of the Balance of Payments which reflects the net inflow of public and private capital.

Capital Flight : A sudden and mass transfer of capital out of a country due to increased risk perceptions.

Cash Exports : Cash exports are those exports where the proceeds are realized within six months from the date of shipment or the due date for payment, whichever is earlier.

Cash in Advance : A payment method for goods in which the buyer pays cash to the seller before shipment of the goods.

Certificate of Origin : A certified document detailing the origin of goods used in foreign commerce.

Charter Party : Renting of an entire vessel or part of its freight space for a specified voyage or stipulated period of time.

Clean Bill of Lading : A document specifying that the carrier receives the goods in apparent good order and condition.

Commitment Fee : The fee payable on the undrawn balances of a loan.

Consignment : The delivery of merchandise from an exporter to a distributor specifying that the distributor will sell the merchandise and then pay the exporter.

Consortium Banks : They are joint ventures of the larger commercial banks.

Convertible Currency : A currency that is freely convertible to any other currency. On the basis of the transactions for which such conversion is allowed, the currency may be either convertible on the capital account or on the current account.

Correspondent Bank : A bank that provides services to another bank in a different location.

Correspondent Banking : An informal linkage between banks and its customers in different countries.

Cost and Freight (C&F) : "C&F to a named port" is used in connection with a price quotation under which the seller must pay all costs of goods and transportation to the named port except cost of insurance.

Cost, Insurance and Freight (C.I.F) : Same as C&F except that seller also provides insurance up to the named destination.

Countertrade : Involves adjustment of value of goods imported against value of goods exported, in terms of an arrangement voluntarily entered into between two parties.

Country Risk : The risk perceived by a non-resident while dealing with a country in a commercial and/or investment transaction, which arises out of political and economic factors.

Covered Interest Arbitrage : The act of making riskless profits by exploiting the lack of synchronization between the forward premium/discount on a foreign currency and the difference between the interest rates in the two countries.

Cross Rate : The exchange rate between two currencies calculated by using their exchange rates with a third currency.

Currency Swaps : A transaction whereby two currencies are exchanged by the parties involved, only to be exchanged back later.

Current Account Balance : A part of the Balance of Payments which reflects the net inflow on account of trade in goods, services and transfer payments.

Customs Tariff : Charges imposed by the government, and most other governments on imported and/or exported goods.

Deemed Exports : Refer to those transactions in which the goods supplied do not leave the country and the payment for the goods is received by the supplier in India.

Depreciation : A reduction in the value of a currency caused by the market forces.

Devaluation : A reduction in the value of a currency dictated by the authorities.

EPCG : EPCG refers to the Export Promotion Capital Goods (EPCG) Scheme, which gives the manufacturer the facility for import of capital goods for export production at concessional rate of duty against certain level of export obligation over a period of time.

Euribor : The German interbank offer rate for loans denominated in euro.

Euro : The new common currency for eleven European nations, which came into effect from January 1, 1999.

Eurodollar Deposit : A currency outside its home country. For example, a dollar deposit outside the US is referred to as an eurodollar deposit.

European Monetary Union : A monetary system followed by 15 European nations, which culminated in a common currency called 'euro' for eleven of them.

Exchange Rate System : The system which facilitates international payments.

Exim Bank : The Export Import Bank of India, which encourages foreign trade by extending credit.

Export License : A permit required to export commodities falling in the negative list.

Export Promotion Council : EPCs are non-profit organizations and help in promoting and developing the exports of the country. Each council is responsible for promotion of a particular group of products, projects and services.

Ex-Works : An international trade term meaning that the seller's sole responsibility is to make the goods available at seller's premises. The buyer bears the full cost and risk involved in bringing the goods from there to the buyer's desired destination.

FEDAI : The Foreign Exchange Dealers' Association of India, the self-regulatory body for the Authorized Dealers in foreign exchange.

Fiat Money : Money whose face value is greater than its intrinsic value because of a government decree.

Fixed Exchange Rate System : A monetary system under which the exchange rates between currencies are maintained at particular levels, which do not change frequently.

Floating Exchange Rate System : A monetary system under which the exchange rates change frequently in accordance with the market forces.

Floating Rate Notes : Bonds with a coupon rate that changes from period to period, with reference to some market rate like LIBOR.

Foreign Direct Investment : Investment in physical assets in a foreign country with the operating control being with the investor.

Forfeiting : It is a form of trade financing undertaken in export transactions wherein the exporter surrenders his right for claiming the payment for services rendered or goods supplied to the importer in favor of the forfeiter.

Forward Discount : The difference between the spot price and the forward price of a currency expressed in percentage terms, with the forward price being lower than the spot price.

Forward Premium : The difference between the spot price and the forward price of a currency expressed in percentage terms, with the forward price being higher than the spot price.

Forward Rate : The rate quoted today for buying/selling a foreign currency at a future date.

Forward Rate Agreement : An agreement under which the seller assures the buyer certain interest rate on a notional sum for a pre-determined term, which is with reference to a pre-selected market rate, at the end of a specified period. The difference between the agreed rate and the actual market rate prevailing at the end of the specified period, is paid by the seller to the buyer, if the agreed rate is higher than the market rate, and vice-versa.

Free Trade Zone : An area designated by the government of a country to which goods may be imported for processing and subsequent export on duty-free basis.

Gold Points : Limits on either side of the gold parity set by transaction and transportation costs, within which the exchange rates could move under the Gold Standard.

Gold Standard : A historical monetary system wherein the participating countries fixed the value of their currencies in terms of gold.

Harmonized System : The Harmonized System (HS) is a classification system for goods in international trade that provides a domestic market uniform system of product classification for all major trading countries.

Import : To bring foreign goods or services into a country.

Importer Exporter Code : A code number issued by the Director General of Foreign Trade (DGFT) which is required to be indicated on export declaration forms submitted by the exporter.

Import License : A license required and issued by the DGFT authorizing the entry of foreign goods into the country.

Incoterms : An acronym for International Commercial Terms, which are a series of 13 trade terms used in international sales contracts to clearly divide the risks and responsibilities of buyers and sellers with regard to the movement of goods between both parties.

Interest Rate Parity : The condition under which the premium on a foreign currency is equal to the interest rate differential between the two countries.

Interest Rate Swap : An agreement under which two parties exchange a series of interest payments on a specified notional principal for a specific maturity.

International Bank for Reconstruction and Development (World Bank) : A supranational body which extends loans at concessional rates to member countries for projects having high economic priority.

International Banking : A sub-set of commercial banking transactions and activity having a cross-border and/or cross-currency element.

International Chamber of Commerce (ICC) : Established in Paris in 1919, this is a non-governmental organization serving the world business.

International Diversification : The process of investing in securities in more than one country.

International Monetary Fund (IMF) : Another supranational body, created to help countries in maintaining exchange rate stability which came into existence along with the World Bank.

International Private Banking : It consists of banking services primarily provided for non-residents.

Invoice : A document which is prima facie evidence of the contract of sale and purchase.

Irrevocable Letter of Credit : An LC where cancellation or any amendment cannot be made without the prior acceptance of all the parties to the said LC.

J-Curve Effect : The phenomenon of a country's trade balance worsening despite a depreciation of its currency, before it starts improving.

Labuan Model : Under this model, offshore banks are permitted to accept foreign currency deposits from non-residents, grant foreign currency loans of any amount to any non-resident, and up to MYR 1mn to any resident without permission from the controller and loans of higher amounts with permission from the controller.

Lagging : Delaying or postponing payables or receivables. Used as a technique for managing exchange exposure.

Law of One Price : The law that states that the price of a commodity should be the same across nations.

Leading : Bringing forward or advancing receivables or payables for the purpose of managing exchange exposure.

Letter of Credit : An arrangement by means of which a bank (Issuing Bank) acting at the request of a customer (Applicant), undertakes to pay to a third party (Beneficiary) a predetermined amount by a given date according to agreed stipulations and against presentation of stipulated documents.

LIBID : The London Interbank Bid Rate. It exists for various currencies and for different maturities.

LIBOR : The London Interbank Offer Rate, the reference rate for most of the international financial transactions. It exists for various currencies and for different maturities.

Licensing Year : It means the period beginning on the 1st April of a year and ending on the 31st March of the following year.

Loro Account : A bank's account with a foreign correspondent bank, from a third party's point of view.

Multinational Consortium Bank : A new bank created by several established parent banks.

Multinational Corporation (MNC) : A company that operates in a number of countries.

Netting : Matching receivables with payables in the same currency to arrive at the net amount.

Nostro Account : A bank's account with a correspondent bank located in a foreign country.

Official Reserves : The Central Bank's holdings of foreign currencies, gold and SDRs.

Offshore Banking Units : They normally comprise sub-offices of multinational banks, set-up to freely transact in international currencies, especially with non-residents.

Open Market Operations : An instrument for controlling the level of money supply in the economy, whereby the Central Bank buys or sells government securities in the market.

Political Risk : It refers to the uncertainty over government action that affects the value of a firm.

Pre-shipment Finance : Pre-shipment finance is a short-term finance (inventory finance) extended to exporters in anticipation of export of goods. This finance enables exporters to procure raw materials, process, manufacture, warehouses, ship the goods meant for export.

Price-specie-flow Mechanism : The mechanism which automatically sets right any imbalance in the international payments under the Gold Standard.

Pro Forma Invoice : An invoice prepared by an exporter before the shipment of merchandise informing the buyer of the kinds of goods to be sent, their value and important specifications such as size, quantity and weight.

Project Exports : Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as "Project Exports".

Protectionism : The effort of a government to protect the domestic industry from a more competitive foreign industry by erecting trade barriers.

Purchasing Power Parity Theorem : The theory that states that the purchasing power of all the currencies in the world should be the same. It has three versions – absolute, relative and expectations forms.

Real Exchange Rate : The nominal exchange rate between two currencies adjusted for the price movements in the two countries over a period of time.

Real Time Gross Settlement System (RTGS) : RTGS allows the funds transfer orders to be settled as soon as they have been sent, provided that the sending bank has sufficient cover in its account with the Central Bank. With this, the exposures become more transparent, and therefore the participant should be in a position to continuously monitor their risk settlement accounts and credit limits, if any.

Reporting Currency : It is the currency in which an entity prepares its financial statements.

Revocable Letter of Credit : A revocable Letter of Credit is one which can be revoked (either cancelled or amended) by the issuing bank without giving notice to any of the parties concerned.

Revolving Credit : A Letter of Credit whereby the credit available to the beneficiary gets reinstated to the original amount once a drawing is made, is called revolving credit.

Sight Draft : A draft payable upon presentation to the drawee.

Society for Worldwide Interbank Financial Telecommunications (SWIFT) : A worldwide computer network that supports international funds transfers between banks.

Spot Rate : The rate quoted today for a currency to be delivered after two working days.

Standby Letter of Credit : In a standby Letter of Credit, the credit is payable upon certification of a party's non-performance of the agreement, of course upon adducing evidence to the effect that payment has indeed been defaulted.

Sterilization : Intervention by a Central Bank to prevent the BoP, a situation from affecting the domestic money supply.

Swap Points : The difference between the spot rate and the forward rate for a currency expressed in points.

Terms of Trade : The ratio of the prices at which a country exports its products to the prices at which it imports its products from other countries.

Transfer Risk : This encompasses potential restrictions on the ability to remit funds across sovereign borders.

UCPDC : Standardized code of practice issued by the International Chamber of Commerce in Paris covering Documentary Credits.

Uruguay Round : The most recent round of trade talks (1989-1994) of the member countries of GATT.

Value Date : The date when the settlement of a spot transaction or a forward contract takes place.

Vostro Account : A Vostro account from the correspondent bank's point of view.

Wharfinger : The owner or in-charge of a structure built near a harbor for facilitating the loading and unloading of goods into ships (a wharf). The goods remain in his custody before being loaded/ after being unloaded for which the exporter/importer is required to pay a rent. The wharfinger enjoys a lien on the goods till the rent is paid.

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