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Market Watch

Banks wary of rising hedging cost

BY SUGATA GHOSH, ET BUREAU | UPDATED: JUL 01, 2019, 04:58 PM IST

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MUMBAI: A dozen large **banks** have alerted the Reserve Bank of India (**RBI**) about the spike in hedging cost of corporates as banks are unable to handle surplus **dollar**.

The higher hedging cost, as borne out by 100 basis points rise in dollar-rupee forward premium in the past three months, is hurting importers and threatening to unsettle plans of many corporates who took cheaper foreign currency loans.

Over the last few weeks several large Indian and MNC banks met senior RBI officials to put across their point, two senior bankers told ET.

They have sought the central bank's intervention in allowing foreign banks operating in India to freely park extra dollars offshore with their head office; alternatively, RBI should carry out swaps, as it had done earlier, to absorb the surplus dollar from the banking system.

There are multiple reasons behind the hardening hedging cost: a new exposure rule for banks; RBI announcing and discontinuing dollar-rupee swap deals; and higher external commercial borrowings (ECBs) by corporates.

Swap Deals Encouraged Corporates

Easier norms on foreign currency borrowings and special foreign **currency swap** deals announced by RBI this year — in which RBI took dollars from banks and supplied them rupees — had encouraged many corporates to step up their foreign currency borrowings. More so, because these three-year swap deals by RBI kept the premium and hedging cost low. And, since it was widely perceived (following hints from RBI officials) that such swaps would be conducted on a regular basis, **corporate** were emboldened to borrow more in foreign currencies and hedge their risks (arising out of currency fluctuation) at a manageable cost.

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MAKING OF THE PROBLEM

RBI's \$/Re swaps kept hedging cost low	Corporates were tempted to borrow in dollars	Problem began with banks unable to handle excess dollars
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EXCESS DOLLARS BECAUSE

MNC banks could not park \$ with HQ	And RBI stopped swaps	Therefore: Forward premium or hedging cost rose as banks swapped \$ in market
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A corporate that brings in foreign currency loan exchanges the money into local currency by entering into a swap deal with a bank — the corporate gives the bank dollars and accepts rupees from the bank. The difference between the interest on dollar which the bank is supposed to pay the corporate and the interest on rupee which the corporate is required to pay the bank roughly constitutes the forward premium.

As more and more corporates borrowed in dollar, more foreign currency had to be swapped. The foreign banks, which are large players in these deals, typically placed the surplus dollar with their head-office abroad — a customary transaction they have been carrying out for decades. But this was no longer possible since April with RBI changing the large exposure rules for banks.

Under the new rule, the quantum of exposure a bank can have on another bank is linked to its capital. (Till now such restrictions for a bank largely applied to its exposure to a corporate or a business group). Even though the Indian branch and the headquarters of a foreign bank are part of a single global balance-sheet, the local bank's exposure to its head-office came under the exposure restrictions laid down in the new regulation.

Thanks to the new rule, foreign banks who took dollar from corporates as well as from other banks (as part of swap deals) could not park the fund with their head-offices. Instead, they were forced to swap the dollars to another bank. With more and more banks entering the market to swap dollar, the swap rate rose. (In other words, the interest on rupees taken in from a swap rose while the interest on dollar given out in a swap fell, thereby, widening the interest differential or the forward premium).

"On one hand, RBI had stopped announcing three-year swaps while on the other hand the new exposure norms held back banks from parking dollar with headquarters. As a result, many banks were stuck with dollars which had to be swapped. This pushed up rates... It was a perfect example of how a well-meaning measure backfired. When forward premium rises, it hurts a lot of people. And when the one-year forward rates goes up, it has a cascading effect on two or three years also though not to the same extent," a banker told ET.

Stretching the large exposure rule to inter-bank deals was primarily to protect local branches and depositors in India from possible turmoil of the main bank abroad. "But this is having unintended consequences...under the circumstances, RBI has to announce more swaps to soak in the dollars. However, we don't know when RBI would do it," said another banker.

Till now, RBI conducted two swaps of \$5 billion each from bids of \$19 billion and \$16 billion. But, the central bank stopped further auctions after a large corporate cornered the entire swap. "More than \$10 billion had to be swapped in the market as there was a bunching up of dollar loans. Banks have told RBI to come out with greenshoe options in subsequent auctions so that no single corporate would bid aggressively. Putting a cap for a single bidder was also suggested... We are yet to hear anything from RBI. But if forward rates have to be lowered in the near term, the regulator has to consider carrying out more swaps or changing the exposure rules," said another banker.

RBI officials did not comment on the matter.

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