

ISDA

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**BY FAX (9122 - 266 1784 & 267 5831)
AND BY COURIER**

Dr. Bimal Jalan, Governor
Dr. Y.V. Reddy, Deputy Governor
Reserve Bank of India
Central Office
Central Office Building
Shahid Bhagat Singh Road
Mumbai 400 001
India

Dear Dr Jalan and Dr Reddy,

Re : Circular dated 23rd June, 2000 relating to Foreign Currency - Rupee Swaps

The International Swaps and Derivatives Association, Inc. ("ISDA") respectfully requests the opportunity to submit this comment letter to the Reserve Bank of India ("RBI") in relation to the circular No. EC.FMD.No.676/02.03.75/99-2000 dated 23rd June, 2000 (the "Circular") on foreign currency-rupee swaps.

ISDA is an international organisation whose membership comprises over 500 of the world's largest commercial, merchant and investment banks, corporations, governmental entities and other institutions. ISDA's members represent a broad cross-section of the institutions that are dealers in, and end-users of, privately negotiated derivatives ("**over-the-counter**" or "**OTC**" derivatives) both in India and world-wide. A recent list of ISDA's members is attached as Annex A to this letter. As you may recall, when RBI had issued the draft IRS Guidelines by its press release dated 22 June 1999, ISDA had made certain submissions/comments. ISDA and its members are glad that ISDA's submissions/comments were taken note of by the RBI in finalising the IRS Guidelines. It has been ISDA's constant endeavour to engage in constructive dialogue with the regulators in different jurisdictions with a view to assist in developing appropriate and sustainable market practices.

1. Introduction

ISDA wishes to express its support of RBI's aims to deter the abuse of derivative transactions which circumvent existing government regulations against the pre-payment of external commercial borrowings.

However, members of ISDA are concerned about some of the more far reaching impacts which the Circular might bring to the currency swap market which go beyond deterring the prepayment of external commercial borrowings. On behalf of its members, ISDA respectfully submits that some of the restrictions in the Circular should be met with caution as they may fetter the ability of banks and authorised institutions to act in a commercial manner which may in turn impact on the efficient functioning of the currency swap markets and other related markets as a whole.

In particular, ISDA has identified the following concerns in respect of the Circular:

- Definition of "fully matched" transactions is unclear
- Hedging of foreign currency exposures on a "fully matched" basis may be impossible
- Alternative measures are available to address RBI's concerns
- Consequential difficulties for Indian corporates to raise funds overseas
- Unfavourable impact on the continued development of the financial markets

Where appropriate, ISDA also respectfully submits to RBI appropriate courses of action for consideration by RBI.

2. The Circular

ISDA understands that, prior to the Circular, authorised dealers in India may arrange foreign currency-rupee swaps with corporates who run long-term foreign currency exposures or are willing to assume long-term foreign currency exposures. In doing so, such transactions are to be concluded on a matched basis as far as possible. However, where this is not feasible, authorised dealers may temporarily warehouse the swaps and absorb the mismatches within their open position and gap limits. ISDA has been given to understand that, in granting this liberty to authorised dealers, RBI was facilitating the development of a market with sufficient depth where a single large transaction will not create undue volatility in the market with the result that Indian corporates could enter into foreign currency-rupee swaps without undue difficulty and at competitive rates.

ISDA notes that, pursuant to the Circular, authorised dealers may only enter into foreign currency-rupee swaps on a "fully matched" basis. In this regard, ISDA understands that there has not been any concrete guidance on what would constitute "a fully matched" transaction and this has given rise to difficulty in interpretation in practice.

3. Complete Restriction on Hedging of Foreign Currency Exposures

ISDA has spoken with a number of market participants who are concerned that it is almost impossible to find exact and "fully matched" transactions in the market. ISDA understands that this would effectively mean a standstill of the foreign currency-rupee swap market.

Although, in theory, Indian corporates can hedge by entering into forwards which are still allowed under current regulations (subject to fulfilment of certain conditions), it is understood that forwards generally have a maximum maturity period of 1 year and there is only a very small market for forwards with maturity beyond 1 year. Furthermore, ISDA understands that Indian corporates may be reluctant to enter into forwards since the tax and accounting treatment of forwards are very different from swaps.

Consequently, Indian corporates have found themselves unable to effectively hedge their balance sheet exposures and this has in turn created an undesirable situation of unhedged long term liabilities. Since the issuance of the Circular, ISDA understands that the spreads for foreign

currency-swaps have widened and that there have been no foreign currency-rupee swaps in the market except in a small number of cases with the express permission from RBI on a case by case basis.

It is believed that this restrictive control may unduly hamper the development of the currency swap market in India and the adoption of sound risk management practices by Indian corporates.

4. Overseas Fund Raising and Foreign Direct Investment

ISDA notes that the difficulty in managing currency risks effectively may have an adverse impact on the ability of Indian corporates to raise funds overseas and the flow of foreign direct investments into India.

ISDA understands that it is common for Indian corporates which raise funds overseas to also enter into currency swaps to hedge their foreign currency risks. When it becomes extremely difficult to hedge foreign currency risks, ISDA notes that the costs of foreign currency borrowings may increase and Indian corporates may find it impossible or prohibitively expensive to raise funds overseas. Consequently, the funding requirements of Indian corporates may not be readily satisfied even when there are foreign lenders willing and ready to extend such foreign currency facilities.

Similarly, it is common for foreign investors in India to hedge the local currency risks of their locally incorporated subsidiaries by such local subsidiaries entering into foreign currency-rupee swaps. If currency risks cannot be effectively managed due to the reason that currency swaps are impossible or otherwise prohibitively expensive, foreign investors may be wary of investing in India even when presented with extremely attractive business opportunities.

Reduction in funds and foreign investments may have a significant adverse impact on the development of an integrated and efficient financial market in India.

5. The Foreign Currency Swaps Market

ISDA understands that one of the reasons for the Circular may be to limit speculation on the rupee and to alleviate any pressure on the rupee spot market. A number of market participants have indicated that most foreign currency-rupee swaps are accompanied by foreign currency debt. The impact on the rupee spot market is accordingly likely to be minimal. From the experience of various ISDA members, Indian corporates usually use foreign currency-swaps for long term hedging purposes and not to take advantage of short term movements in the rupee exchange rate.

On a more general note, since RBI introduced interest rate and currency swaps, the foreign currency and money markets have become much more integrated. There are clear indications that the financial markets have become more efficient and robust than they have ever before as a result. To bring the currency swap market to a virtual standstill now by prohibiting the warehousing of currency swaps would not be conducive, or may even bring about a setback, to the continued healthy growth and development of the financial markets and to the adoption and implementation of sound risk management policies by Indian corporates.

6. Conclusion

ISDA believes that foreign currency swaps are an essential and necessary tool for corporates to prudently manage their currency risks. To impose the requirement that the swaps must be perfectly matched may unduly reduce the opportunities for effective currency risk management.

ISDA appreciates the concerns of RBI to limit the abuse of foreign currency swaps to circumvent Indian mandatory rules in relation to prepayment of foreign debt. However, ISDA understands from a number of market participants that it is not a common practice for Indian corporates to try to circumvent the government regulations on prepayment of foreign debt by using foreign currency swaps. ISDA respectfully submits that in any event this concern can be more effectively addressed by imposing restrictions which are more finely tuned and focused on such avoidance measures without unduly disrupting the whole foreign currency swap market.

ISDA sincerely hopes that RBI will reconsider the scope of the Circular to allow market participants greater flexibility in prudent currency risk management and to revise the Circular in view of issues highlighted in this letter. Toward this end, ISDA believes that it would be mutually beneficial for representatives of ISDA to meet with RBI to discuss these important issues arising from the Circular.

ISDA would also like to take this opportunity to inform RBI that ISDA has recently set up a regional office in Singapore (in addition to Tokyo) in response to the rapidly growing derivative business and ISDA's memberships in Asia. ISDA verily believes that this will give a further boost to its presence in Asia and strengthen its exchanges and cooperation with various government and regulatory bodies in the region, including RBI.

If RBI has any questions regarding ISDA's comments or wishes to have a meeting arranged to discuss any issues arising on the Circular, ISDA would be most grateful if RBI could contact Mr. Azam Mistry on 852-2822 3818 in Hong Kong or Ms. Angela Papesch on 65-538 3879 in Singapore.

Yours faithfully,

**For The International Swaps and
Derivatives Association, Inc.**


Azam Mistry
ISDA Board of Directors

&
Director, Head of Risk Management Advisory
Treasury and Capital Markets
Hongkong and Shanghai Banking Corporation Ltd.


Angela Papesch
Head of Asia-Pacific Office, ISDA

CC: Ms Usha Thorat, Chief General Manager-in-Charge, IDMC, RBI
Ms Shyamala Gopinath, Chief General Manager, DEIO, RBI