Handbook on

SETTLEMENT OF FOREIGN EXCHANGE IN INDIAN RUPEE

BANKING, FINANCIAL SERVICES AND INSURANCE BOARD (BFSIB)

THE INSTITUTE OF COST ACCOUNTANTS OF INDIA

Statutory Body under an Act of Parliament

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Behind every successful business decision, there is always a CMA

Vision Statement

“The Institute of Cost Accountants of India would be the preferred source of resources and professionals for the financial leadership of enterprises globally.”

Mission Statement

“The CMA Professionals would ethically drive enterprises globally by creating value to stakeholders in the socio-economic context through competencies drawn from the integration of strategy, management and accounting.”

About the Institute

The Institute of Cost Accountants of India is a statutory body set up under an Act of Parliament in the year 1959. The Institute as a part of its obligation, regulates the profession of Cost and Management Accountancy, enrols students for its courses, provides coaching facilities to the students, organises professional development programmes for the members and undertakes research programmes in the field of Cost and Management Accountancy. The Institute pursues the vision of cost competitiveness, cost management, efficient use of resources and structured approach to cost accounting as the key drivers of the profession. In today's world, the profession of conventional accounting and auditing has taken a back seat and cost and management accountants are increasingly contributing toward the management of scarce resources and apply strategic decisions. This has opened up further scope and tremendous opportunities for cost accountants in India and abroad.

After an amendment passed by Parliament of India, the Institute is now renamed as "The Institute of Cost Accountants of India" from "The Institute of Cost and Works Accountants of India". This step is aimed towards synergising with the global management accounting bodies, sharing the best practices which will be useful to large number of trans-national Indian companies operating from India and abroad to remain competitive. With the current emphasis on management of resources, the specialized knowledge of evaluating operating efficiency and strategic management the professionals are known as "Cost and Management Accountants (CMAs)". The Institute is the largest Cost & Management Accounting body in the world, having approximately 5,00,000 students and 90,000 members all over the globe. The Institution headquartered at Kolkata operates through four regional councils at Kolkata, Delhi, Mumbai and Chennai and 115 Chapters situated at important cities in the country as well as 11 Overseas Centres. It is under the administrative control of Ministry of Corporate Affairs, Government of India.

Behind every successful business decision, there is always a CMA

CMA Ashwin G. Dalwadi
President
The Institute of Cost Accountants of India

PRESIDENT'S MESSAGE

The Banking, Financial Services and Insurance Board has brought out this publication titled "Settlement of Foreign Exchange in INR" and I thank all the BFSI Board Members and CMA Chittaranjan Chattopadhyay, Chairman, BFSIB for conceptualizing and putting in untiring efforts for the fruition of this publication.

This Handbook covers the full scope of pertinent topics such as the in–depth analysis of the Vostro account, financing International Trade and takes a peek into the future of International Trade.

I am sure that this Handbook will cater exclusively not only to the Banking community but also to members, students, traders and different practitioners in Foreign Exchange and Treasury businesses.

I also thank the notable experts who have contributed their valuable time and experience to make this publication a success. We hope to see many more noteworthy publications in the near future from BFSI Board so that the members and stakeholders get benefited.

In an effort to contribute to a greener and cleaner environment, we have released this publication in e-format. All stakeholders can download this publication from the BFSI portal on Institute's website for their knowledge enhancement.

(CMA Ashwin G. Dalwadi)

President

The Institute of Cost Accountants of India (ICMAI)

CMA B B Nayak
Vice President
The Institute of Cost Accountants of India

VICE-PRESIDENT'S MESSAGE

I thank CMA Ashwin G. Dalwadi, President of ICMAI and BFSI Board Members and especially CMA Chittaranjan Chattopadhyay, Chairman, Banking, Financial Services and Insurance Board (BFSIB) for initiating the online publication of the handbook titled "Settlement of Foreign Exchange in INR".

I would like to thank CMA Nijai Gupta, Resource Person of the publication, Shri B. Raj Kumar, Former Advisor of the Department and Former Deputy Chief Executive of Indian Banks' Association, Shri Syamal Ghosh Ray, Former Consultant and Former General Manager, Union Bank of India (erstwhile Andhra Bank) and Shri Vikas Babu Chittoprolu, Deputy General Manager, Union Bank of India for both their individual and collective efforts in giving shape to the Handbook.

With this context, I would like to re-iterate that the Handbook on the topic of "Settlement of Foreign Exchange in Indian Rupee" is a whole-hearted attempt to educate professionals about the different aspects of the trade carried out in Indian rupees and the steps taken to establish INR as a global currency. The Reserve Bank of India has issued guidelines for the new mechanism that will enable invoicing and settlement of trade between domestic importers and exporters, specifically in Indian rupees (INR). The decision will be especially beneficial for growth in trade and the INR Surplus balance in special Vostro accounts can be used for payments for investment in Government treasury bills and securities.

I am sure that the members, students and all stakeholders as well as those in the Banking industry will find the handbook as a ready reckoner for the queries that they may have regarding this topic.

I would express my gratitude to the rest of the BFSI Team for their laudable efforts for working on this publication.

(CMA Bibhuti Bhusan Nayak)

Vice-President

The Institute of Cost Accountants of India

CMA Chittaranjan Chattopadhyay
Chairman – Banking, Financial Services & Insurance Board
The Institute of Cost Accountants of India

FOREWORD

The negative spillover of the panoptic destruction from the Covid-19 pandemic followed by the Ukraine conflict further exacerbated the slowdown in the global economy. The zero-Covid policy of China having caused supply chain disruptions along with the looming shadow of stagflation had affected the Indian economy. As the Capital market is forward looking, it is imperative to inculcate policies that resonate equally well with the changes in the fiscal, monetary, climate and debt policy. The war's effect on energy prices had been felt across all the strata of the Indian society, leading to lower real income, raising production costs of goods and services thereby tightening financial conditions. It is commendable that the Central Bank maintained such resilience and realism amidst the geopolitical conflict that was creating tumultuous macro-economic environment at that time.

On 11th July 2022, the Reserve Bank of India (RBI) allowed the settlement of international trade in Indian rupees. Since then, Rupee invoicing has become a buzzword. The successive interest rate hikes by the US Federal Reserve to tackle inflation has considerably strengthened the US dollar. The situation justifies policies which requires limited usage of the dollar so as to arrest the weakening of the Indian rupee. As per the Reserve Bank of India, internationalization of the rupee is inevitable. As per the new Foreign Trade Policy 2023, India targets to achieve $2 trillion of exports and focuses on international trade settlement in rupees.

A transparent and efficient framework for conducting international trade transactions in INR will ultimately lead to the global acceptance and widespread economic exchange. This would help the INR as a currency of choice for trade among the economic partners.

I am confident that the Handbook will prove to be useful to the members of the Institute as well as Bankers and other professionals. This handbook contains the wide gamut of the subject matter that can be easily grasped in a lucid and simple language.

I wish you all a very happy reading!!!!

CMA Chittaranjan Chattopadhyay
Chairman
Banking, Financial Services & Insurance Board
The Institute of Cost Accountants of India

BANKING, FINANCIAL SERVICES & INSURANCE BOARD

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NEED, IMPORTANCE AND HISTORY OF INTERNATIONAL TRADE

The need for international trade emanated from the "Hunger" of the people. International trade gives access to the individuals to utilise a wide variety of goods and services which would have been unavailable in any other circumstances. For example, in the past as the food choices were very limited; a person in the midst of the hot and arid desert of the Middle East had nothing to eat except for animal meat (mostly camel) or dates. The non- availability of natural resources, fertile soil, proper climatic conditions and relatively high input costs of agriculture would raise the valid question of providing staple and basic food items (such as grains, pulses, fresh fruits and vegetables etc.) to people to satiate their hunger. Archetypal apex predators (bigger animals) at the top of the food chain relentlessly chase and hunt smaller animals to satiate their hunger. In the similar manner, the hunger of people had forced the rulers of the country to explore other avenues to obtain food. What started as exploration for food had slowly expanded to other requirements. For instance, currently India with its fertile land and congenial climatic conditions had food surplus but has shortages in energy stock like crude oil. This necessitates the need for engaging in international trade between two countries and results in selling/buying or export/import of goods for goods.

Source: Google - Image; RBI allows international trade settlement in Rupee - The Hindu Business Line

The importance of international trade was felt by India (and every other country) to promote such cross-country business through firms/ companies under various trade regulations like Foreign Trade Policy and settlement of foreign exchange under FEMA 1999, creating Institutions like Customs, DGFT, FEDAI, Banks, Central Banks etc. for facilitating such trade and business. In the process, countries started benefiting in terms of higher growth, meeting trade/fiscal deficits, creating forex reserves, creating profit for the firms and employment for the individuals and promotion of respective countries' currencies for settlement of international trade.

We live in an age where international trade is an indispensable aspect. You can order things from across the globe with the click of a button. International trade is a massive industry and it's only growing. The history of international trade goes back to thousands of years, but it took off in the modern era after the Industrial

Revolution. Just like in other areas of life, there have been considerable changes in the way international trade is carried out.

What is International Trade?

International trade refers to the exchange of goods and services between countries. This can include the import and export of goods and services, as well as the transfer of natural resources, industrial resources, technology, capital, and intellectual properties. International trade can be conducted through a variety of channels, such as direct investments, bilateral trade agreements, and multilateral organizations like the World Trade Organization (WTO).

What is the need for International Trade?

The need for international trade arises because countries including their businesses and individuals have different resources, skills, and production capabilities. Few countries have advantages in their advanced technologies; Nature blessed resource endowments, favourable government policies, existence of economies of scale leading to production exceeding the demand. Few countries may not have such advantages and for few, a mix of both. Hence, by trading with one another, countries can access a wider variety of goods and services and can specialize in producing the goods and services for which they have a comparative advantage. This way trade allows for greater economic efficiency, can promote economic growth culminating into new international political economy and enabling the countries to rethink their economic policies. Additionally, trade enables the sharing and understanding of cultures and ideas.

History of international trade:

Trade has been a vital aspect of human civilization whether at the local or international level for thousands of years. The origins of trade can be traced back to ancient civilizations, such as the Sumerians and the Egyptians, who traded goods and services through barter and other forms of exchange. As civilizations developed, trade became more complex and sophisticated. Development of money, advances in transportation, advances in communication have aided people to trade goods and services over greater distances. International trade has a long history of evolution having a profound impact on the individual countries' economies and the whole global economy. It is a complex and dynamic field that continues to evolve. Some of the key milestones in the evolution of international trade with different historical periods characterized by different forms of trade and trade networks are enumerated below:

Prehistoric Trade: The domestication of the horse around 4800 BC allowed for the development of horse riding around 3700 BC, and long distance travel across the Central Asian regions is said to be the start of trading across different places.

Ancient Trade: During the period ending till 1st Century, trade flourished through an exchange of goods and services based on a standard of value both parties considered fair. Trade between ancient civilizations, such as the Sumerians, Mesopotamians, Egyptians, and Phoenicians, was conducted through barter and other forms of exchange without the use of money. Trade networks existed between China and Mediterranean. Sea faring people such as the Phoenicians and the Greeks established trades routes by sea. In ancient Mesopotamia and Egypt, trade was mainly conducted through the exchange of goods in marketplaces. The ancient Egyptians, for example, traded goods such as papyrus, linen, and gold with other civilizations in the Near East and Africa. The use of money as a medium of exchange also developed during ancient times, with the first coinage appearing around 600 BCE in Lydia (now part of Turkey)

Medieval Trade: During the middle ages from 1st Century to 15th Century, trade was dominated by merchants and guilds, which controlled the production and sale of goods in a location. Guild is an association of artisans or merchants who oversee the practice of their trade in a place / town. Trade was conducted through a variety of different trade routes and networks. The most noteworthy of these were the Silk Road route, the Mediterranean Sea trade routes and the Hanseatic League.

The Silk Road route, which had been in use since ancient times, continued to connect Asia and Europe during the medieval period. This trade route was used to transport goods such as silk, spices, and precious metals, and it also played a significant role in the spread of ideas and cultural exchange between different civilizations.

The Mediterranean Sea routes (also called as Spice routes) connected the ports of the Islamic world, the Byzantine Empire, and the Italian city-states. With the raise and spread of Islam from Arabian heartland in 7th Century, Muslim traders started dominating Mediterranean and Indian Ocean trade. The Islamic Caliphate controlled the Red Sea and the Indian Ocean and facilitated the trade of luxury goods such as spices, silk and gold with the Mediterranean countries. The Italian city-states, particularly Venice and Genoa, became major trading powers in the Mediterranean region through their control of important trade routes and ports

The Hanseatic League is a trade organisation that is a federation of trading cities and its merchants in northern Europe. It controlled trade in the North and Baltic Sea, and its members traded goods such as timber, grain, and fish with other European countries

Overall, international trade during the medieval period was conducted through a variety of land and sea routes, and it played a significant role in the economic development of various civilizations and the spread of culture and ideas. However, trade was limited by the lack of reliable transportation and communication technologies, the difficulty of maintaining trade routes across hostile territories and the lack of protection from pirates and other dangers.

Exploration Age: The exploration age which spanned from the late 15th to the early 17th century, was characterized by the expansion of European nations into new regions which further led to the establishment of colonies. This period was marked by the voyages of explorers such as Christopher Columbus, Vasco da Gama, and Ferdinand Magellan, who explored new trade routes between Europe, the Americas, and Asia and established contact with new civilizations. Two most significant trade route established during this period were:

- America and Europe (the route to the Americas and the Caribbean was discovered by Columbus in 1492 and was used to transport goods such as gold, silver, and spices from the Americas to Europe)
- b) Europe and Asia (The sea route around Africa to Asia discovered by Vasco da Gama in 1498 was used to transport goods such as spices, silk, and precious metals from Asia to Europe).

The Age of Exploration connected east and the west and also marked the beginning of the transatlantic slave trade. Millions of enslaved Africans were forcibly taken to the Americas to work on plantations, particularly in the Caribbean and Brazil, this trade was a major source of wealth for European countries and had a devastating impact on the African continent.

Mercantilism: Mercantilism is a dominant economic theory in Europe spanning between 16th to 18th century that advocated for a country to increase its wealth through a combination of trade, manufacturing, and resource extraction. It was characterized by the belief that a country's wealth and power could be increased through the accumulation of gold and other valuable resources, as well as through the production and export of goods. Governments were led to impose price and wage controls and foster national industries. To have Balance of payments surplus, they promoted exports of finished goods and imports of raw materials, ensuring that they limit the exports of raw materials and the imports of finished goods at the same time. With the age of exploration and thoughts of mercantilism, colonisation of Americas, Africa and Asia started which helped the trade between Europe and the rest of the world increase dramatically. This period saw the rise of European trading companies, such as the Dutch East India Company and the British East India Company, which controlled much of the trade between Europe and Asia.

Industrialisation: With the industrial revolution of the 18th and 19th centuries, international trade increased as new technologies and transportation methods made it easier to move goods and people around the world. The growth of manufacturing and the increased use of steam power and machinery led to the development of larger, more complex businesses and the rise of the modern economy. This led to a greater demand for raw materials leading to continuous colonization of Africa and Asia by the European countries to gain control of their resources and to have their captive trade outlets. During this period there was a transition of thoughts from Mercantilism to Liberalism and again to resurgence of protectionism.

Internationalisation/Globalisation: In the19th and early 20th centuries, the world saw significant increase in international trade and globalization. The "British" Industrial Revolution made for a fantastic twin engine of global trade. On one hand, steamships and trains could transport goods over thousands of miles within and across countries. On the other hand, its advanced industrial technologies allowed Britain to make products that were in demand all over the world, like iron, textiles and manufactured goods.

The outbreak of two World Wars brought an abrupt end to globalisation and everything the burgeoning high society of the West had got used to, with the countries closing the borders for trade to protect their economies. The end of the World War II marked a new beginning for the global economy under the leadership of a new hegemon, the United States of America. Aided by the technologies of the Second Industrial Revolution viz., car and plane; global trade started to rise once again. The development of technology and communication infrastructure made it easier and cheaper to transport goods around the world. International trade is conducted on a massive scale and has become a central part of the global economy. To end protectionism and to increase global trade, advocated and backed by the US, global trade agreements and organizations, such as the World Trade Organization (WTO), which aim to reduce barriers to trade and promote free trade between countries, have started. This free trade has given rise to significant increase in international trade and many countries joined the United Nations (UN). UN enabled more free trade agreements between the Member States. This period also saw the creation of many multinational corporations (MNCs) that could produce goods cheaply due to cheaper sourcing of raw materials and using mass production techniques helping in greater economies of scale. These MNCs became extremely powerful entities by controlling much of global trade as they could influence political decisions by lobbying Governments, taking advantage of their power over consumers through advertising campaigns, or buying out competitors who threatened their market share.

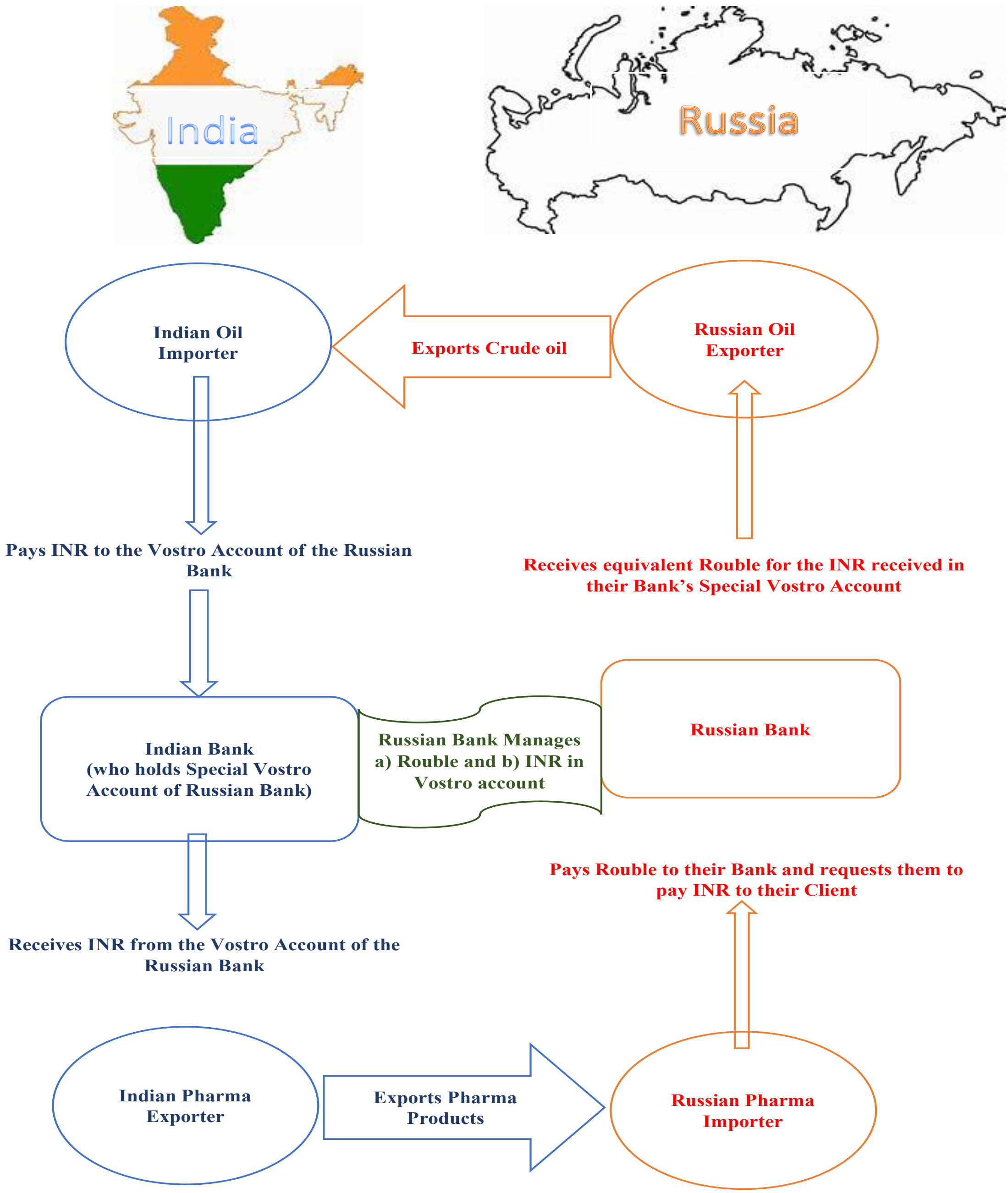
Digitisation: With the advent of the internet and e-commerce, new technologies from the Third Industrial Revolution, international

trade has become more digital, allowing for more efficient and convenient exchange of goods and services between countries. These technologies helped further global integration of value chains where in one could do R&D in one country, sourcing in others, production in yet another, and distribution of the final product all over the world. Invoicing of materials is happening on digital mode and the payment settlements of the transactions are happening at a click of button and amounts transferred / received to / from the counterparties in other countries across the seas are happening in a matter of seconds.

Trade has integrated the Global Economy

As we have seen from the brief historical journey of international Trade, Trade has played a significant role in shaping the global economy. We have seen trade start in one marketplace to trade within the select regions to trade across the countries and continents. We have seen exchange from barter mode to money exchange to Foreign exchange and now to crypto exchange. From free trade to trade barriers to again free trade, we have seen the international trading doing a 360-degree change. We have also seen a 360-degree change in free state to being a colony to again a free state. Use of new technologies, modern transportation, advances in communications had changed the face of trade and now the countries are increasingly dependent on each other for goods and services thus integrating the global economies.

Illustrative example of likely trade between India and Russia using a Special Vostro Account



Currently, how does the trade transaction happen?

- Consider an Indian Pharma exporter who is exporting to Russia.
- Indian Pharma Company invoices the trade in USD for pharma exports he is making to the Russian Company.
- As per the terms of trade, the Russian importer had to buy USD in their market using RUB and then remit the funds to India in USD to meet the trade obligation.
- In this case though both the countries have a separate currency viz., Indian Rupee (INR) and Russian Rouble (RUB). However, they are pricing / invoicing their trade in USD.
- Both the parties are having exchange Rate risk i.e., USDRUB Risk for Russian Importer and USDINR Risk for the Indian Exporter.
- They have additional settlement charges / Corresponding Bank charges to be paid to the US Banks for settlement and enablement of trade and settlement.
- Hence, in the existing trade, both the exporter and importer had to bear the transaction / settlement transactions in their respective currencies with their local banks and also to US Banks.

Considering the same transaction, how is it envisaged using the Special Vostro Account?

- Consider an Indian Pharma exporter who is exporting to Russia.
- USD leg can be done away with and the trade can happen in INR
- Indian Pharma Company invoices the trade in INR for pharma exports he is making to the Russian Company.
- As per the terms of trade, the Russian importer pays RUB to its bank and then requests them to remit INR to India to meet the trade obligation.
- The Russian Bank remits INR from its Vostro to the Indian Exporter duly debiting the Russian importer with equivalent Rouble. Russian Bank earns the exchange Income and settlement / corresponding Fees. Whereas the Indian Bank earns only corresponding Fees.
- Only one party has exchange Rate risk i.e., USDRUB Risk for Russian Importer and Indian Exporter does not have Exchange Rate Risk.

SETTLEMENT OF INTERNATIONAL TRADE

The subject of "Settlement of international trade" is discussed in this Chapter under the following heads:

a. Barter system
b. Metal as medium of exchange
c. Foreign Currency – Nostro, Vostro, ACU and Special Vostro Account in INR
d. Use of money transfer companies for settlement of trade transactions, money laundering in the disguise of trade settlement
e. Regulatory Authorities and the role of FEMA, 1999
f. Role of IT Companies and software for trade finance activities
g. SWIFT/Russian SPFS system

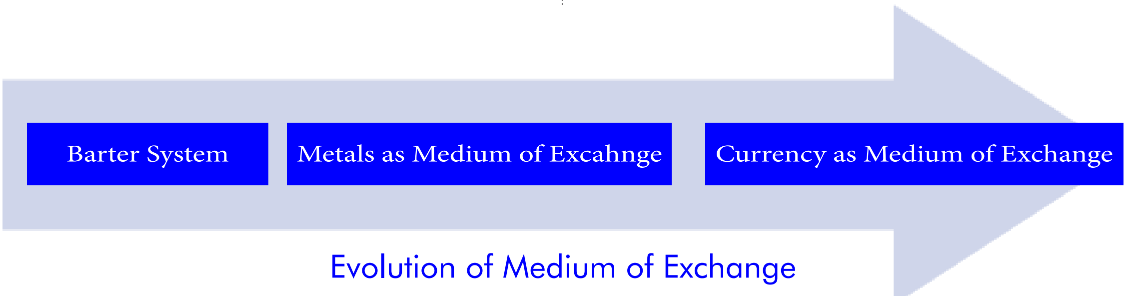
BARTER SYSTEM

A barter system is a method of exchange in which goods or services are directly exchanged for other goods or services, without the use of money as the medium of exchange. This Barter system can be used to facilitate trade between countries organisations in different part of the world, which is called as International Barter Trade. The best part of the barter system is that a country with surplus supplies sell their surplus goods and the country which is in short supply buy the goods. Barter system had two major problems namely (I) finding the supplier of surplus goods and the buyer of the goods and (ii) how to fix the swap ratio. For example, how many barrels of oil shall be equal to how many tons of grains. In a few villages in Haryana, people till date exchange farm products like vegetables, black grams or pulses etc with other goods or for service fee of tailors, farmers, labours etc.

METAL AS MEDIUM OF EXCHANGE

Precious metals such as gold and silver were among the first ones to be used as a medium of exchange and they continue to hold the faith of the people. However, the problem of finding the buyer/supplier and fixing the swap ratio, lead to settlement of trade thru metal like Gold, Silver or any other metal acceptable to traders. Internationally, the traders from Rome, Italy and other European countries use to travel to Kerala (in 17th Century) through merchant ship and used to buy Black pepper, Spices and cotton Linen for selling in home countries and settle the payment with Gold. Infact, Roman empire was worried with the fancy of Roman traders to buy Spices, Black pepper etc from India that will finish the gold stock with them. In the process, traders in Kerala used to earn gold and share part of their gold earnings with Temples, so one may observe that Kerala traders and Kerala Temples are richer in gold. Also, domestically, India had 560 states before Independence and each state use to have its own currency/ coin for settlement of trade. So, traders from Rajasthan, traditionally men and women in Rajasthan used to wear Gold/silver ornaments on to their bodies as a matter of security & also for settlement of trade with traders from other states. The Gold became most accepted form of settlement for International Trade and countries like India/China with less amount of Gold Reserves, were settling their international trade thru Silver.

During this period, several theories of international trade like Mercantilists, Trade based on Absolute Advantage (Adam Smith), Comparative advantage (David Ricardo), National Competitive Advantage (Porter's Diamond Theory), Product Life-cycle Theory etc emerged and emphasised the need for international trade and its settlement. The system of settling international trade thru Metal was going smooth but suddenly stopped post 2nd World War, as many European countries lost their Gold Reserves. Other countries' traders felt the problem of security of gold, life



Evolution of Medium of Exchange

and purity of gold, as many traders had started mixing other metals like bronze, yellow metal etc with the gold and the purity of Gold got diluted. All this led to a halt in international trade post Second World War in 1942.

FOREIGN CURRENCY

In 1944, 44 countries met in Bretton Woods to deliberate on the mechanism to settle international trade. While deliberating, USA, offered countries to use USD as a means of settlement of international trade and offered that any surplus USD left with the trading country, can be exchanged with Gold at a fixed price of USD 35 per troy ounce. USA, had huge gold reserves as it had not lost much of its gold during the world war. Accordingly, other countries accepted and trusted US proposal and international trade started with settlements in USD, considering USD at par with Gold. The Bretton Woods conference deliberation also proposed to create two world class Institutions – IMF and the World Bank. IMF was conceived to help countries in case of Balance of Payment (BOP) and currency crisis, and the World Bank was set up to provide long term finance at cheaper rates or through equity, to redevelop the war-torn countries or help countries like India to develop their infrastructure. India took the help of IMF during 1991 BOP crisis, South East Asian Countries took help during 1997 during their currency crisis and countries like Pakistan, Sri Lanka, Bangladesh, Mexico, Argentina and many more countries are also helped by IMF from time to time, thru SDR mechanism to meet BOP crisis and the like.

End of Bretton Woods System

In August 1971, U.S. President Richard Nixon announced the "temporary" suspension of the Dollar's convertibility into gold. While the Dollar had struggled throughout the 1960s within the parity established at Bretton Woods, this crisis marked the breakdown of the system. But the world continues to use USD as a invoicing and settlement currency.

Risk of Settlement:

Herstatt Risk 1974, also known as settlement risk or cross-currency settlement risk, is the risk associated with settlement of foreign exchange transactions due to time zone differences between the settlement of currencies. In 1977, SWIFT was set-up to support the global trade and settlement with a standardised global financial messaging services to communicate about the cross-border payment. Herstatt Risk was largely eliminated using the Continuous Linked Settlement (CLS) throughout the world.

Nostro, Vostro and SWIFT as settlement Mechanism:

With the growth of International trades through a foreign currency the following kind of accounts gained prominence:

1. Nostro Accounts: My account with outside bank, or our foreign currency account with overseas banks in their country, in their currency
2. Vostro Accounts: Overseas banks' INR account with us, in our country in our currency

When an Indian Bank opens a Foreign currency account; that account is a Nostro account for the Indian Bank and Vostro account for the Foreign bank e.g., If SBI opens USD account with Citi Bank, New York, it is SBI's Nostro account and from the perspective of Citi Bank, New York, it is SBI's vostro in USD (local currency is USD for Citi Bank).

International Trade Settlement - Methods of Payments Permitted By FEMA

The following are the methods of payments permitted by FEMA

Particulars	Details
Advance Payment	✓ Importer sends money first to the exporter ✓ Goods are exported post receipt of the payment ✓ Beneficial to the exporter ✓ Importer has no assurance of receiving the goods ✓ Goods to be exported within 1 year from the date of receipt of advance or return the money with interest
Open Account	✓ Payment at agreed intervals ✓ Established relationship between importer and exporter ✓ Beneficial for the importer ✓ Exporter has neither good nor the money
Documentary Collections – DP/ DA	✓ Documents are routed through a bank ✓ Documents are not released to the importer until payment has been affected/acceptance received ✓ Provides formal means to collect unpaid obligation ✓ Country Risk are not hedged for the exporter ✓ Under URC 522 of ICC, Paris
Letter of Credit	✓ Undertaking from a bank to make the payment provided credit compliant documents are presented ✓ Secured method of payment ✓ Beneficial for both exporter and Importer ✓ Under UCP 600 of ICC, Paris

Mode of settlement in Rupee: Nostro, Vostro, ACU & Special Vostro Account in Rupee:

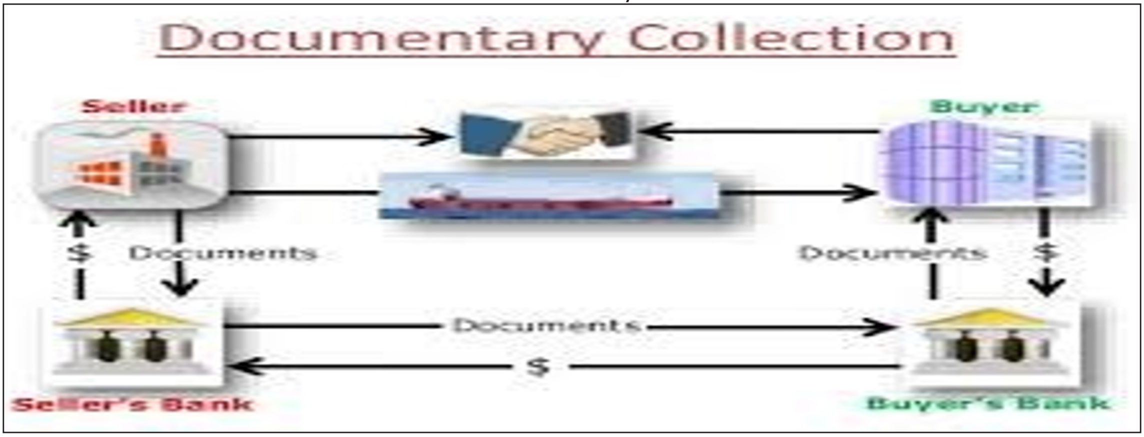
The above methods are used for settlement of foreign exchange for international trade world-wide with the help of the following types accounts and SWIFT:

1. Nostro Accounts: My account with outside bank, or our foreign currency account with overseas banks in their country, in their currency
2. Vostro Accounts: Overseas banks' INR account with us, in our country in our currency
3. LORO: Their account (any currency) with another bank e.g., if a bank is not a scheduled commercial bank (generally cooperative banks) and is not allowed to maintain current account with RBI. For clearing of cheques this cooperative bank shall use some other scheduled commercial bank for collection and clearing of cheques / demand draft etc. Similarly, if an authorised dealer (AD) bank is not allowed to maintain Nostro account abroad, then this bank uses the Nostro account of another AD bank for their forex (export / import / Inward / outward transactions) settlement in foreign currency.
4. ACU Dollar / Euro / JPY Account –: On December 9, 1974, at the initiative of the United Nations Economic and Social Commission for Asia and Pacific (ESCAP), Asian Clearing Union (ACU) was established with its headquarters at Tehran (Iran), for promoting regional co-operation. The main objective of the clearing union is to facilitate payments among member countries for eligible transactions on a multilateral basis, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade among the participating countries. The Asian Monetary Units (AMUs) is the common unit of account of ACU and is denominated as 'ACU Dollar', 'ACU Euro' and 'ACU Yen', which is equivalent in value to one US Dollar, one Euro and one Japanese Yen respectively. Bangladesh, Bhutan, India, Iran, Maldives, Myanmar, Nepal, Pakistan and Sri Lanka are currently using this mechanism. Majority of transactions, as possible, should be settled directly through the accounts maintained by AD Category-I banks with banks in the other participating countries and vice versa; only the spill-overs in either direction are required to be settled by the Central Banks in the countries concerned through the Clearing Union
5. Special Mechanism for trade settlement with Iran-: India has a Special Mechanism for trade settlement with Iran in which Indian Oil Companies were paying Rupees to a local Iranian Bank for the Oil imports to India. These funds were used to pay for Imports from India by Iranian Companies.
6. Now Special Vostro Account in INR is permitted to accommodate trade with countries (including sanctioned / OFAC countries viz Russia, Sri-Lanka & Iran) as an additional arrangement for payment (non-repatriable INR). Instead of paying and receiving US dollars, the invoice will be made in Indian Rupees if, the counterparty has a Special Vostro Account in Rupee.

INTERNATIONAL TRADE SETTLEMENT MECHANISM/CYCLE

(NO LC – under Collection Basis – URC 522 – ICC Paris)

The flow of trade settlement mechanism- documentary collection is as illustrated below:



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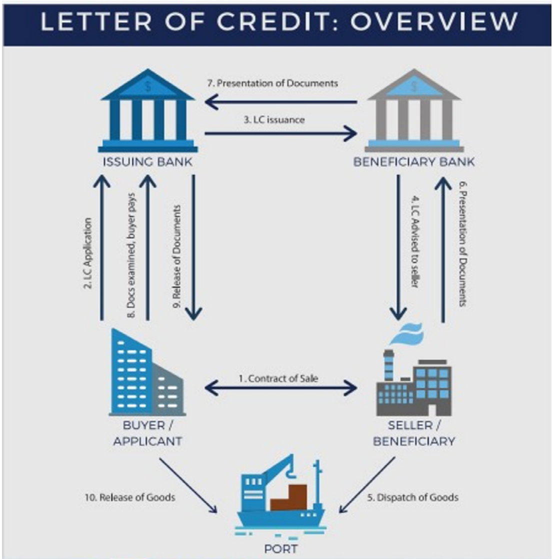
INTERNATIONAL TRADE SETTLEMENT MECHANISM/CYCLE

(Under LC – UCP 600 (2007 Revision) of ICC, Paris)

LC is a sort of guarantee issued by a bank, on behalf of the buyer (applicant) favouring the supplier (beneficiary), undertaking to pay by authorizing another bank (negotiating bank) to pay on complying with the terms and conditions mentioned therein.

LC is also known as documentary credit as banks deal in documents and not in goods. Each LC should mention "UCP LATEST VERSION" or "This LC is subject to UCPDC publication no. 600, (2007 Revision) ICC guidelines" to be operative



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Types of LC's Used in International Trade

Irrevocable: That which cannot be cancelled or amended without the consent of the beneficiary

Irrevocable Confirmed: LC that has been confirmed by advising another bank in the same country or another country Irrevocable

Transferable: That which is transferred by the advising bank at the request of the beneficiary to the third party

Irrevocable Back-to-Back: Wherein another LC is established by the beneficiary on the security of the main LC

Irrevocable Revolving: Wherein the credit available gets re-instated after utilization of the amount; it can be cumulative or non-cumulative

Irrevocable Standby: Used for transactions in US in place of guarantee for payment of loan/ lease etc

Irrevocable Red Clause: Where payment is made in advance through LC mechanism by the buyer's bank against the Indemnity and undertaking by the beneficiary to export the goods

Irrevocable. Restricted: Where the LC is restricted for negotiation to a particular bank

Irrevocable Deferred Payment: Where the payments are made in Instalments and deferred over one year

<u>Checklist on Receipt of LC:</u> The following points to be checked on receipt of LC:

Name & Address of the Applicant, Beneficiary, Currency and Amount

(Should be in English language only)

Description of goods (should be as per LC)

Terms of shipment/payment/reimbursement

Mode of transport, part/trans-shipment

Restricted or confirmed, charges thereon

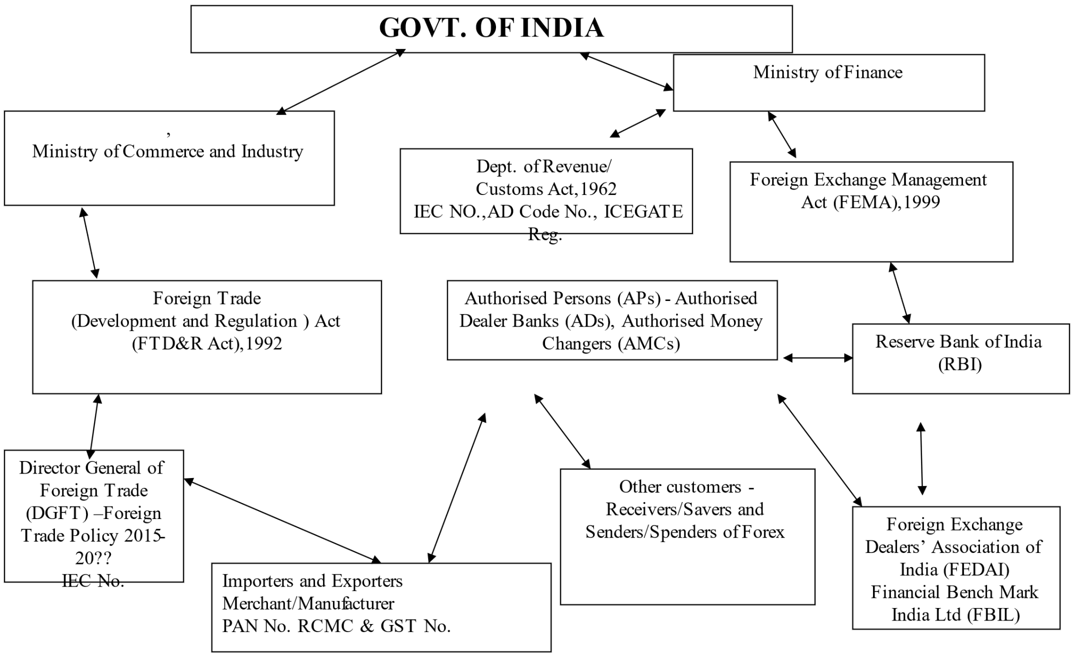
Inspection and other terms and conditions matches with that of the Performa Invoice or Contract Shipment/ expiry date and negotiation period

USE OF MONEY TRANSFER COMPANIES FOR SETTLEMENT OF TRADE TRANSACTIONS OR DOING MONEY LAUNDERING/ HAWALA IN THE DISGUISE OF TRADE SETTLEMENT

Countries like Afghanistan · Albania · Algeria· Andorra · Angola · Anguilla · Antigua and Barbuda · Argentina etc use cash USD or services of money transfer companies like Western Union of US etc for settlement of international trade (via USD). This kind of settlement brings the risk of double payments and also the possibility of the money being used for terrorist activities or drug trafficking and also for money laundering in the disguise of trade settlement or settlement with sanctioned countries like IRAN etc. Here a surprising fact is, US Western Union allowed to operate in Financial Action Task Force (FATF)/ sanctioned countries, whereas Banks in FATF/ sanctioned countries are not allowed to open Nostro account with US banks in US., Even Taliban is were freely using USA's Western Union for money laundering for the supply/sale of drugs and terrorist activities with the help of banks in Afghanistan.

REGULATORY AUTHORITIES & ROLE OF FEMA 1999/ ADMINISTRATION OF FOREIGN EXCHANGE IN INDIA

Administration of Foreign Exchange in India



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The Director General of Foreign Trade (DGFT) (FTP) Stipulates regulations relating to physical movement of goods and services, drafts EXIM (Foreign Trade) Policy under the guidance of the Ministry of Commerce, Issues IEC to different types of merchant or manufacturer exporters/ importers, MSME status exporters etc.

The DGFT notified changes to facilitate rupee trade vide Para 2.52 (d) of Notification dated 22nd Sept., 2022. The Commerce Ministry had notified its decision to allow invoicing, payment and settlement of external trade in rupees. The move was required to align the foreign trade policy of the Government with the July announcement of the Reserve Bank of India (RBI) and facilitate rupee trade. According to the notification, domestic firms undertaking imports through this mechanism will make payment in rupee, which will be credited into the Special Vostro Account of the correspondent bank of the partner country, against the invoices for the supply of goods or services from the overseas seller/supplier. Indian exporters undertaking exports of goods and services through this mechanism shall be paid the export proceeds in INR from the balances in the designated special vostro account of the correspondent bank of the partner country.

The Reserve Bank of India (RBI) stipulates regulations relating to movement of funds (FEMA) for the goods exported/imported and other remittances and also stipulates credit norms for banks. The Foreign Exchange Dealers Association of India (FEDAI) is the apex forum of banks authorised to deal in FOREX, issues guidelines and imparts training to bank personnel in the areas of FOREX business.

The Fixed Income Money Market & Derivatives Association of India (FIMMDA) has been formed to undertake developmental activities, such as, introduction of benchmark rates and new derivatives instruments and, devise standardized best market practices

Financial Bench Mark of India Ltd (FBIL) fixes the MIBOR linked and MTM Rates (www.fbil.org.in)

The International Chamber of Commerce (ICC), -PARIS had come out with INCOTERMS - 2020, UCP 600 (2007), URC 522, URDG 758

The Clearing Corporation of India Ltd – (CCILINDIA) is the FOREX Retail Platform for all types of exporters and importers

Areas to be understood

- Open a bank account with any AD (Authorized Dealer) bank (presently there are 92 AD Banks in India). (Visit www.fedai.org.in)
- Registration with the relevant Export Promotion Council/FIEO, Export Credit Guarantee Corporation, PAN/GST Registration
- Obtaining IEC from the DGFT
- Registration with Customs – AD Code No. and IEC No. thru ICEGATE (Indian Customs Electronic Gateway).
- What is the FEMA 1999 requirements for settlement of international trade in India (currency, time limit, third party/advance payment & payment of commission)?
- What are the Incoterms/payment methods used in international trade?
- The concept of "exposure" on buyer, country, currency and settlement in international trade How to cover the exposure to ensure that payment comes in time
- Shipment of goods – appointment of CHA (Clearing House Agent) or thru ICEGATE.
- Custom clearance.
- Preparation of documents (Avoid shipment of goods in the name of bank (unless permitted under LC).
- Presentation of documents, direct or through bank.
- Information for currency, amount, description of goods, shipment details, insurance, Incoterms and payment terms, buyer/seller, country of destination etc. should be the same in all the documents presented

Precaution before Shipment (or terms in agreement in Proforma Invoice or Purchase Order)

❖ Ensuring proper Incoterms 2020- ICC, Paris which define and delineate the duties and responsibilities of the seller and buyer (Ensure marine insurance for FOB, CFR, FCA & CPT terms by buyer before shipment); Ensuring acceptable payment terms.

❖ Ensuring receipt of LC (if payment term is LC) and checking each term of LC with PI/PO before shipment.

❖ Ensuring ability to comply with all the terms and conditions of LC and ensure that they match with the PI or PO before making shipment.

❖ Ensuring credit insurance on buyer and buyer's country through ECGC etc.

❖ If need be, avail working capital finance before shipment at MCLR or external bench mark interest rates under the scheme for export finance.

- ❖ In the case of MSME/merchant exporter ensure 3 to 2 per cent subvention renewed by RBI till March 2024.
- ❖ Ensure bank's fixing MCLR or other external benchmark rates, as part of fund based working capital limits.

Precaution after Shipment

Ensuring presentation of documents as per PI/PO on collection or on negotiation basis (compliant documents) under a LC.

Avoid dispatching documents directly to buyer without advance payment.

Ensure LC from buyers or invoice factoring through an International Factor.

Prefer Forfaiting without recourse in case of likely risk of non-payment.

In case of dispute with the buyer for quality etc. try solving amicably by offering discount or settling quality claim by appropriate credit note (if payment already received).

If payment is not made by the LC issuing bank due to discrepancies in the documents, then try convincing the buyer for accepting discrepancies and solving the issue amicably.

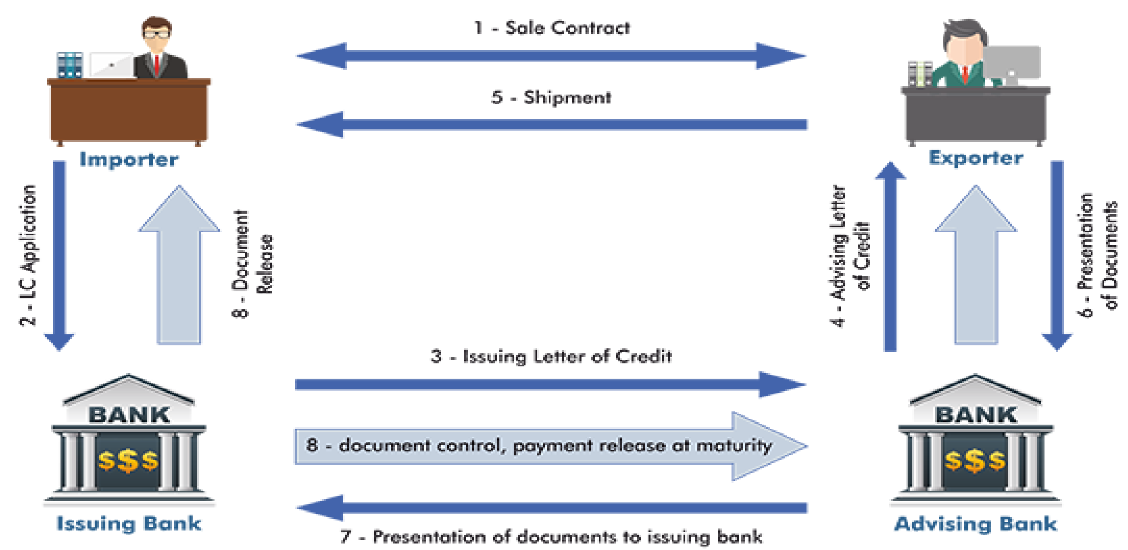
If no discrepancy, then insist on payment under UCP through your bankers or lawyers with IBA, FEDAI or ICC, Paris.

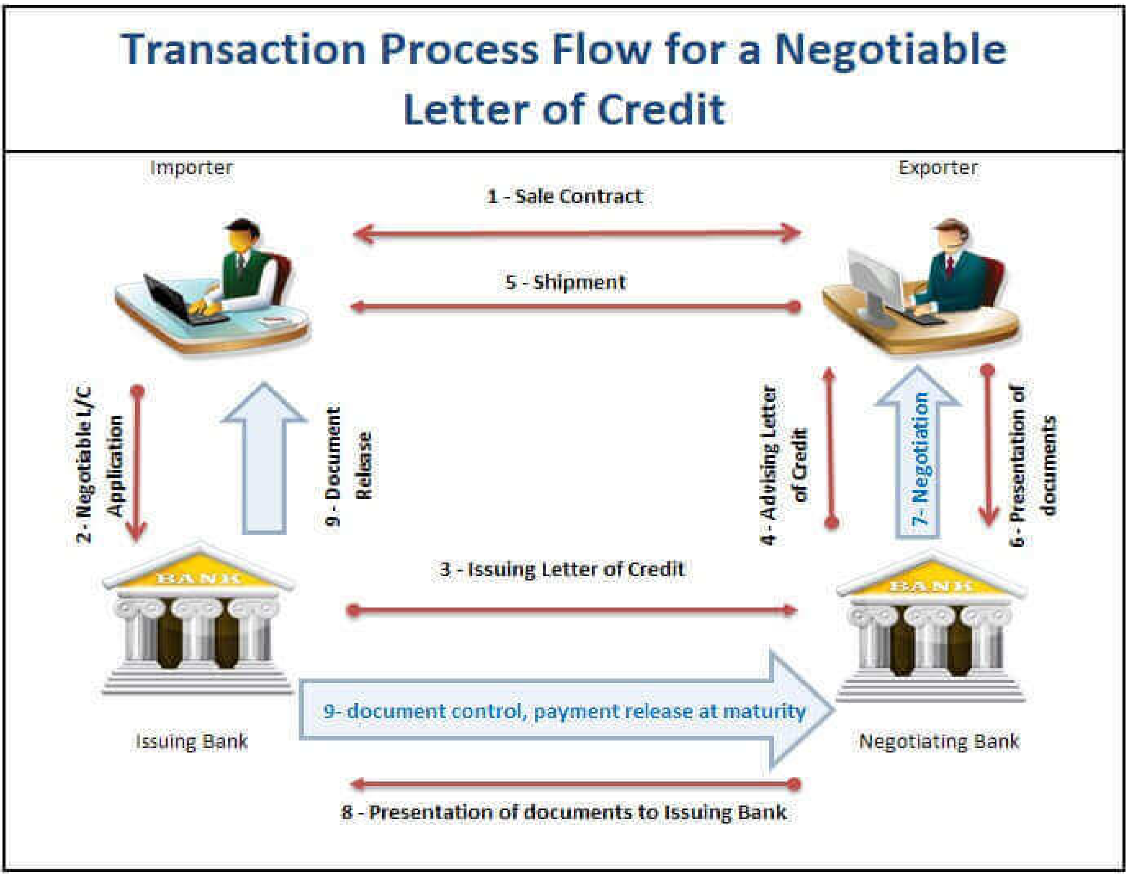
How to Ensure payment from buyers – In case of dispute

If the documents are sent on collection basis under URC 522 or under LC - UCP 600 of ICC, Paris then follow the undermentioned steps-

- Take the help of friend, relative, business associates in the buyer's company.
- Ensure safety of goods by storing or try selling goods to alternate buyer or re-import (if unable to sell the same) with the help of bank or transport company.
- Make a legal case with the help of bank/ lawyer.
- Obtain extension of time from the Bank or RBI or concerned Ministry, as the case may be.

Export Payment flow under a LC





ROLE OF IT COMPANIES AND SOFTWARE FOR TRADE FINANCE ACTIVITIES

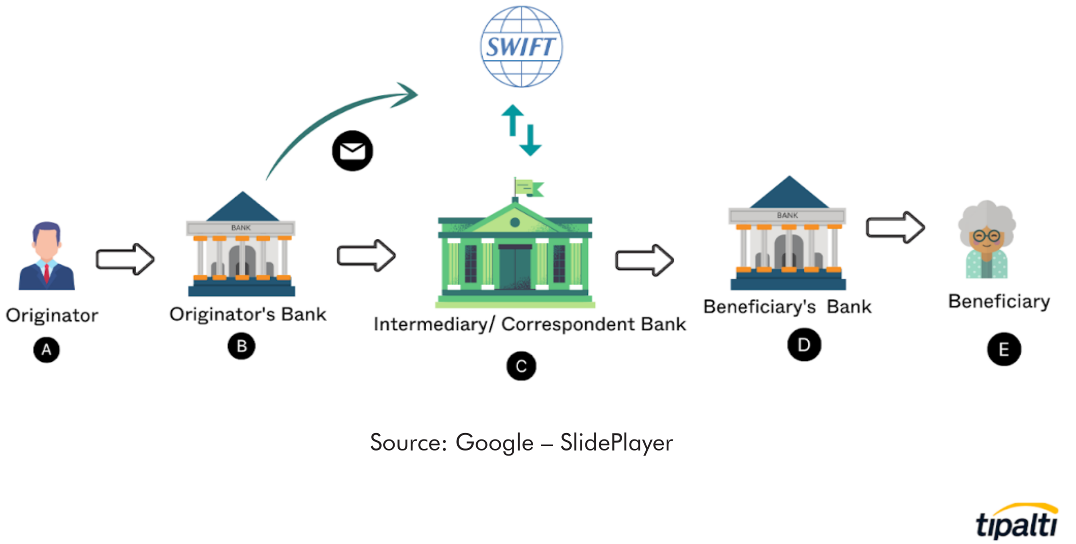
Today, the entire credit for the progress made in International Trade and its settlement goes to IT/software companies. These companies have made life easier for exporters, importers, bankers, Regulators, authorities like Customs, shipping, airlines, insurance companies, inspection agencies etc in the matter of documentation, monitoring of exports, imports, regulation compliances, tracking shipments, meeting insurance claims and inspection of goods etc.

Bankers are able to make instant money transfer globally and related parties are benefitted not only in terms of money transfer, but reconciliation, confirmations and settlement of disputes with the advance and secured IT system world-wide

SWIFT

Society for World-wide Inter-Bank Financial Telecommunications between the banks and financial institutions have helped exporters/ importers for message communication for LC's, BG's, money transfers etc. in a highly secured environment between the banks world-wide. Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a member-owned cooperative that provides safe and secure financial transactions for its members.

This payment network allows individuals and



Source: Google – SlidePlayer

businesses to take electronic or card payments even if the customer or vendor uses a different bank than the payee. SWIFT, today, is the largest and most streamlined method for international payments and settlements.

SWIFT works by assigning each member institution a unique ID code (a BIC number) that identifies not only the bank's name but the country, city, and branch. SWIFT has been used to impose economic sanctions on countries like Iran and Russia.

Russian SPFS system is designed to overcome the use of SWIFT due to sanctions by US and its allies.

Unified Payments Interface (UPI) Product Overview - NPCI

Unified Payments Interface (UPI) is a system that powers multiple bank accounts into a single mobile application (of any participating bank), merging several banking features, seamless fund routing and merchant payments into one hood. This is used for payments within India but soon may be extended to other countries for settlement of trade etc

BRETTON WOODS SYSTEM & DOLLARISATION OF INTERNATIONAL TRADE

In July 1944, delegates from 44 Allied nations gathered at a mountain resort in Bretton Woods to discuss a new international monetary order. The purpose was to create a system to facilitate international trade while protecting the autonomous policy goals of individual nations. It was meant to be a superior alternative to the inter-war monetary order that arguably led to both the Great Depression and World War II.

The discussions were largely dominated by the interests of the two great economic super powers of the time, the United States and Britain. But these two countries were far from being united in their interests, with Britain emerging from the war as a major debtor nation and the U.S. poised to take on the role of the world's great creditor. US wanting to open the world market to its exports, prioritized the facilitation of freer trade through the stability of fixed exchange rates. Britain wanting freedom to pursue autonomous policy goals, pushed for greater exchange rate flexibility in order to avoid balance of payments issues.

Rules of the new arrangement and evolution of Dollarisation:

A compromise of fixed-but-adjustable rates was finally settled upon. Member nations would peg their currencies to the U.S. dollar and to ensure the rest of the world that its currency was dependable, the U.S. would peg the dollar to gold, at a price of $35 an ounce. Member nations would buy or sell dollars in order to keep within a 1 per cent band of the fixed-rate and could adjust this rate only in the case of a "fundamental disequilibrium" in the balance of payments.

In order to ensure compliance with the new rules, two international institutions were created: The International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD later known as the World Bank). The new rules were officially outlined in the IMF Articles of Agreement. The Articles stipulated that current account restrictions would be lifted while capital controls were allowed, in order to avoid destabilizing capital flows.

In 1973, the Bretton Woods system collapsed, which led to huge foreign currency losses for various banks throughout the world.

Bretton Woods system led to the Dollarization of international trade. Dollarization means the use of U.S. dollar in addition to or instead of the domestic currency of another country. It is an example of currency substitution. Dollarization usually happens when a country's own currency loses its usefulness as a medium of exchange, due to hyperinflation or instability.

Dollarization usually occurs in developing countries with a weak central monetary authority or an unstable economic environment. Dollarization happens when a country begins to recognize the U.S. dollar as a medium of exchange or legal tender alongside or in place of its domestic currency.

Dollarization normally occurs when the local currency has become unstable and begin to lose its usefulness as a medium of exchange for market transactions. Dollarization can have both benefits and costs. It typically results in enhanced monetary and economic stability, but necessarily involves loss of economic autonomy in monetary policy.

It can occur as an official monetary policy or as a de facto market process. Either through official decree like Ecuador or Panama Island or through adoption by market participants, the U.S. dollar comes to be recognized as a generally accepted medium of exchange for use in day-to-day transactions in a country's economy. Sometimes the dollar assumes official status as legal tender in the country. The main reason for dollarization is to receive the benefits of greater stability in the value of currency over a country's domestic currency. For example, the citizens of a country within an economy that is undergoing rampant inflation may choose to use the U.S. dollar to conduct day-to-day transactions, since inflation will cause their domestic currency to have reduced buying power

Since the abandonment of the gold standard at the outbreak of WWI and the Bretton Woods Conference following WWII, some countries have been desperately seeking ways to promote global economic stability and hence their own prosperity. For the majority of these countries, the optimal way to obtain currency stability has been to peg the local currency to a major convertible currency. However, another option is to abandon the local currency in favour of the exclusive use of the U.S. dollar (or another major international currency, such as the euro). This is known as full dollarization.

ROLE OF IMF, WORLD BANK, WTO, FTAS, RTAS & CENTRAL BANKS

POST BRETTON WOODS CONFERENCE IN 1944

Founded at the Bretton Woods Conference in 1944, the two institutions that have complementary missions are formed Viz., World Bank and International Monetary Fund (IMF). The World Bank works with developing countries to reduce poverty and increase shared prosperity, while the International Monetary Fund serves to stabilize the international monetary system and acts as a monitor of the world's currencies. The World Bank provides financing, policy advice and technical assistance to Governments and also focuses on strengthening the private sector in developing countries. The IMF keeps track of the economy globally and in member countries, lends to countries with balance of payments difficulties and gives practical help to members. Countries must first join the IMF to be eligible to join the World Bank Group; today, each institution has 189 member countries.

ROLE OF INTERNATIONAL MONETARY FUND

The IMF created post Bretton Woods system works to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. The IMF's primary purpose is to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries and their citizens to transact with each other. It does so by keeping track of the global economy and the economies of member countries, lending to countries with balance of payments difficulties and rendering practical help to members.

ROLE OF WORLD BANK GROUP

The World Bank created post Bretton Woods system is one of the world's largest sources of funding and knowledge for developing countries. Its five institutions (viz International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA) and International Centre for Settlement of Investment Disputes(ICSID) share a commitment to reducing poverty, increasing shared prosperity, and promoting sustainable development. Together, IBRD and IDA form the World Bank, which provides financing, policy advice, and technical assistance to Governments of developing countries. IDA focuses on the world's poorest countries, while IBRD assists the middle-income and creditworthy poorer countries.

IFC, MIGA, and ICSID focus on strengthening the private sector in developing countries.

Through these institutions, the World Bank Group provides financing, technical assistance, political risk insurance and settlement of disputes of private enterprises, including financial institutions.

ROLE OF WTO, FTAs/REGIONAL TRADE AGREEMENTS

The overall objective of the WTO is to help its members use trade as a means to raise living standards, create jobs and improve people's lives. The WTO operates the global system of trade rules and helps the developing countries to build their trade capacity. It also provides a forum for its members to negotiate trade agreements and to resolve the trade problems they face with each other.

Improving people's lives

The fundamental goal of the WTO is to improve the welfare of people around the world. The WTO's founding Marrakesh Agreement recognizes that trade should be conducted with a view to raising the standards of living, ensuring full employment, increasing real income and expanding global trade in goods and services while allowing for the optimal use of the world's resources.

Negotiating trade rules

The WTO was born out of five decades of negotiations aimed at progressively reducing obstacles to trade. Where countries have faced trade barriers and wanted them to be lowered, the negotiations have helped to open markets for trade. Conversely, in some circumstances, WTO rules support maintaining trade barriers – for example, to protect consumers or the environment.

Overseeing WTO Agreements

At its heart are the WTO Agreements, negotiated and signed by the bulk of the world's trading nations. Essentially contracts, these documents provide the rules for international commerce and bind Governments to keep their trade policies within the agreed limits. Their goal is to help producers of goods and services, exporters and importers conduct their business, with a view to raising the standards of living, while allowing Governments to meet social and environmental objectives.

Maintaining open trade

The system's overriding purpose is to help trade flow as freely as possible – provided there are no undesirable side effects – because this stimulates economic growth and employment and supports the integration of developing countries into the international trading system. Its rules have to be transparent and predictable, to ensure that individuals, companies and Governments know what the trade rules are around the world and to assure them that there will be no sudden change of the policies.

Settling disputes

Trade relations often involve conflicting interests. Agreements, including those painstakingly negotiated in the WTO, often need interpretation. The most harmonious way to settle these differences is through a neutral procedure based on an agreed legal foundation. That is the purpose behind the dispute settlement process written into the WTO Agreements.

Free Trade Agreement (FTA)

Free Trade Agreements reduce or eliminate the barriers to trade across international borders. Free trade is the opposite of trade protectionism. In the U.S. and the E.U., free trade agreements do not come without regulations and oversight.

For example, a nation might allow free trade with another nation, with exceptions that forbid the import of specific drugs not approved by its Regulators, or animals that have not been vaccinated, or processed foods that do not meet its standards.

Regional Trade Agreements (RTA)

RTAs reduce trade costs and define many rules in which economies operate. If efficiently designed, they can improve policy cooperation across countries, thereby increasing international trade and investment, economic growth and social welfare.

ROLE OF CENTRAL BANKS

The central bank has been described as the "lender of last resort," which means it is responsible for providing its nation's economy with funds when commercial banks cannot cover a supply shortage. In other words, the central bank safeguards the country's banking system from failing.

Central banks carry out a nation's monetary policy and control its money supply, often mandated with maintaining low inflation and steady GDP growth. At the macro level, central banks influence interest rates and participate in open market operations to control the cost of borrowing and lending throughout an economy. Central banks also operate on a micro-scale, setting the commercial banks' reserve ratio and acting as lender of last resort when necessary.

Transitional Economies

Today developing economies are faced with issues such as the transition from managed to free market economies. The main concern is often controlling inflation. This can lead to the creation of an independent central bank but can take some time, given that many developing nations want to maintain control over their economies. But Government intervention, whether direct or indirect through fiscal policy, can stunt central bank's development.

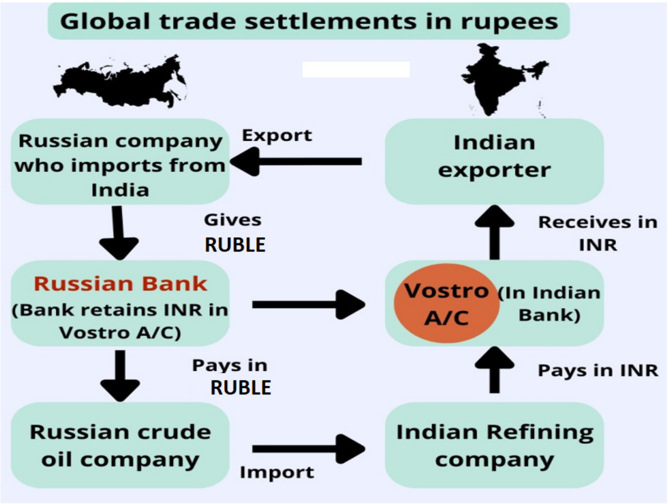
Unfortunately, many developing nations are faced with civil disorder or war, which can force a government to divert funds away from the development of the economy as a whole. Nonetheless, one factor that seems to be confirmed is that, for a market economy to develop, a stable currency (whether achieved through a fixed or floating exchange rate) is needed. However, the central banks in both industrial and emerging economies are dynamic because there is no guaranteed way to run an economy, regardless of its stage of development.

Central banks are responsible for overseeing the monetary system for a nation (or group of nations), along with a wide range of other responsibilities of managing balance of payment and overseeing monetary policy to implementing specific goals such as currency stability, low inflation, and full employment.

NEW SPECIAL VOSTRO ACCOUNT IN INR FEMA, 1999

RBI has allowed International Settlement of Trade in INR as an additional arrangement for Invoicing, Payment (non-repatriable INR) and settlement of Exports / Imports in INR, instead of paying and receiving US dollars.

RBI has permitted settlement of trade thru special Vostro Account in INR as per below chart:



Insight -IAS Source- Google Image

History of INR usage in International Trade

Earlier in the 1960s, the rupee was accepted in gulf countries such as Qatar, the UAE, Kuwait, and Oman. India also had payment agreements with Eastern Europe and the rupee was used as a unit of account under these payment agreements. However, in the mid-1960s, these arrangements were terminated.

Till recently, all export contracts and invoices shall be denominated either in freely convertible currency or Indian Rupees. The practice of export invoicing in INR, but proceeds shall be realised in freely convertible currency

Trade with Nepal and Bhutan in INR is existing for a long time covered under a special arrangement

International Trade Settlement in Indian Rupees – New RBI Directive:

The broad framework for cross border trade transactions in INR under Foreign Exchange Management Act, 1999 (FEMA) is as under:

1. Invoicing: All exports and imports under this arrangement may be denominated and invoiced in Rupee (INR).
2. Exchange Rate: Exchange rate between the currencies of the two trading partner countries may be market determined.
3. Settlement: The settlement of trade transactions under this arrangement shall take place in INR in accordance with the procedure laid down in Para 3 of RBI circular dated July 11, 2022 which reads thus:

   "In terms of Regulation 7(1) of Foreign Exchange Management (Deposit) Regulations, 2016, AD banks in India have been permitted to open Rupee Vostro Accounts. Accordingly, for settlement of trade transactions with any country, AD bank in India may open Special Rupee Vostro Accounts of correspondent bank/s of the partner trading country. In order to allow settlement of international trade transactions through this arrangement, it has been decided that:

a) Indian importers undertaking imports through this mechanism shall make payment in INR which shall be credited into the Special Vostro Account of the correspondent bank of the partner country, against the invoices for the supply of goods or services from the overseas seller/ supplier.

b) Indian exporters, undertaking exports of goods and services through this mechanism, shall be paid the export proceeds in INR from the balances in the designated Special Vostro account of the correspondent bank of the partner country".

Approval Process:

To settle trade transactions with any country, RBI has laid out the guidelines in the circular.

1. The bank of a partner country (with which import/export has to be done) may approach the authorized dealer (AD) bank in India for the opening of a Special INR VOSTRO account.

2. The AD bank will seek approval from the RBI with details of the arrangement to go forward.

3. AD banks in India have been permitted to open Rupee Vostro Accounts. AD bank maintaining the special Vostro account shall ensure that the correspondent bank is not from a country or jurisdiction in the updated FATF Public statement on High Risk & Non Co-operative jurisdictions on which FATF has called for counter measures.

4. Accordingly, for settlement of trade transactions with any country, AD bank in India may open Special Rupee Vostro Accounts of correspondent bank/s of the partner trading country.

5. Indian traders undertaking imports via this mechanism shall make payments in rupees which shall be credited into the Special Vostro account of the correspondent bank of the partner country.

6. Indian exporters shipping goods and services under this mechanism shall be paid export proceeds in rupees from the balances in the designated Special Vostro account of the correspondent bank of the partner country.

Other regulations pertaining to Vostro accounts as per Master Direction - Risk Management and Inter-Bank Dealings

1. Debit or Credit to Non-Resident Bank:

   (i) Credit to the account of a non-resident bank is a permitted method of payment to non-residents and is, therefore, subject to the regulations applicable to transfers in foreign currency.

   (ii) Debit to the account of a non-resident bank is in effect an inward remittance in foreign currency.

2. Rupee Accounts of Non-Resident Banks

   AD Category I banks may open/close Rupee accounts (non-interest bearing) in the names of their overseas branches or correspondents without prior reference to the Reserve Bank. Opening of Rupee accounts in the names of branches of Pakistani banks operating outside Pakistan requires specific approval of the Reserve Bank.

3. Funding of Accounts of Non-resident Banks

   (i) AD Category-I banks may freely purchase foreign currency from their overseas correspondents / branches at on-going market rates to lay down funds in their accounts for meeting their bonafide needs in India.

(ii) Transactions in the accounts should be closely monitored to ensure that overseas banks do not take a speculative view on the Rupee. Any such instances should be notified to the Reserve Bank.

NOTE: Forward purchase or sale of foreign currencies against Rupees for funding is prohibited. Offer of two-way quotes in Rupees to non-resident banks is also prohibited.

4. Transfers from other Accounts

Transfer of funds between the accounts of the same bank or different banks is freely permitted.

5. Conversion of Rupees into Foreign Currencies

Balances held in Rupee accounts of non-resident banks may be freely converted into foreign currency. All such transactions should be recorded in Form A2 and the corresponding debit to the account should be in form A3 under the relevant Returns.

6. Responsibilities of Paying and Receiving Banks

In the case of credit to accounts the paying banker should ensure that all regulatory requirements are met and are correctly furnished in form A1/A2 as the case may be.

7. Refund of Rupee Remittances

Requests for cancellation or refund of inward remittances may be complied with without reference to Reserve Bank after satisfying themselves that the refunds are not being made in cover of transactions of compensatory nature.

8. Overdrafts / Loans to Overseas Branches/ Correspondents

(i) AD Category I banks may permit their overseas branches / correspondents temporary overdrawals not exceeding Rs.500 lakhs in aggregate, for meeting normal business requirements. This limit applies to the amount outstanding against all overseas branches and correspondents in the books of all the branches of the authorised AD Category I bank in India. This facility should not be used to postpone funding of accounts. If overdrafts in excess of the above limit are not adjusted within five days a report should be submitted to the Chief General Manager, Financial Markets Regulation Department, Reserve Bank of India, Central Office, 9th Floor, Central Office Building, Shahid Bhagat Singh Road, Fort, Mumbai – 400 001 within 15 days from the close of the month, stating the reasons thereof. Such a report is not necessary if arrangements exist for value dating.

(ii) AD Category I bank wishing to extend any other credit facility in excess of (i) above to overseas banks should seek prior approval from the Chief General Manager, Financial Markets Regulation Department, Reserve Bank of India, Central Office.

Documentation

The export / import undertaken and settled in this manner shall be subject to usual documentation and reporting requirements.

Letter of Credit (LC) and other trade related documentation may be decided mutually between banks of the partner trading countries under the overall framework of Uniform Customs and Practice for Documentary Credits (UCPDC) and INCOTERMS.

LC / exchange of messages in safe, secure and efficient manner may be agreed mutually between the banks of partner countries as being done by Banks in Iran, Syria/Lebanon etc.

The bank of a partner country may approach an AD bank in India for opening of Special INR Vostro account. The AD bank will seek approval from the Reserve Bank with details of the arrangement. The AD bank maintaining the Special Vostro Account shall ensure that the correspondent bank is not from a country or jurisdiction in FATF on high risk and non-co-operative Jurisdictions. However, this arrangement can be done to accommodate correspondent bank of sanctioned / OFAC countries.

Advance against exports

Indian exporters may receive advance payment against exports from overseas importers in Indian rupees through the above Rupee payment mechanism. Before allowing any such receipt of advance payment against exports, Indian banks shall ensure that the available funds in these accounts are first used towards payment obligations arising out of already executed export orders / export payments in the pipeline. The said permission would be in accordance with the conditions mentioned in Para-C.2 on Receipt of advance against exports under Master Direction on Export of Goods and Services 2016 as given in the table below.

In order to ensure that the advance is released only as per the instructions of the overseas importer, the Indian bank maintaining the Special Vostro Account of its correspondent bank shall, apart from usual due diligence measures, verify the claim of the exporter with the advice received from the correspondent bank before releasing the advance.

Setting-off of export receivables

'Set-off' of export receivables against import payables in respect of the same overseas buyer and supplier with facility to make / receive payment of the balance of export receivable / import payables, if any, through the Rupee payment mechanism may be allowed. These payments are allowed subject to the conditions mentioned in para-C.26 on Set-off of export receivables against import payables under Master Direction on Export of Goods and Services 2016.These conditions are as given in the table (Annexure-2)

Bank Guarantee

Issue of bank guarantee for trade transactions, undertaken through this arrangement, is permitted subject to adherence of the provisions of FEMA Notification No. 8, as amended from time to time and the provisions of Master Directions on Guarantees and Co-acceptances

Use of Surplus Balance

The Rupee surplus balance held may be used for permissible capital and current account transactions in accordance with mutual agreement. The balance in Special Vostro Accounts can be used for the following:

a) Payments for projects and investments.

b) Export/Import advance flow management

c) Investment in Government Treasury Bills, Government securities, etc. in terms of extant guidelines and prescribed limits, subject to FEMA and similar statutory provision

Compliance:

All compliance related to FEMA/DGFT/FEDAI/ FATF has to be complied with. Accordingly, handling of documents, reporting to RBI, R-Return, settlement in EDPMS/IDPMS/IRM/ ORM, KYC Compliance etc., has to be complied by the Indian Banks just as the compliance needed for a Foreign exchange transaction settled in Foreign Currency.

For Outward / Import transactions (both

invoicing and settlement denominated in INR), lodgement of bills, realisation of Bills, settlement of BOE, write off, setoff, ORM adjustment / closure, R-Return etc. has to be handled by the Indian Bank maintain the Vostro Account

For Inward / Export Transactions (denominated in Foreign Currency or INR) , lodgement of Bills, realisation, settlement of shipping Bills, write off setoff, IRM adjustment / closure, R-Return, e-BRC issuance etc. has to be handled by the Indian Bank maintain the Vostro Account

Benefits of the Mechanism of International Trade Settlement in Indian Rupees

1. Reduce India's dependency on US dollars: This is an additional arrangement for invoicing, payment and settlement of exports and imports. This arrangement helps to trade with eligible countries to reduce our dollar requirements and broaden the trading scope.
2. Internationalisation of Rupee: This mechanism helps in promoting the growth of global trade with emphasis on exports from Indian and to support the increasing interest of global trading communities in the domestic currency. It will gradually contribute to the global acceptance of rupees for international trade transactions. Thus making Rupee International.
3. Reduce Trade Deficit by Saving Foreign Currency: India being a net importing country, it needs a lot of foreign currency reserves to maintain sufficient import cover. With this mechanism, we can expect to save foreign exchange and hence will reduce our trade deficit.
4. Reduce imported Inflation: This mechanism helps in technically financing our trade deficit with Rupees. This will help reduce our imports and hence imported inflation through currency depreciation can be avoided.
5. Helps in Stabilising Rupee: With the increase in India's external trade getting invoiced in the INR, the internal demand for the US dollar would decrease, helping to stabilise the INR price against the US dollar.
6. Broaden the participation in Government Bonds and T-Bills: Surplus funds in Vostro accounts are allowed to be used to buy G-Secs and T-Bills. This helps broaden the participation base and help makes Indian G-Secs attractive.
7. Lower Interest Rates: Broad participation and increased investment in G-Secs reduces the interest rates and can help Indian corporates reduce their borrowing costs.
8. Reduces Vulnerability to external shocks: This mechanism will provide additional arrangement for invoicing, payment and settlement of exports and imports. Hence, can give buffer in case of external shocks. Also helps in overcome the dependency on the SWIFT payments system
9. Helps in better economic and trading ties with the neighbouring countries: This mechanism will help trading with our neighbours and dollar starved countries like Srilanka, Bangladesh etc. increasing our economic and trading ties with them.
10. Helps in trading with sanctioned countries: This mechanism will help in dealing with the countries that have restrictions for trade settlements in USD like Russia and Iran.
11. Reduce conversion expenses: Indian Exporters will have reduced conversion expenses as the settlement happens in their home currency which reduces the risk of foreign exchange.
12. Helps in Full Convertibility: If the

mechanism gathers pace India can work on Full convertibility

Which Countries are likely to use the New Model?

The RBI has not explicitly named countries for which the new mechanism could be used. So, the mechanism is open for all countries. The following are the possible reasons for countries' interest in the new Mechanism.

- Foreign Exchange Crisis Ridden Countries: Difficulties in mobilising US dollars are affecting the trade prospects of several countries which face acute foreign exchange shortages. Traders from several parts of Africa, Scandinavia, Latin America and Asia are unable to mobilise the US dollar for invoicing. The problem of mobilising the US dollar affects trades between these countries and the rest of the world. This mechanism if used can help the countries in invoicing their export and import trade in INR and will ease the flow of payments for those counties. It will brighten the prospects of their bilateral trade with India.
- Sanction Hit Countries: Countries under sanctions like Russia and Iran who are finding it difficult to do an international trade will be benefitted from this INR Vostro mechanism.
- Countries interested in participating in India's Growth: With India being seen as growth engine of the world for future years, there are countries who would like to be part of India's growth.

As on date 30-35 countries including those from Asia, Scandinavia and Africa have expressed interest in better understanding the rupee trade mechanism for possible adoption. India's neighbours Viz.,Sri Lanka, Bangladesh, Myanmar, Nepal that have been facing shortage of dollar reserves have also shown interest in trade settlements in rupee. India is also in talks with Southeast Asian, African and Latin American countries to start trade settlement in rupee.

Latest Developments on Special Vostro Rupee Accounts (SVRA):

1. As per media reports, Russian banks including Sberbank, VTB, Gazprom, BCS, MTS, Tinkoff, Soyuz, Credit Europe Bank (Russia), PSCB, Ros and JSCB have opened Special Vostro Rupee Accounts (SVRA) with IndusInd Bank, UCO Bank, HDFC Bank, Union Bank of India and Canara Bank. Sberbank and VTB have opened one such account with their local branches.
2. Meanwhile, SBI Mauritius and People's Bank of Sri Lanka have opened SVRA accounts with State Bank of India (SBI). Sri Lankan banks viz., Seylan Bank, NDB Bank and Commercial Bank of Ceylon have opened SVRA accounts with Indian Bank. Bank of Ceylon has opened one such account with its branch in India.
3. India's rupee trade settlement mechanism is also attracting interest from other countries including Tajikistan, Cuba, Luxembourg and Sudan.
4. The RBI has prepared a concept paper for trade settlement in the Indian rupee with the country's third-largest trading partner the UAE. According to Sunjay Sudhir, India's Ambassador to the UAE, the Central Bank of the UAE is looking at the matter and discussing it with the RBI officials to operationalize the mechanism. "We have shared RBI's concept paper with the UAE, which has already designated a nodal person for this. Both countries' central banks are in talks with each other to operationalize trading in local currencies. The main objective of this is to reduce the cost of the transaction," Sudhir has said.

5. India's finance ministry has also asked the Indian Banks' Association (IBA) and the FIEO to begin an awareness campaign to sensitize stakeholders about the rupee trade.

Major Issues to this Mechanism:

Banks have been found to face several challenges in using new Special Vostro Account in INR for settlement of trade with Russia and other sanctioned countries. Two major challenges are:

1. **Risk of Sanctions on Indian Banks:** Risk of US sanctioning / freezing / expropriating the foreign currency assets / balances in USD / other currencies Nostro Accounts of Indian banks helping trade settlement with Russia and other sanctioned countries.
2. **Pressure from Western Countries:** We can expect pressure from Western countries to not allow such mechanism.
3. **Complicates domestic Monetary Policy:** With diversified trading partners in new mechanism, domestic monetary policy may become complex tracking inputs from economies of different trade partners
4. **Issues of Trade deficits with our trading partner:** Trade settlement in INR with countries where India has trade surplus will have no issues. But settlement with trade deficit countries would be difficult.

Banks seek clarity on Grey Areas' from RBI on Special Rupee Vostro Accounts:

Banks have reached out to the Reserve Bank of India (RBI) seeking clarity on legal and regulatory grey areas regarding the Rupee Vostro Accounts before operationalising them to settle international trade, including that with Russia. A Vostro Account is an account where a foreign bank acts as an agent to provide financial services on behalf of a domestic bank. The account enables domestic banks to provide international banking services to their clients with global needs. This account keeps a foreign entity's holdings in the Indian bank denominated in Indian rupees. When an Indian importer wants to make a payment to a foreign trader in rupees, the amount is credited to the Vostro Account.

Status of relevant Policies / Schemes vis-a-vis INR Settlement Mechanism:

1. Amendments notified by DGFT to enable INR Settlement:

DGFT Notified vide Notification No. 33/2015-2020, Dated: 16th September, 2022 by inserting the Para 2.52(d), to permit Invoicing, payment and settlement of exports and imports in INR in sync with RBI's A.P. (DIR Series) Circular No. 10 dated 11th July, 2022.

DGFT vide Notification No. 43/2015 -2020-DGFT, Dated: 9th November, 2022, made Amendments under FTP, to permit exports benefits / fulfilment of Export Obligations for Invoicing, payment and settlement of exports and imports in INR, as per RBI's A.P. (DIR Series) Circular No. 10 dated 11th July, 2022. Accordingly amendments in FTP were made in para 46 (Import for export); 2.53 (Export to Iran — Realizations in Indian Rupees to be eligible for FTP benefits / incentives); 3.20 (Status Holder); 4.21 (Currency for Realization of Export Proceeds)

DGFT Vide Public Notice No. 35/2015-20-DGFT; Dated 9th November, 2022, Amendment made in Para 5.11 of the HBP, to permit the Invoicing, payment and settlement of exports and imports in INR for Export Proceeds under EPCG Scheme

With the above amendments to the Policy, the Ministry of Commerce notified its decision to allow invoicing, payment and settlement of external trade in rupees. The move was required to align the foreign trade policy of the Government with the July 2022 announcement of the Reserve Bank of India (RBI) and facilitate rupee trade.

According to the notification, domestic firms undertaking imports through this mechanism will make payment in rupee, which will be credited into the Special Vostro Account of the correspondent bank of the partner country, against the invoices for the supply of goods or services from the overseas seller/supplier. Indian exporters undertaking exports of goods and services through this mechanism shall be paid the export proceeds in INR from the balances in the designated Special Vostro Account of the correspondent bank of the partner country.

Even exports under Duty Free Import Authorisation Scheme (DFIA) and Duty Free Replenishment Certificate (DFRC) scheme should be settled in INR as per FTP handbook 2.5

2. Export Realizations in Indian Rupees – Export Benefits Duty Drawback Scheme: Section 75 of the Customs Act, 1962, and the Customs and Central Excise Duties Drawback Rules, 2017, state that the sales proceeds must be realized. (But does not mention any particular currency). So, the entitlements of Drawback will be available against payments received through SVRA accounts.

3. Refunds due to Zero-Rated Exports under GST - Rule 96A & 96B:

   a) Rule 96A (1) (a) for Export of Goods states Exporter to Pay the Tax due along with the interest if the goods are not exported out of India within three months from the date of issue of the invoice for export. The rule does not state any Condition of Realization of Export Proceedings.

   b) Rule 96A (1) (b) for Service Exports states Exporter to Pay the Tax due along with the interest if payment of such Services is not received by the exporter in convertible foreign exchange or in Indian rupees, wherever permitted by the Reserve Bank of India.

   c) Rule 96B Refers to sale proceeds in respect of such Export Goods that have not been realized, in full or in part, in India within the period allowed under the Foreign Exchange Management Act, 1999 (42 of 1999). This Rule does not specify any realization of Export Proceeds in convertible foreign exchange or in Indian rupees.

   Hence, from the above Rules it is very clear that Export Refunds are allowed even if the Export Proceeds are Received in INR.

4. Export Realizations in Indian Rupees – Export Benefits under Remission of Duties and Taxes on Exported Products (RoDTEP) Scheme: As per Para 4 of Notification No. 76/2021-Cus(NT) dated September 23, 2021, Duty Credit allowed under the RoDTEP scheme is subject to realization of sales proceeds within the period allowed by the RBI. But no specific mention about realization in any Particular Currency. So Realizations in Indian Rupees is entitled for RoDTEP Benefits.

5. However, there is suitable modification required to be made for allowing export proceeds received through SVRA.

   a) SEZ Act, 2005 and SEZ Rules, 2006 with respect to certain provisions of achieving Positive Net Foreign Exchange Earnings.

b) Export Oriented Units

Initiatives to be taken by India for International Trade:

1. **Trading out the Rupee for other international currencies:** Currently, payment / setoff of export receivables against import payables in respect of same overseas buyer and supplier with facility to make / receive payments of the balance of exports receivables / import payables are allowed to be settled through Rupee. This will be an issue with the trade partners with Trade deficits. We may explore the options as follows:

   a) Allowing the Vostro banks to trade out the rupee for other international currencies. For Instance, Vostro balances of Russian trade partner can be used to make payment in say Chinese Yuan.

   b) We may allow foreign banks to use the INR in their vostro accounts to trade with another foreign bank (essentially meaning allowing of two countries to trade with each other using INR). For instance, Russia might want to buy from Srilanka, and Srilanka is likely to accept INR as a payment. This helps Russia to have multilateral uses of the INR and need not be compelled to buy G-Secs.

2. Free Trade Agreements (FTA): FTA is a pact between two or more nations to reduce barriers to imports and exports among them. FTAs will promote rupee for international trade settlements. As on March 2022, India has 11 FTAs and 6 PTAs (Preferential Trade Agreement). Since the FY 2022-23, India has picked up pace FTA arrangement and signing. Two trade deals with UAE and Australia had been signed now and expect to sign FTAs with United Kingdom, Canada, European Union, Gulf Coopeartion Council (GCC) in this FY. With a strong INR settlement framework, once stabilised will help India's International trade.

3. Incentivise the Exporters and Importers: Incentives need to be given to the exporters/ importers for trade settlements in INR

UCO BANK BECOMES FIRST LENDER TO GET RBI'S APPROVAL FOR RUPEE TRADE

UCO Bank has received the Reserve Bank's approval to open a Special Vostro Account with Gazprom Bank of Russia for trade settlement in Indian rupees. The Kolkata-based public sector Bank is the first Indian bank to receive the regulator's approval following the RBI's July 2022 decision to allow Indian banks to settle trade in Indian currency.

The Russian Bank, which was set up by world's largest gas producer and exporter Gazprom to provide banking services for gas industry enterprises has been operating since 1990. One of the top three banks in Russia, Gazprom Bank offers a whole range of banking and investment services to over 45,000 corporate and three million private clients. In a recent interaction with Business Standard UCO Bank MD & CEO, Soma Sankara Prasad, stated that they have received many applications from banks from several countries for opening a Special Vostro Account. He stated thus:

"They have come out with a circular regarding the special vostro account. It will work in cases where the balance of trade is even with the country. It is a good mechanism, which has been introduced by the RBI where a certain amount of trade can take place in rupee."

"We have received some applications for opening Special Vostro Accounts from banks of other countries. We are looking at it."

Following the Russian invasion of Ukraine in February this year, India's trade with Russia has been rising. During the April-June quarter, India's imports from Russia was valued at $9.27 billion, up by 369 per cent. Crude oil comprised almost two-thirds of the imports from Russia. Other major imported items included coal, soybean and sunflower crude oil, fertilisers etc.

On July 11, 2022 the RBI issued a circular allowing trade settlements between India and other countries, including Sri Lanka and Russia, in rupee.

The RBI circular stated that Indian importers undertaking imports through the INR trade mechanism will make the payment in rupees by crediting the amount into the Special Vostro Account of the correspondent bank of the partner country, against the invoices for the supply of goods or services from the overseas seller/supplier. The RBI had said the exchange rate between the currencies of the two trading partner countries will be market determined.

Many banks in India are planning to open such Special Vostro Accounts for settling trade transactions with other nations. Indian exporters sending out goods and services through this mechanism should be paid in rupees from the balances in the designated Special Vostro Account of the correspondent bank of the partner country, the RBI notification said.

UCO Bank was chosen by the Union Government in 2012 as the payment bank for oil imports from Iran, after the United States tightened the earlier rounds of sanctions. UCO Bank was chosen because of its limited global presence, which made it less vulnerable from repercussions over its involvement with then sanctioned Iran. UCO Bank reaped rich benefits from that deal. However, in recent times there has been no fresh inflows as India is no longer importing oil from Iran.

"Earlier till 2019, we were buying oil from Iran. Therefore, a huge amount of rupee balance was there in Iranian banks' account with us. Since we have stopped buying oil from Iran from 2019, the rupee balance has gone down," said UCO Bank CEO and MD, adding that UCO Bank was looking at ways to augment the rupee balance.

QUOTATION OF FOREIGN CURRENCIES LINKED TO USD FOR SETTLEMENT OF INTERNATIONAL TRADE

We need Forex market to convert foreign currency received by us or foreign currency to be paid by us for settling international trade, travel and other inward/ outward remittances for Immigration, medical services and such other commitments.

In a foreign exchange transaction one currency is exchanged for another. A foreign exchange transaction involves (I) buying of one country's currency by paying for it in another country's currency; and (ii) selling one country's currency for payment to be received in another country's currency. A currency exchange rate Is simply the ratio of a unit of currency of country A to a unit of the currency of country B at the time of the buy or sell transaction.

CONVERTIBILITY OF CURRENCY

Convertibility is the process by which a country's currency can be converted into gold or another currency. Convertibility is extremely important for international commerce. When a currency in inconvertible, it poses a risk and barrier to trade with foreigners who have no need for the domestic currency.

The following types of rates are quoted/pegged in different countries through the three-tier system of market i.e., central bank, inter-bank (authorised dealers), and corporates/retailers.

Flexible exchange rates – Rates determined by the forces of supply and demand without Government intervention. Most advanced countries follow this type of exchange rate system

Fixed exchange rates – Rates pegged within a narrow range of values by central banks' ongoing purchases and sales of currencies. Examples: China, Hong Kong, UAE, Saudi Arabia (about 20 such countries in the world follow this practice).

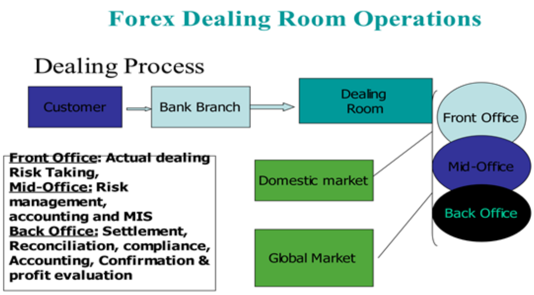
The Current System- Managed/Dirty Float: - An exchange rate system that combines features of freely floating rates with intervention by central banks (to moderate fluctuations in exchange rates). In India, we follow this system and get USD/INR quotation only from the market participants (AD banks) as under.

In India, INR is fully convertible for current account transactions and partly convertible for capital account transactions; for instance, FPI/FII's flows only are fully convertible. In advanced countries like US, UK, Japan, European countries, the currency is fully convertible for current account and capital account transactions. Forex reserves though part of balance of payment are managed by the Central Bank.

Foreign Exchange Market in India

Source: Google – SlidePlayer

The ideal system would foster international trade, fuel lower inflation and promote a more stable economy.



Source: Google – SlidePlayer

The Integrated Dealing Room set-up (foreign exchange and money market operations) is depicted in the following flowchart.

FOREX MARKET CHARACTERISTICS

Customers are those who buy and sell Forex for their trade requirements, hedging and trading - Merchant market/Retail market

Commercial banks are those authorized to deal in Forex - Interbank market – Whole sale market

Market maker – Mainly trading

Market taker – Mainly cover operations

Central banks – control/manage volatility and undue movements of their currency

Exchange brokers act as intermediary between banks for doing the deals

Hedge/Pension/Mutual Funds & Insurance Cos – Invest and speculate on the Forex movements

Over-the-Counter Market - Forex dealings

The market for foreign exchange is a continuous inter-bank market (24 hours) in 4 different time zones – New Zealand to NYK to New Zealand

Trading begins in New Zealand, followed by Australia, Asia, the Middle East, Europe, and America

Forex market follows the sun around the earth in terms of trading from Monday till Saturday.

Average daily turnover is USD 6.70 Trillion per day

Indian Forex market open from 9 AM to 5 PM. Daily turnover is USD 60 Billion (Merchant 18 billion, Inter-Bank 42 billion)

Foreign exchange market can be described as wholesale (inter-bank) and retail market- Network of banks, corporations, individuals, Forex traders, Arbitragers, brokers and Money Changers

What Variables affect Exchange rates?

Country's balance of payment situation: Inflows – outflows -surplus leads to stronger currency.

Crude oil price, rate of inflation

Rate of Interest –currency with higher interest will appreciate in the short term.

Economic condition of the country and economic policies of the

Government – High/Low growth rate

Fiscal / Monetary Policy- deficit financing leads to depreciation of currency

Political scenario and degree of uncertainty in the political situation –Political stability leads to stable rates

Direct intervention of Central bank to smoothen unduly large short-term fluctuations

Market Sentiment: Perception of traders

Technical Reasons

- Government control can lead to unrealistic value like in UAE, China.

- Free flow of capital from lower interest rate to higher interest rates.

- Speculation – higher the speculation higher the volatility in rates

Developments abroad–Eurozone Debt/ COVID-19 Crisis/US stimulus/- Geopolitical situation in Russia, Ukraine, Sri Lanka, Syria, Afghanistan etc.

- Comments from FM/RBI Governor/Rating Agencies

Quotation of Exchange Rates in Inter-bank Forex market

Exchange rates are quoted on spot basis based on the purchasing power parity (PPP) and demand and supply (BOP) theory.

The purchasing power parity was put forward by Gustav Cassel after the First World War thus: "The rate of exchange between two currencies in the long run must stand essentially on the quotient of the internal purchasing powers of these currencies". The value of one currency in terms of another currency will be determined by the relative values of two currencies as indicated by their relative purchasing power over goods and services. Simply stated currencies are valued for what they can buy.

For instance, if 100 Jpy can buy a Parker pen and the same pen can be bought for 1 USD it can be inferred that 1 USD and 100 Jpy can buy the same pen and thus 1 USD is equal to 100 Jpy.

Demand and Supply (BOP)

Also known as 'demand and supply theory' it holds that the foreign exchange rate, under free market condition, is determined by the conditions of demand and supply in the foreign exchange market (Just like the price of any commodity). The value of a currency appreciates when demand for it increases and depreciates when the demand falls, in relation to its supply in the Forex market.

The extent of demand and supply for a country's currency depends upon its balance of payment position.

Forex transactions have two aspects namely (I) purchase and (ii) sale. Bank would pay INR while purchasing USD and accept INR while selling USD.

Any purchase or sale transaction is referred to from bank's point of view and the item referred to is the foreign currency.

Thus, a purchase transaction by a customer is actually a sale transaction by the bank and

sale of foreign currency by a customer is a purchase transaction by a bank

World-wide 4 Currencies viz GBP, Euro, AUD & NZD are quoted as under:

1 GBP = USD, 1 Euro= USD, 1 NZD=USD 1 AUD= USD, wherein home currency is the base currency and USD is the quoted/terms currency

While quoting three letter ISO standard is used, where the first two words viz GB denote the name of the country, Great Britain and the third letter word P denotes the name of the currency, Pound

Hence the left side quote is a base currency and the right-side quote is a term or quoted currency

All are quoted on Spot basis. That means settlement of the currency shall happen on the 2nd working day, due to time zone difference between the countries.

In other currencies including India the base currency is USD and the quoted/terms currency is the home currency.

Example: India-USD/INR 1 USD=INR 1.50/51; Japan: 1 USD= JPY 142.20/25, 1 USD/AED= 3.6725/35

Other market conventions

Quotations in inter-bank are usually up to four decimal places except for JPY where it is up to two decimal places and the last two digits are called pips or points.

Direct and indirect methods of quoting. No fees charged. Transaction cost in the bid-offer spread.

Message confirmations through SWIFT.

Forex dealings in Over-the-Counter Market.

The market for foreign exchange is a continuous inter-bank market (24 hours) in 4 different time zones – NZ to NYK to NZ

Trading begins in New Zealand, followed by Australia, Asia, the Middle East, Europe, and America

Forex market follows the sun around the earth concept.

www.ccilindia.com plays an important role in trading and settlement of foreign exchange in India

Types of Transactions

Inter-Bank Transactions: Transactions with the market participant Bank at inter-bank/ base rate, settled as under: (Saturday/Sunday excluded) -

Ready or Cash: Value today

Tomorrow or "tom": Value tomorrow

Spot transactions: Two business days after trade date

Forward transactions: Any value date beyond spot

Swap transaction: Combination of spot and forward

Merchant transactions: Transactions with the customer at card rate or negotiated rate (based on the agreed margin with the customer

HEDGING CURRENCY RISK IN INTERNATIONAL TRADE

Hedging of currency risk can be done in the following ways:

1. Availing PCFC at LIBOR/SOFR rate of interest, wherein the USD/FC is converted at Spot TT buying rates, which in turn becomes the bench-mark or natural hedging at Spot TT buying rate.
2. Booking forward contract with the AD bank. Exporters/importers can hedge their currency risk by booking OTC Forward contract up to a period of 1 year with the AD Bank against the LC or Order.
3. Booking Futures with BSE, NSE or MCX up to 1 year without LC/Order but by paying required Initial/MTM margin to the Exchange broker. The Exchange only books the Futures on squaring off basis and daily MTM basis. Actual delivery of FC/ USD takes place with the banks only.
4. Booking Options contract with AD bank or Exchange, based on the view of the exporter/importer. This contact can be booked against payment of option premium upfront for the exposure and can be exercised or allowed to expire after considering the profit or no profit at the time of due date of the option contract.

FOREX RISK MITIGATION STRATEGIES

Hedging transaction risk - Internal techniques

Invoice in home currency, Leading and Lagging, Netting or Natural Hedge/Matching, EEFC

Hedging transaction risk - External techniques

Forward contracts, Futures contracts, Options, Forex/Currency swaps

Money market hedges- Interest rate swaps/ FRAs

Based on anticipated exposure or contracted exposure

Risk management policy =100 per cent or 50 per cent hedged and 50 per cent open (self-hedge)

Currencies always fluctuate in value when compared to one another. As a result, in the case of international financial transactions, there is always a possibility of foreign exchange loss (or profit) due to these currency fluctuations. A Forex hedge is a hedging currency trade, whose sole intent is to protect a current position or an upcoming currency performance. Also known as currency risk and exchange rate risk, it gets activated when the exporter involved in an international transaction trade in a currency that is not its home or domestic currency. In this context it will be useful to refer to the following excerpts from the interview given by CMA Nijay Gupta Consultant and Advisor in Forex Risk Management to the Export Promotion Council.

"What is Forex hedging?

A Forex hedge is a transaction implemented to protect an existing or anticipated position (export order/ transaction) from an unwanted move in exchange rates. Forex hedging is to hedge/ insure against the volatility in the movement of exchange rate to ensure realization of export proceeds as per the costing done while pricing the product or fixing the INCOTERMS (International Commercial Terms) at particular exchange rate.

It is important to remember that a hedge is not a money-making strategy. A Forex hedge is meant to protect from losses, not to make a profit, even if there may be times when the exporter experiences gain due to currency fluctuations. Importantly, most hedges are intended to remove a portion of the exposure risk rather than all of it, as there are costs to hedging that can outweigh the benefits after a certain point.

What is the process of opening a Forex hedge?

The Forex hedge can be done by availing PCFC with the bank or booking forward contract with the bank or option contract with the Exchange or a bank or through futures contract with an Exchange. Below is an explanation of some of the terms associated with opening a Forex hedge:

Forward contract

Forward contract is a contract to exchange an agreed amount of dollars for the foreign currency on a decided future date. This leads to an agreement on the price and locks the export sale on that price. Even if the foreign currency (INR, in this case) appreciates, the business is protected, even though you cannot gain in case of a devaluation of the INR.

Futures contract

Here, you agree to purchase currency in the future at an agreed foreign exchange rate. These currency contracts are purchased from exchanges like the NSE. Unlike a forward contract, futures have a secondary market of their own. So, you can sell them before the agreed date as well, in case you see a favourable currency market or need liquidity for your business. The agreed exchange price in a futures contract is generally a range, and what you get at the end of the term is an approximate amount rather than the exact amount.

Currency options

With currency options, banks offer exporters an opportunity to buy or sell a certain amount of currency at a fixed price, on or before an agreed date. Exporters are not under any obligation to buy or sell; the opportunity ends on the agreed date. The price at which the currency can be bought or sold is known as the strike price. To sum up, all these strategies are akin to buying insurance against any currency fluctuation loss that exporters may incur over a period of time. However, bear in mind that exporters will also inevitably miss out on any windfall that may be due to favourable currency movements.

How can an exporter decide on a hedging strategy? What should be the key considerations?

Forex hedging protects the exporter from losses arising out of currency fluctuations. The exporter doing the hedging can reduce the risk of loss until the settlement of payment.

It can also help exporters with decision making. For example, if the exporter decides to take a long position in the forward market and eliminates the risk of the foreign currency transaction, hedging can help the exporter understand the expenses involved in the exposure management as well as the foreign exchange exposure itself.

Hedging brings certainty to the transaction in terms of price and receivables. By locking the currency value of the export transaction through currency options or future options, the effects of adverse currency movements are eliminated. With the prospect of losing money taken care of, hedging also protects the company's earnings as losses are avoided.

In an unpredictable currency market, exporters may be apprehensive in putting receivables at stake. But with smart hedging practices, they can be more confident in taking up export orders. Thus, hedging also helps exporters expand their businesses by encouraging them to grasp more opportunities.

The exporter needs to have its own Forex risk management strategy as fully hedged or party hedged strategy or could have natural hedge (if there is a matching imports). Based on the policy of the management, the company can go ahead with hedging the forex risk.

What are the advantages of Forex Hedging to exporters?

FX hedging benefits those interested in protecting a portfolio from risks associated with currency, interest rate and commodity or product input. Currency hedging can reduce or virtually eliminate the impact of foreign exchange movements during the term of an investment by way of currency transfer to a paired currency value. Hedging limits, the losses to a great extent by ensuring realizing the value/pricing of the product done at a particular level of Forex vis-à-vis INR rate or self-hedge by not covering the forex risk.

Hedging also enables a company to offset interests on contracts by locking in an exchange rate on a forward contract at effectively no cost while the difference between the interest rates on the two currencies is favourable. Fair value hedges enable a trader with two interest rate swaps that are outstanding to optimize their contract with a currency transfer.

It improves diversification of your holdings. Hedging spreads out your open positions to reduce the risk of a single variable or event hitting your positions with losses across the board.

What are the disadvantages of Forex Hedging to exporters?

Greed is the greatest disadvantage while hedging for the exporters. Like recently the INR depreciated by 12 per cent from INR 73 per dollar to almost Rs. 81 per Dollar. So, managements of few companies lost their contract from overseas buyer or felt loss of opportunity, as most of them already sold/ hedged their foreign currency receivables.

Your profit potential will likely be reduced. While a hedge reduces your risk, it also cuts into your profit potential. This is because in cases where profits continue to rise for your initial open positions, your hedged position is likely to decrease in value.

Cancellation of overseas contract or not realizing the foreign currency as per delivery dates of the contract can lead to loss for the exporters.

Although Forex hedging is typically used to limit risk for exporters, poor execution of this strategy can be disastrous for your trading account.

Due to the complexity of hedging in forex, exporters even experienced ones can never be fully assured that their hedge will counteract any possible losses. Even with a well-designed hedge, it's possible for both sides to generate a loss. Factors such as commissions and swaps should also be carefully considered.

Exporters should not engage in complex hedging strategies until they have a strong understanding of market swings and how to time trades to capitalize on price volatility. Poor timing and complex pairing decisions could lead to rapid losses within a short period of time.

Why and when should an exporter consider Forex Hedging?

Foremost, exporters should make their forex risk management policy and then based on the risk perception, the management should hedge their risk, full or part or consider natural hedge (if they have imports too) to cover the risk in volatility of forex.

A short-term hedge can be a great way to protect profits when you're unsure of certain factors that could cause volatile price movements. This uncertainty can range from a suspicion that an asset has been overbought to concerns that political or economic instability could cause certain forex pairs to plummet in value—particularly when you've opened a long position on those pairs.

However, it is suggested that hedging must be looked at as a long-term inclusion in a company's risk management strategy rather than immediate or short-term gains that can prove highly risky, especially considering unforeseen developments such as the Ukraine crisis or the sudden depreciation in currency values.

How can an exporter exit a hedge?

Exporters can exit a hedge by cancelling the forward contract or taking reverse position of the forex contract already booked with a bank or exchange.

When you're exiting a direct or complex hedge keeping your initial position open, you need to close out only the second position. When you're closing out both sides of a hedge, you'll want to close these positions simultaneously to avoid the potential losses that can come if there is a gap.

It's important to keep track of your hedged positions so that you're able to close out the right positions at the right time to complete the execution of this strategy. Overlooking one open position in the process can derail your entire hedging strategy—and potentially hit your trading account with steep losses."

FX Retail platform of Clearing Corporation of India (www. CCILIndia.com)

Mr. Gupta* advises all exporters/Importers to take the advantage of FX Retail platform of Clearing Corps of India with the help of their own AD Bank in India. This platform helps international traders to track the exchange rate, the exchange margin applied by banks and forward Forex booking limits granted by bank against a one-time fee of Rs. 500. This can be done on the laptop/desktop of the company official responsible for exchange rate booking etc

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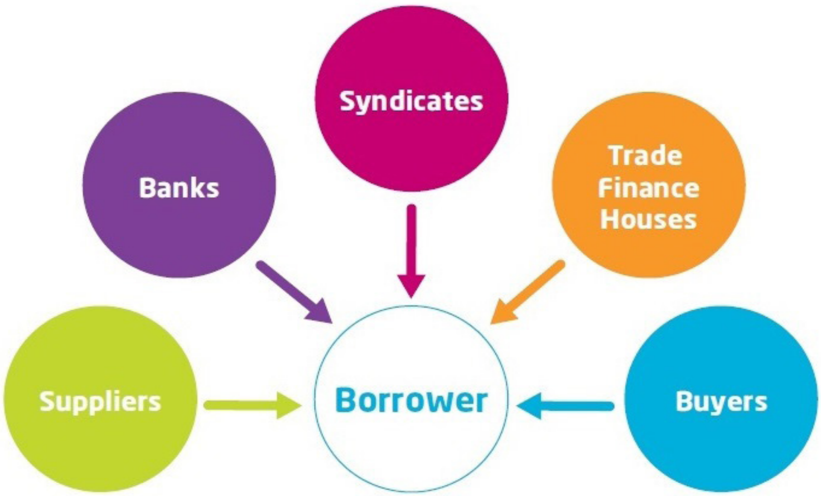
FINANCING INTERNATIONAL TRADE AND ROLE OF BANKS

Providers of Trade Finance



Source : Google – Trade Finance analytics – Meridean Enterprises

Users of Trade Finance

Source : Google – Trade Finance analytics – Meridean Enterprises

Banks deal in documents related to trade and not in goods. Bank's role in facilitating trade is categorized as financer or agent.

BANK AS A FINANCIER

Fund Based Financing - Term loans and working capital loans which take care of the pre-shipment and post-shipment finance

Non – fund-based financing - By means of letter of credit and bank guarantees

Bank as an Agent - Handling of the documents on behalf of other bank, importer or exporter, routing the fund to other bank e.g., remittances. Not undertaking any financing activity, import/ collection documents and remittances

Buyer's Bank

Bank's business Interests are in providing non-fund finance fee-based services (For document collection & presentation). The buyer's bank can assist in:

- Providing payment assurance to seller on behalf of the buyer
- Providing finance in respect of the sale
- Effecting payment to the seller on behalf of the buyer
- Handling documents covering the sale and risk mitigation

Seller's Bank

Bank's business interests are in providing finance and fee-based services (for document collection and presentation)

The seller's bank can assist in:

- Assuring payment as a third party
- Providing finance
- Pre-shipment /Post-shipment credit to buyer
- Handling documents for regulatory requirements
- Obtaining payment for seller from Buyer's Bank

SOURCES OF FINANCE IN INTERNATIONAL TRADE

Sources for Exporters -

Own Funds

- Advance from buyer
- Credit from Suppliers

Scheme for finance from bank's/financial institutions at pre or post shipment stage and also for Imports of goods for export

Common scheme for all types of exporters in all the banks in India

Scheme guided by RBI vide its Monetary Policy

Money given at concessional rate of interest at pre-shipment and post shipment stage to meet short-term working capital requirements.

Repayment of loan/credit from overseas only

Banks are partly refinanced by RBI and this ranks for priority sector finance of banks

Interest rate equalization (subvention) provided @ 3 per cent p.a. for MSME exporters. Merchant exporters allowed interest equalisation at the rate of 2 per cent on credit for export of products.

RBI has the following schemes through which all types of exporters are given finance on priority basis at concessional rate of interest through all AD banks in India.

1. Pre-shipment Stage

   Packing credit is provided against LC or confirmed order, Hypothecation of goods, against ECGC cover on exporters up to 80 per cent of the value of goods in INR at MCLR rates or PCFC (Packing credit in foreign currency) at LIBOR/SOFR related rates up to a period of 1 year to be liquidated/settled against advance payment or discounting/negotiation of export documents after export of goods or debit to EEFC a/c. MSMEs exporters are given subvention at 3 per cent and merchant exporters at 2 per cent in the MCLR of interest. Also known as packing credit (PC) to be used for procurement of raw material, local or imported, storage of raw material or finished goods in warehouse prior to shipment and charges relating to transportation, marine freight, export documentation, etc

2. Post-shipment Stage

Hundred per cent finance given in INR/ foreign currency at MCLR/SOFR against the export documents with 3 or 2 per cent subvention (depending upon the type of borrower) by liquidating the packing credit or discounting the bills (if PC is not availed) depending upon the tenor of the bill. For DP sight bills finance is provided up to normal transit period (NTP) between 5 days to 25 days depending upon the destination involved. In case of DA bills, finance is provided up to a maximum period of 270 days, depending upon the tenor of the draft/ credit allowed to the borrower. Liquidation of pre-shipment finance must (if PC taken) or collection bills – (Can take finance at any time in INR or foreign currency) through the following:

Bills Purchase – DP/Sight Bill – up to NTP (By selling foreign currency or Just continuation of INR finance taken at pre-shipment stage);

Bills Discounted – DA Bills (up to tenor/due date of the bill or 270 Days from the Date of Shipment – whichever is lower);

Bills Negotiated – DP/DA Bills – under a LC (subject to NTP/Due date/tenor of the bill – Max 270 days from the date of shipment

Factoring – With or without recourse

Forfaiting – Without recourse up to 10 years (even PC at one bank & and forfaiting with another bank). Best suited for all.

SCHEME OF FINANCE FOR IMPORTERS

Buyer's Credit – Foreign currency demand loan/foreign currency term loan

- Buyer's credit also known as trade credits (TC) under FEMA 1999, refers to loans for payment of capital/non-capital goods imported into India under Foreign Trade Policy of Govt of India, arranged by the importer or a financial intermediary from a bank or financial institutions outside India.
- Importer's bank guarantees the loan, mitigating the risk for the exporter.
- Buyer's credit allows the buyer, or the importer, to borrow in foreign currency (USD, GBP, EURO, JPY etc.) at SOFR (earlier LIBOR) rates, lower than what would be available domestically.
- With buyer's credit, exporters are guaranteed payment(s) on the due date; whereas importer gets extended time for making an import payment as per the cash flows;
- The importer can deal with exporter on sight basis, negotiate a better discount and use buyers credit route to avail financing. The importer can use this financing of trade under collections, or LCs.
- Buyer's credit allows an exporter, without much complexity, to execute large orders and allows the importer to obtain financing and flexibility to pay for large or even small orders.

Supplier's Credit

Supplier's credit is a form of financing import into India. In this method, overseas suppliers or financial institutions outside India provide financing to the importer on SOFR/LIBOR linked rates against usance letter of credit issued by importer's bank in India

Suppliers' credit structure was understood as financing of import usance letter of credit by overseas branches / foreign banks whereas buyers' credit was considered as financing against LOU/LOC till it was stopped by RBI.

Over the years Indian importers have used suppliers' credit and buyers' credit as two different modes of import financing. RBI had defined them as 'trade credit' under Master Direction for ECB and trade credit

Suppliers Credit: Supplier of goods is the recognized lender against a LC.

Buyers Credit: Banks, financial institutions, foreign equity holder(s) located outside India and financial institutions in International Financial Services Centres located in India against LOU.

IMPACT OF SANCTIONS ON INTERNATIONAL TRADE SETTLEMENT ON LOGISTICS, CREDIT INSURANCE AND EXPROPRIATION OF FOREIGN ASSETS BY US AND ITS ALLIES

The followings are the immediate impact of sanctions by US and its allies for trading and settling with Russia through Special Vostro Account in INR:

1. Blocking of Indian Bank's Nostro Account with US Banks in USD
2. Blocking of India's Forex reserves in US invested in US assets
3. Blocking of Indian's personal assets in US
4. Expropriation of Nostro balances and USD assets held by India, Indians and Indian Banks in US
5. Blocking of all kinds of flows like ECBs, FII, FDI in/out of India to/from US
6. Blocking of dealings by US companies in India and Indian companies with US companies
7. Blocking of logistic, airlines, counter-insurance, credit insurance, listing with US Exchanges etc for Indian companies.

FUTURE OF INTERNATIONAL TRADE AND SETTLEMENT IN INR AS A GLOBAL CURRENCY BACKED BY SOVEREIGN GOLD BOND (SGB) BY RBI

The way ahead:

RBI can consider following alternatives to counter reluctance on the part of AD Banks fearing sanctions from US for settling trade with Russia through Special Vostro Accounts in INR:

1. Allow any payment bank like post office payment bank or a small finance bank to open Special Vostro Account of a Russian Bank in INR for settling this type transactions with Russia, as these banks may not have substantial assets with US.
2. Authorise co-operative banks / financial institutions / others (AD Category) to undertake this business, as these banks may not have substantial assets with US.
3. Instead of trying for opening of Special Vostro Account in INR with any AD Bank, let RBI itself operate these accounts through NPCI or CCIL etc and invest surplus Special Vostro Account - INR in RBI's Sovereign Gold Bond (SGB) and use that money to buy gold and export it to Russia (for the surplus in Special. Vostro Account in INR to overcome the issue of transfer of money to Russia. Settle Import of black gold thru yellow gold......

Look at gold chart at the end.

CASE STUDIES ON SETTLEMENT OF INTERNATIONAL TRADE

A. HERSTAT BANK CASE STUDY – 1974

This led to Basel I guidelines for the bank in 1988s –. A first case study in settlement risk in foreign exchange business

Herstatt Bank (Bankhaus I.D. Herstatt) was a privately owned bank in the German city of Cologne. It went bankrupt on 26 June 1974, an event widely referred to as the Herstatt crisis. Herstatt's failure specifically highlighted the importance of settlement risk in foreign-exchange markets, which became correspondingly known as Herstatt risk.

The Herstatt crisis had important policy consequences. In the subsequent months of 1974, Germany established the Liquiditäts-Konsortialbank [de] and, at the international level, central bankers created the Basel Committee on Banking Supervision. With considerably more delay, concerns about Herstatt risk were revived during late 1980s and 1990s and resulted in the creation of

CLS Bank, operational since 2002 as a global foreign exchange market settlement utility.

Herstatt Bank was founded in 1955 by Ivan David Herstatt, with financial assistance from Herbert Quandt, Emil Bührle and Hans Gerling, the head of an insurance company who held a majority share. In 1974 the bank had assets of over DM2 billion, making it the 35th largest bank in Germany. Herstatt Bank became a significant participant in the foreign exchange markets. During 1973 and 1974, the U.S. dollar experienced significant volatility. The bank made wrong bets on the direction of the dollar and by June 1974 had accumulated DM470 million in losses as against capital of only DM44 million.

On 26 June 1974, German regulators forced the troubled Bank Herstatt into liquidation. That day, a number of banks had released payment of Deutsche Marks (DEM) to Herstatt in Frankfurt in exchange for US dollars (USD) that were to be delivered in New York. The bank was closed at 16:30 German time, which was 10:30 New York time. Because of time zone differences, Herstatt ceased operations between the times of the respective payments. The counterparty banks did not receive their USD payments.

Responding to the cross-jurisdictional implications of the Herstatt debacle, the G-10 countries (the G-10 is actually eleven countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States), Luxembourg and Spain formed a standing committee under the auspices of the Bank for International Settlements (BIS). Called the Basel Committee on Banking Supervision, the committee comprises representatives from central banks and regulatory authorities. This type of settlement risk, in which one party in a foreign exchange trade pays out the currency it sold but does not receive the currency it bought, is sometimes called Herstatt risk.

The failure of Herstatt Bank was a key factor that led to the worldwide implementation of real-time gross settlement (RTGS) systems, which ensure that payments between one bank and another are executed in real-time and are considered final. The work on these issues was coordinated by the Basel Committee on Banking Supervision under the Bank for International Settlements.

The Continuous Linked Settlement (CLS) bank and system was launched almost 30 years later in 2002. This payment versus payment (PVP) process enables member banks to trade foreign currencies without assuming the settlement risk associated with the process, whereby a counterparty could fail before delivering their leg of the transaction

B. BANGLADESH BANK USD 81 MIO HEIST -2018

The Bangladesh Bank robbery, also known colloquially as the Bangladesh Bank cyber heist, was a theft that took place in February 2016. Thirty-five fraudulent instructions were issued by security hackers via the SWIFT network to illegally transfer close to US$1 billion from the Federal Reserve Bank of New York account belonging to Bangladesh Bank, the central bank of Bangladesh. Five of the thirty-five fraudulent instructions were successful in transferring US$101 million, with US$20 million traced to Sri Lanka and US$81 million to the Philippines. The Federal Reserve Bank of New York blocked the remaining thirty transactions, amounting to US$850 million, due to suspicions raised by a misspelled instruction. All the money transferred to Sri Lanka has since been recovered. However, as of 2018 only around US$18 million of the US$81 million transferred to the Philippines has been recovered. Most of the money transferred to the Philippines went to four personal accounts, held by single individuals, and not to companies or corporations.

C. SETTLEMENT MECHANISM AT CLEARING CORPORATION OF INDIA LTD

CCIL is a Central Counterparty (CCP) which was set up in April 2001 to provide clearing and settlement for transactions in Government securities, foreign exchange and money markets in the country. CCIL acts as a central counterparty in various segments of the financial markets regulated by the RBI viz. the government securities segment i.e., outright, market repo and triparty repo, USD-INR and forex forward segments. Moreover, CCIL provides non-guaranteed settlement in the rupee denominated interest rate derivatives like Interest Rate Swaps/Forward Rate Agreement market. It also provides non-guaranteed settlement of cross currency trades to banks in India through Continuous Linked Settlement (CLS) bank by acting as a third-party member of a CLS Bank settlement member. CCIL also acts as a trade repository for OTC interest rate and forex derivative transactions.

D. INDIAN PUBLIC SECTOR BANK – DIAMOND & GOLD TRADER CASE STUDY -2020

The Indian Public Sector Bank (PSU Bank) scam relates to fraudulent letter of undertaking worth Rs 10,000 crore issued by the bank. The key accused in the case were a jeweller and designer dealing in gold & diamond, his maternal uncle and other relatives and some Bank employees. The diamond trader and his relatives escaped from India in early 2018, days before the news of the scam became public. PSU Bank scam has been dubbed as the biggest fraud in India's banking history.

How the 10,000-crore scam happened?

Bankers used fake Letters of Undertakings (LoU's) at PSU Bank's Brady House branch in Fort, Mumbai. The LoU's were opened in favour of branches of Indian banks for import of pearls for a period of one year, for which Reserve Bank of India guidelines lay out a total time period of 90 days from the date of shipment. This guideline was ignored by overseas branches of Indian banks. They failed to share any document/information with PSU Bank, which were made available to them by the firms at the time of availing credit from them.

The diamond trader got his first fraudulent guarantee from PSU Bank on March 10, 2011 and managed to get 1,212 more such guarantees over the next 74 months. The Enforcement Directorate (ED) recovered bank token devices of the foreign dummy companies used by the fugitive diamond trader to transfer the fraudulent funds. The probe agency found that the brother of diamond trader had destroyed the devices and had even secured a server located at United Arab Emirates (UAE) soon after the scam broke out. These dummy firms had been receiving the fraudulent PSU Bank LoU's and were based out in British Virgin Island and other tax havens. The enforcement agency has so far seized movable and immovable properties to the tune of Rs 2362 crore in the PSU Bank fraud case.

How was the PSU Bank management oblivious to this?

PSU Bank employees misused the SWIFT network to transmit messages to another PSU bank and a private bank on fund requirement. While all these were done using SWIFT passwords, the transactions were never recorded in the bank's core system — thereby keeping the PSU bank management in the dark for years.

How did the scam unfold?

On 29 January 2018, the PSU bank lodged a FIR with CBI stating that fraudulent LoU's worth Rs 2.8 billion (Rs 280.7 crore) were first issued on 16 January. In the complaint, the PSU bank had named three diamond firms, Diamonds R Us, Solar Exports and Stellar Diamonds. As of 18 May 2018, the scam has ballooned to over Rs 14,000 crore.

Who is this, Diamond Trader?

The diamond trader is a luxury diamond jewellery designer who was ranked 57th in the Forbes list of billionaires in 2017. He is also the founder of a chain of diamond jewellery retail stores. This trader is the Chairman of Firestar International, the parent of the chain, which has stores in key markets across the globe. He has 16 stores in diverse locations such as Delhi, Mumbai, New York, Hong Kong, London and Macau. He is currently in the United Kingdom and is seeking political asylum in Britain.

E.1997 SOUTH-EAST ASIA CURRENCY CRISIS LEAD TO BASEL II GUIDELINES FOR THE BANKS

A crisis that caused by the collapse of the currency exchange rate and hot money bubble in East and Southeast Asia in 1997. The Asian Financial Crisis is a crisis caused by the collapse of the currency exchange rate and hot money bubble. It started in Thailand in July 1997 and swept over East and Southeast Asia. The financial crisis heavily eroded the currency values, stock markets, and other asset prices in many East and Southeast Asian countries.

On July 2, 1997, the Thai government ran out of foreign currency. No longer able to support its exchange rate, the Government was forced to float the Thai Baht, which was pegged to the U.S. dollar before. The currency exchange rate of the Baht thus collapsed immediately. Two weeks later, the Philippian Peso and Indonesian Rupiah underwent major devaluations as well. The crisis spread internationally, and Asian stock markets plunged to their multi-year lows in August. The capital market of South Korea maintained relatively stable until October. However, the Korean Won dropped to its new low on October 28th and the stock market experienced its biggest one-day drop to that date on November 8th.

Causes of the Asian Financial Crisis

The causes of the Asian Financial Crisis are complicated and disputable. A major cause is considered to be the collapse of the hot money bubble. During the late 1980s and early 1990s, many Southeast Asian countries, including Thailand, Singapore, Malaysia, Indonesia, and South Korea, achieved massive economic growth of 8 to 12 per cent increase in their gross domestic product (GDP). The achievement was known as the "Asian economic miracle." However, a significant risk was embedded in the achievement. The economic developments in the countries mentioned above were mainly boosted by export growth and foreign investment. Therefore, high interest rates and fixed currency exchange rates (pegged to the U.S. dollar) were implemented to attract hot money. Also, the exchange rate was pegged at a rate favourable to exporters. However, both the capital market and corporates were left exposed to foreign exchange risk due to the fixed currency exchange rate policy.

In mid-1990s, following the recovery of the U.S. from a recession, the Federal Reserve raised the interest rate against inflation. The higher interest rate attracted hot money to flow into the U.S. market, leading to an appreciation of the U.S. dollar. The currencies pegged to the U.S. dollar also appreciated, and thus hurt export growth. With a shock in both export and foreign investment, asset prices, which were leveraged by large amounts of credits, began to collapse. The panicked foreign investors began to withdraw. The massive capital outflow caused depreciation pressure on the currencies of the Asian countries. The Thai Government first ran out of foreign currency to support its exchange rate, forcing it to float the baht. The value of the baht thus collapsed immediately afterward. The same also happened to the rest of the Asian countries soon after.

Effects of the Asian Financial Crisis

The countries that were most severely affected by the Asian Financial Crisis included Indonesia, Thailand, Malaysia, South Korea, and the Philippines. They saw a plunge in their currency exchange rates, stock markets, and prices of other assets. The GDPs of the affected countries even fell by double digits. From 1996 to 1997, the nominal GDP per capita dropped by 43.2 per cent in Indonesia, 21.2 per cent in Thailand, 19 per cent in Malaysia, 18.5 per cent in South Korea, and 12.5 per cent in the Philippines. Hong Kong, Mainland China, Singapore, and Japan were also affected, but less significantly.

Besides its economic impact, the Asian Financial Crisis also resulted in political repercussions. The Prime Minister General of Thailand, Yongchaiyudh and the President of Indonesia, Suharto, resigned. An anti-Western sentiment was triggered, especially against George Soros, who was blamed for triggering the crisis with large amounts of currency speculation by some individuals. The impact of the Asian Financial Crisis was not limited to Asia. International investors became less willing to invest in and lend to developing countries, not only in Asia but in other areas of the world. Oil prices also fell due to the crisis. As a result, some major mergers and acquisitions in the oil industry took place to achieve economies of scale.

IMF's Role in the Asian Financial Crisis

The International Monetary Fund (IMF) is an international organization that promotes global monetary cooperation and international trades, reduces poverty, and supports financial stability. The IMF generated several bailout packages for the most affected countries during the financial crisis. It provided packages of around $20 billion to Thailand, $40 billion to Indonesia, and $59 billion to South Korea to support them and thus they did not default. The bailout packages were structural-adjustment packages. The countries that received the packages were asked to reduce their government spending, allow insolvent financial institutions to fail, and raise interest rates aggressively. The purpose of the adjustments was to support the currency values and confidence over the countries' solvency.

Lessons Learnt from the Asian Financial Crisis

One lesson that many countries learnt from the financial crisis was to build up their foreign exchange reserves to hedge against external shocks. Many Asian countries weakened their currencies and adjusted economic structures to create a current account surplus. The surplus can boost their foreign exchange reserves. The Asian Financial Crisis also raised concerns about the role that a government should play in the market. Supporters of neoliberalism promote free-market capitalism. They considered the crisis a result of Government intervention and crony capitalism.

The conditions that IMF set within their structural-adjustment packages also aimed to weaken the relationship between the government and capital market in the affected countries, and thus promote the neoliberal model.

F. US SUB-PRIME/GLOBAL FINANCIAL CRISIS 2008-09 – LED TO BASEL III GUIDELINES FOR BANKS

What is the US Sub-Prime/Global Financial Crisis of 2008-2009?

The global financial crisis of 2008-2009 refers to the massive financial crisis the world faced from 2008 to 2009. The financial crisis took its toll on individuals and institutions around the globe, with millions of American being deeply impacted. Financial institutions started to sink;

many were absorbed by larger entities and the US Government was forced to offer bailouts to keep many institutions afloat. The crisis, often referred to as "The Great Recession," didn't happen overnight. There were many factors that lead to the crisis, and their effects still linger to this day. Let's take a look at a brief outline of the Global financial crisis of 2009-2009.

The Housing Market Bubble

The foundation of the global financial crisis was built on the back of the housing market bubble that began to form in 2007. Banks and lending institutions offered low interest rates on mortgages and encouraged many homeowners to take out loans that they couldn't afford. With all the mortgages flooding in, lenders created new financial instruments called mortgage-backed securities (MBS), which were essentially mortgages bundled together that could then be sold as securities with minimal risk load due to the fact that they were backed by credit default swaps (CDS). Lenders could then easily pass along the mortgages and all the risk. Outdated regulations that weren't rigorously enforced allowed lenders to get sloppy with underwriting, meaning the actual value of the securities couldn't be established or guaranteed.

The Bubble Bursts

Banks began to lend recklessly to families and individuals without true means to follow through on the mortgages they'd been granted. Such high-risk (subprime) loans were then inevitably bundled together and passed down the line. As the subprime mortgage bundles grew in number to an overwhelming degree, with a large percentage moving into default, lending institutions began to face financial difficulties. It led to the dismal financial conditions around the world during the 2008-2009 period and continued for years to come.

The Aftermath of the Global Financial Crisis of 2008-2009

Many who took out subprime mortgages eventually defaulted. When they could not pay, financial institutions took major hits. The Government, however, stepped in to bail out banks. The housing market was deeply impacted by the crisis. Evictions and foreclosures began within months. The stock market, in response, began to plummet and major businesses worldwide began to fail, losing millions. This, of course, resulted in widespread layoffs and extended periods of unemployment worldwide. Declining credit availability and failing confidence in financial stability led to fewer and more cautious investments, and international trade slowed to a crawl.

Eventually, the United States responded to the crisis by passing the American Recovery and Reinvestment Act, 2009, which used an expansionary monetary policy, facilitated bank bailouts and mergers and worked towards stimulating the economic growth.

ACRONYMS AND DEFINITIONS

ACU

Asian Clearing Union - objective of the clearing union is to facilitate payments among 8 member countries for eligible transactions on a multilateral basis, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade among the participating countries.

Authorised Dealer Bank – AD Bank

Authorised dealers are the institutions that have the license from the RBI to sell and buy foreign currencies. Most of the authorised dealers are banks

BOP

The balance of payments of a country is the difference between all money flowing into the country in a particular period of time and the outflow of money to the rest of the world.

CCIL INDIA

The Clearing Corporation of India helps trading and settlement of money market, Govt Securities and Forex transactions among the member banks and financial institutions.

CLS

Continuous Linked Settlement (CLS) is a global initiative to reduce foreign exchange settlement risk by settling both legs of foreign exchange transactions simultaneously. Transactions are settled across the books of CLS Bank International (CLS Bank), a special purpose bank established to facilitate the CLS process

DGFT

Directorate General of Foreign Trade (DGFT) is the agency of the Ministry of Commerce and Industry of the Government of India responsible for administering the laws regarding foreign trade.

DP

Deliver Against Payment is a mechanism wherein instructions are given by one bank to another collecting bank to deliver documents against payment by the buyer/drawee of the bill

DA

Deliver Against Acceptance is a mechanism wherein instructions are given by one bank to another collecting bank to deliver documents against acceptance by the buyer/drawee of the bill for payment on a future date

DOCUMENTARY CREDIT

Documentary Credit is known as letter of credit meant to secure payment to the seller/exporter of goods. LC is established by the importer/buyer’s bank favouring the exporter.

DIRTY FLOAT

Dirty float or managed float regime is an international financial environment in which exchange rates fluctuate from day to day, but central banks attempt to influence their countries’ exchange rates by buying and selling currencies to maintain a certain range. The peg used is known as a crawling peg

HAWALA

A traditional system of transferring money used in Arab countries and South Asia, whereby the money is paid to an agent who then instructs an associate in the relevant country or area to pay the final recipient.

LORO

Loro account is derived from the Italian word “Loro,” which means ‘there,’ which means this account is a ‘Third Party Account.’ In bilateral correspondence.

Liberalism

Liberalism is a political and economic philosophy that emphasizes individual liberty, limited government, and free markets. It emerged in the 18th century as a reaction to mercantilism and feudalism and has since become one of the dominant political ideologies in the Western world. Liberalism generally supports the idea of limited government, individual freedom, and free market economy with some variations on the degree of government intervention in economy and society. Broadly there are two kinds of liberalism - Classic liberalism (also known as laissez-faire liberalism, advocates for minimal government intervention in the economy and maximum individual freedom. It promotes the idea of free markets, private property, and competition as the most efficient ways to allocate resources and create wealth) and Social liberalism(also known as welfare liberalism, emphasizes the role of government in ensuring social and economic equality, protecting individual rights and promoting social justice. It stresses on the importance of active state intervention in order to correct market failures and redistribute)

ECGC

Export Credit Guarantee Corporation is a Corporation of Govt of India, which provides credit insurance to the exporter against the possible default of payment by the buyer or the country

ECB

External Commercial Borrowings is used when a corporate borrows the money from an overseas bank/institution in foreign currency at LIBOR (a bench mark used) related rates of interest

EEFC

Exchange Earners Foreign Currency current account is used by the received of the Inward remittance in foreign currency for outward remittances at a later date to avoid the loss on buying/selling of the currency by the exporters

EDPMS

Export Data Processing and Monitoring System is an online software introduced by the RBI in 2014 for all banks to bring their transactions with the exporters online

FATF

The Financial Action Task Force, also known by its French name, Groupe d'action Financière, is an intergovernmental organisation founded in 1989 on the initiative of the G7 to develop policies to combat money laundering. In 2001, its mandate was expanded to include terrorism financing

FEMA, 1999

Foreign Exchange Management Act, 1999, is an Act of the Parliament of India "to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India" This Act replaced the old FERA,1973

FEDAI

Foreign Exchange Dealers Association of India frames the Rule book to be followed by AD banks in India

FIMMDA

Fixed Income Money Market Derivates Association frames the rules for money market operations by banks in India

FBIL

Financial Bench Mark of India Ltd, a subsidiary of FEDAI and FIMMDA provides rates for MTM, FCNR deposits etc

FTA

Free Trade Agreements are used for facilitating trade between countries

FTP

Foreign Trade Policy of DGFT (Govt of India) discusses about the rules, procedure for export/import of goods and the procedure to register with DGT for becoming international trader

Hedging

Hedging is the technique used for guarding the foreign currency risk with a bank etc

IDPMS

Import Data Processing and Monitoring System is intended to track the import transactions through banking system. Customs will modify the bill of entry format to display the AD Code of bank concerned, as reported by the importers.

ICEGATE

Indian Customs Electronic Gateway is the national portal of Indian Customs of Central Board of Indirect Taxes and Customs (CBIC) that provides e-filing services to the trade, cargo carriers and other trading partners electronically.

INCOTERMS 2020

INCOTERMS 2020 aligns different levels of insurance coverage in Cost Insurance and Freight (CIF) and Carriage and Insurance Paid To (CIP). Incoterms® 2020 includes arrangements for carriage with own means of transport in FCA, Delivered at Place (DAP), Delivered at Place Unloaded (DPU), and Delivered Duty Paid (DDP).

ICC

International Chamber of Commerce, Paris is an organization comprised of more than six million members from countries around the world, tasked primarily with representing and helping to establish rules that affect and govern the interests of individuals and organizations in every part of world

IMF

The International Monetary Fund is an agency of the United Nations and an international financial institution, headquartered in Washington, D.C., consisting of 190 countries

INR

Indian Rupee – a three-digit numeric code assigned by ISO 4217 to Indian Currency

INTEREST RATE SUBVENTION

Interest rate subvention is the subsidy given by RBI to AD banks for providing finance to MSME etc. to boost exports from India

Mercantilism

Mercantilism is an economic theory that holds that a country's wealth is measured by its stock of gold and silver and that the world economy is a zero-sum game in which one country's gain is another country's loss. This theory was dominant in Europe from the 16th to the 18th century and advocated for government regulation of a country's economy, including the encouragement of exports and the restriction of imports, in order to accumulate precious metals.

MSME

The Ministry of Micro, Small and Medium Enterprises is the Ministry in the Government of India. It is the apex executive body for the formulation and administration of rules, regulations and laws relating to micro, small and medium enterprises in India.

MIBOR

Mumbai Inter-bank offered rate is the interest rate used by banks for their lending/borrowing of money market transactions amongst themselves

MTM

Mark to market is a method of measuring the fair value of accounts that can fluctuate over time, such as assets and liabilities.

NOSTRO

A NOSTRO account refers to an account that a bank holds in a foreign currency in another bank

OFAC COUNTRIES: Office of Foreign Asset Control published USA

PCFC

Packing Credit in Foreign Currency is used when money is lent by AD bank to exporter at pre-shipment stage in foreign currency

PPP

Purchasing power parity is used to understand the value of one currency against other countries currency

SWIFT

Society For World-Wide Inter-Bank Financial Transaction is used for transmitting messages between the member countries

SPFS SYSTEM

SPFS is a Russian equivalent of the SWIFT financial transfer system, developed by the Central Bank of Russia

SANCTIONED COUNTRIES

Sanctioned Countries are designated by the U.S. Government as having limited or comprehensive trade sanctions and embargoes imposed for reasons of anti-terrorism, non-proliferation, narcotics trafficking, or other reasons. Sanctions are prohibitions on transactions (e.g., financial exchanges, providing or receiving services of value) with designated countries, entities, or individuals

Secured Overnight Financing Rate

The secured overnight financing rate (SOFR) is a benchmark interest rate for dollar-denominated derivatives and loans that will replace LIBOR.

UCP 600

The Uniform Customs and Practice for Documentary Credits is a set of rules on the issuance and use of letters of credit. The UCP is utilized by bankers and commercial parties in more than 175 countries in trade finance

UN

The United Nations (UN) is an intergovernmental organization established in 1945 with the goal of promoting international cooperation and maintaining peace and security around the world. The UN's mission is to help countries work together to achieve peace, security, and sustainable development, and to promote respect for human rights and fundamental freedoms. The UN has six main organs: The General Assembly, the Security Council, the Economic and Social Council, the Trusteeship Council, the International Court of Justice, and the Secretariat. Headquarters in New York City UN has 193 member states.

URC 522

Uniform Rules for Collection of ICC, Paris used by banks to describe their responsibilities and duties in the collection of documents for payment etc.

USD

United States Dollar – a three-digit numeric code assigned by ISO 4217 to American Currency

VOSTRO

A VOSTRO account is an account a correspondent bank holds on behalf of another bank.

WTO

The World Trade Organization is the apex inter-governmental organization that regulates and facilitates international trade. Governments use the organization to establish, revise, and enforce the rules that govern international trade.

UN

The United Nations (UN) is an intergovernmental organization established in 1945 with the goal of promoting international cooperation and maintaining peace and security around the world. The UN's mission is to help countries work together to achieve peace, security, and sustainable development, and to promote respect for human rights and fundamental freedoms. The UN has six main organs: the General Assembly, the Security Council, the Economic and Social Council, the Trusteeship Council, the International Court of Justice, and the Secretariat. Headquarters in New York City UN has 193 member states.

Regulatory Framework

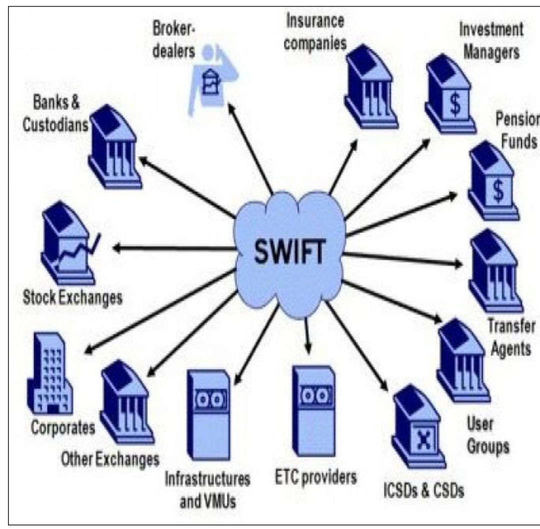
RBI/2022-2023/90

A.P. (DIR Series) Circular No.10 July 11, 2022 enclosed

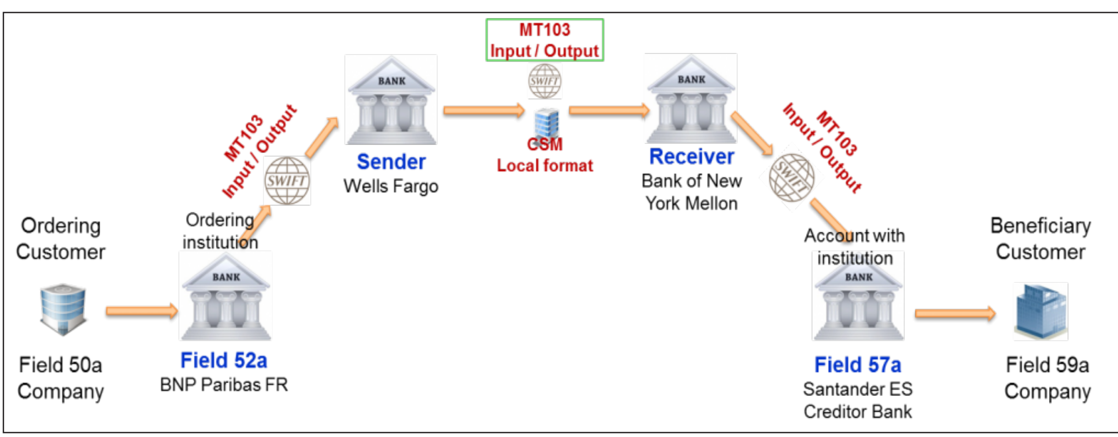
RBI/2022-2023/89 July 08, 2022

A.P. (DIR Series) Circular No. 09 dated 8th July enclosed

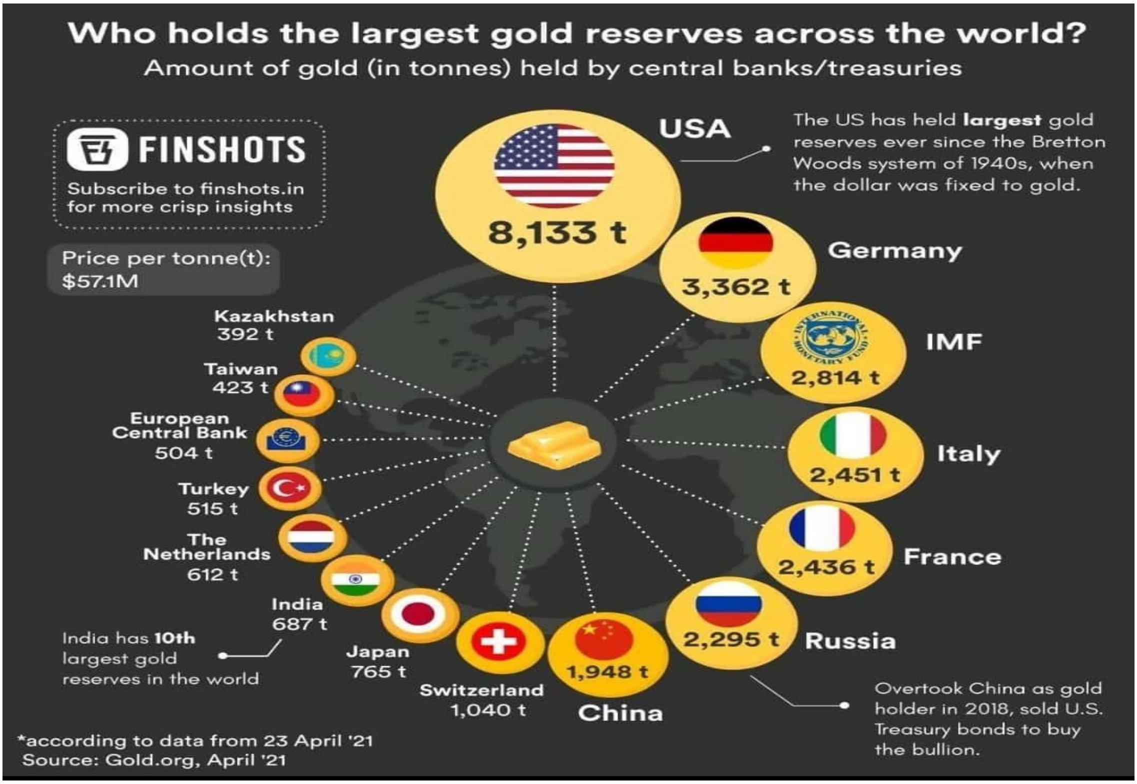
SWIFT



Source: www.thehansindia.com

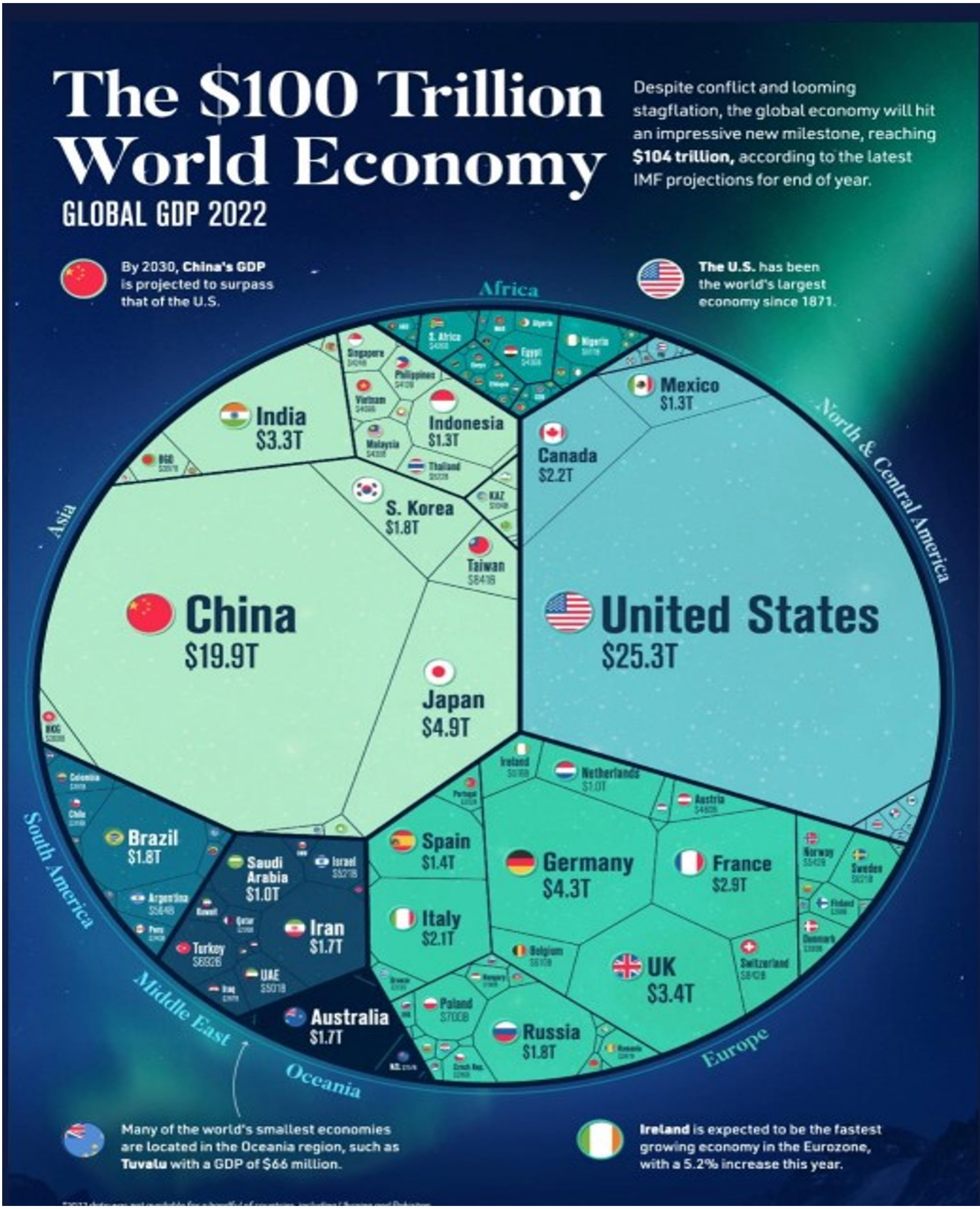


Source: Google; SWIFT MT103 serial payment analysis 1/3 | Paiementor

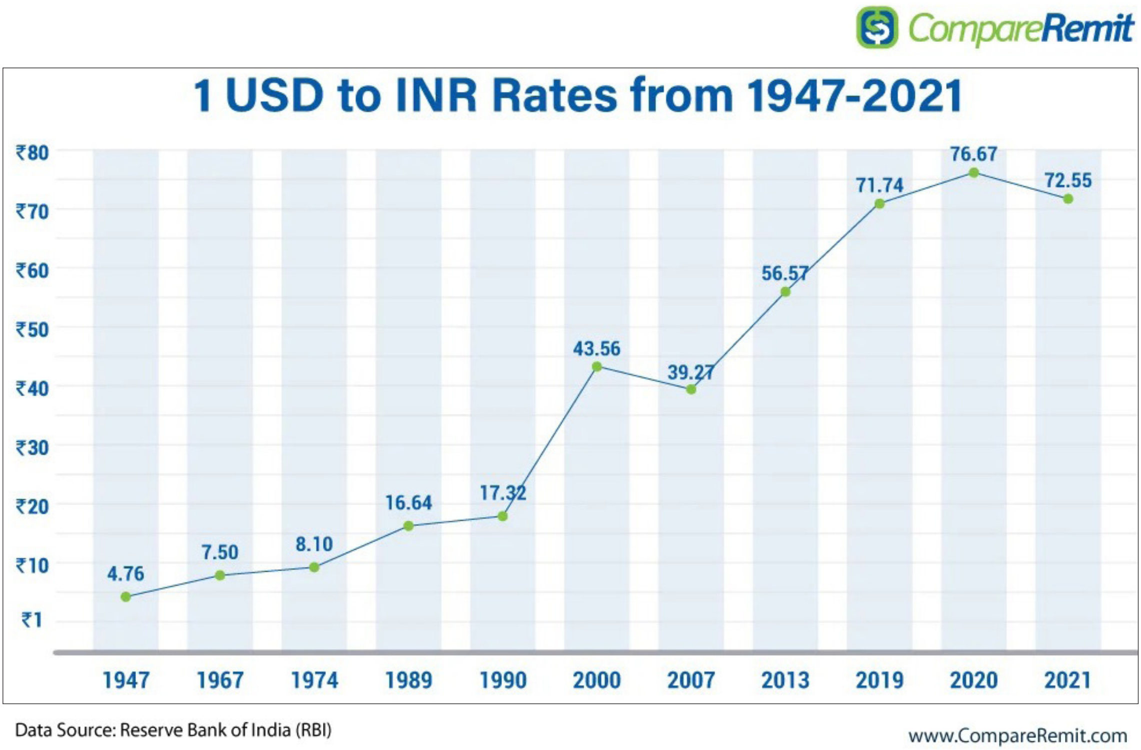


Source: Google; 4fga - #Gold Did you know which country in the world has the highest Gold Reserve? #Gold is a #dependable #Asset

Source: Google; RBI allows Trade Settlements in Rupee



Source : Google, The $100 Trillion Global Economy in One Chart - Visual Capitalist



ANNEXURES

Annexure -1

Conditions on Receipt of advance against exports

(Under Master Direction on Export of Goods and Services 2016)

(1) In terms of Regulation 15 of Notification No. FEMA 23 (R)/2015-RB dated January 12, 2016, where an exporter receives advance payment (with or without interest), from a buyer outside India, the exporter shall be under an obligation to ensure that the shipment of goods is made within one year from the date of receipt of advance payment; the rate of interest, if any, payable on the advance payment does not exceed London Inter-Bank Offered Rate (LIBOR)/ 17any other widely accepted / Alternative reference rate + 100 basis points; and the documents covering the shipment are routed through the AD Category – I bank through whom the advance payment is received.

Provided that in the event of the exporter's inability to make the shipment, partly or fully, within one year from the date of receipt of advance payment, no remittance towards refund of unutilized portion of advance payment or towards payment of interest, shall be made after the expiry of the said period of one year, without the prior approval of the Reserve Bank.

EDPMS will capture the details of advance remittances received for exports in EDPMS. Henceforth, AD Category – I banks will have to report all the inward remittances including advance as well as old outstanding inward remittances received for export of goods/ software to EDPMS. Further, AD Category – I banks need to report the electronic FIRC to EDPMS wherever such FIRCs are issued against inward remittances.

The quarterly return being submitted for delay in utilization of advances received for export stands discontinued.

(2) AD Category- I banks can also allow exporters having a minimum of three years' satisfactory track record to receive long term export advance up to a maximum tenor of 10 years to be utilized for execution of long term supply contracts for export of goods subject to the conditions as under:

i. Firm irrevocable supply orders and contracts should be in place. The contract with the overseas party/ buyer should be vetted and the same shall clearly specify the nature, amount and delivery timelines of the products over the years and penalty in case of non-performance or contract cancellation. Product pricing should be in consonance with prevailing international prices.

ii. Company should have capacity, systems and processes in place to ensure that the orders over the duration of the said tenure can actually be executed.

iii. The facility is to be provided only to those entities, which have not come under the adverse notice of Enforcement Directorate or any such regulatory agency or have not been caution listed.

iv. Such advances should be adjusted through future exports.

v. The rate of interest payable, if any, should not exceed LIBOR/any other widely accepted / Alternative reference rate plus 200 basis points.

vi. The documents should be routed through one Authorized Dealer bank only.

vii. Authorised Dealer bank should ensure compliance with AML / KYC guidelines

viii. Such export advances shall not be permitted to be used to liquidate Rupee loans classified as NPA.

ix. Double financing for working capital for execution of export orders should be avoided.

x. Receipt of such advance of USD 100 million or more should be immediately reported to the Trade Division, Foreign Exchange Department, Reserve Bank of India, Central Office, Mumbai.

xi. In case Authorized Dealer banks are required to issue bank guarantee (BG) / Stand by Letter of Credit (SBLC) for export performance, then the issuance should be rigorously evaluated as any other credit proposal keeping in view, among others, prudential requirements based on board approved policy.

   a. BG / SBLC may be issued for a term not exceeding two years at a time and further rollover of not more than two years at a time may be allowed subject to satisfaction with relative export performance as per the contract.

   b. BG / SBLC should cover only the advance on reducing balance basis.

c. BG / SBLC issued from India in favour of overseas buyer should not be discounted by the overseas branch / subsidiary of bank in India.

Note: AD Category – I bank may also be guided by the Master Circular on Guarantees and Co-acceptances issued by Department of Banking Regulation.

xii. AD Category – I bank may allow the purchase of foreign exchange from the market for refunding advance payment credited to EEFC account only after utilizing the entire balances held in the exporter's EEFC accounts maintained at different branches/banks.

(3) AD Category- I banks may allow exporters to receive advance payment for export of goods which would take more than one year to manufacture and ship and where the 'export agreement' provides for shipment of goods extending beyond the period of one year from the date of receipt of advance payment subject to the following conditions: -

i. The KYC and due diligence exercise has been done by the AD Category – I bank for the overseas buyer;

ii. Compliance with the Anti-Money Laundering standards has been ensured;

iii. The AD Category-I bank should ensure that export advance received by the exporter should be utilized to execute export and not for any other purpose i.e., the transaction is a bonafide transaction;

iv. Progress payment, if any, should be received directly from the overseas buyer strictly in terms of the contract;

v. The rate of interest, if any, payable on the advance payment shall not exceed London Inter-Bank Offered Rate (LIBOR)/ 17any other widely accepted / Alternative reference rate + 100 basis points;

vi. There should be no instance of refund exceeding 10% of the advance payment received in the last three years;

vii. The documents covering the shipment should be routed through the same authorised dealer bank; and

viii. In the event of the exporter's inability to make the shipment, partly or fully, no remittance towards refund of unutilized portion of advance payment or towards payment of interest should be made without the prior approval of the Reserve Bank.

(4) (i) As it has been observed that there is substantial increase in the number and amount of advances received for exports remaining outstanding beyond the stipulated period on account of non-performance of such exports (shipments in case of export of goods), AD Category –I banks are advised to efficiently follow up with the concerned exporters in order to ensure that export performance (shipments in case of export of goods) are completed within the stipulated time period.

(ii) It is further reiterated that AD category –I bank should exercise proper due diligence and ensure compliance with KYC and AML guidelines so that only bonafide export advances flow into India. Doubtful cases as also instances of chronic defaulters may be referred to Directorate of Enforcement (DoE) for further investigation. A quarterly statement indicating details of such cases may be forwarded to the concerned Regional Offices of RBI within 21 days from the end of each quarter.

Annexure-2

Conditions on Set-off of export receivables against import payables

(under Master Direction on Export of Goods and Services 2016)

AD category –I bank may deal with the following requests received from their Exporter/Importer constituents for allowing set-off of outstanding export receivables against outstanding import payables:

i. Set-off of outstanding export receivables against outstanding import payables from/ to the same overseas buyer/supplier.

ii. Set-off of outstanding export receivables against outstanding import payables with their overseas group/associate companies either on net basis or gross basis, through an in-house or outsourced centralized settlement arrangement.

The set-off shall be subject to the following conditions:

a) The arrangement shall be operationalized/ supervised through/by one AD Category – I bank only

b) AD Category – I bank is satisfied with the bonafides of the transactions and ensures that there are no KYC/AML/CFT concerns;

c) The invoices under the transaction are not under investigation by Directorate of Enforcement/Central Bureau of Investigation or any other investigative agency;

d) Import/export of goods/services has been undertaken as per the extant Foreign Trade policy

e) The export / import transactions with ACU countries are kept outside the arrangement;

f) Set-off of export receivables against goods shall not be allowed against import payables for services and vice versa.

g) AD Category – I bank shall ensure that import payables/export receivables are outstanding at the time of allowing set-off. Further, set-off shall be allowed between the export and import legs taking place during the same calendar year.

h) In case of bilateral settlement, the set-off shall be in respect of same overseas buyer/ supplier subject to it being supported by verifiable agreement/mutual consent.

i) In case of settlement within the group/ associates companies, the arrangement shall be backed by a written, legally enforceable agreement/contract. AD Category – I bank shall ensure that the terms of agreement are strictly adhered to;

j) Set-off shall not result in tax evasion/ avoidance by any of the entities involved in such arrangement.

k) Third party guidelines shall be adhered to by the concerned entities, wherever applicable;

l) AD Category – I bank shall ensure compliance with all the regulatory requirement relating to the transactions;

m) AD Category – I bank may seek Auditors/ CA certificate wherever felt necessary.

n) Each of the export and import transaction shall be reported separately (gross basis) in FETERS/EDPMS/IDPMS, as applicable.

o) AD Category – I bank to settle the transaction in E/IDPMS by utilizing the 'set-off indicator' and mentioning the details of shipping bills/bill of entry/invoice details being settled in the remark column (including details of entities involved).

भारतीय रिज़र्व बैंक

RESERVE BANK OF INDIA

RBI/2022-2023/90
A.P. (DIR Series) Circular No.10 July 11, 2022

To

All Category-I Authorised Dealer Banks

Madam/Sir

International Trade Settlement in Indian Rupees (INR)

In order to promote growth of global trade with emphasis on exports from India and to support the increasing interest of global trading community in INR, it has been decided to put in place an additional arrangement for invoicing, payment, and settlement of exports / imports in INR. Before putting in place this mechanism, AD banks shall require prior approval from the Foreign Exchange Department of Reserve Bank of India, Central Office at Mumbai.

2. The broad framework for cross border trade transactions in INR under Foreign Exchange Management Act, 1999 (FEMA) is as delineated below:

(a) **Invoicing**: All exports and imports under this arrangement may be denominated and invoiced in Rupee (INR).

(b) **Exchange Rate:** Exchange rate between the currencies of the two trading partner countries may be market determined.

(c) **Settlement:** The settlement of trade transactions under this arrangement shall take place in INR in accordance with the procedure laid down in Para 3 of this circular.

3. In terms of Regulation 7(1) of Foreign Exchange Management (Deposit) Regulations, 2016, AD banks in India have been permitted to open Rupee Vostro Accounts. Accordingly, for settlement of trade transactions with any country, AD bank in India may open Special Rupee Vostro Accounts of correspondent bank/s of the partner trading country. In order to allow settlement of international trade transactions through this arrangement, it has been decided that:

(a) Indian importers undertaking imports through this mechanism shall make payment in INR which shall be credited into the Special Vostro account of the correspondent bank of the partner country, against the invoices for the supply of goods or services from the overseas seller /supplier.

(b) Indian exporters, undertaking exports of goods and services through this mechanism, shall be paid the export proceeds in INR from the balances in the designated Special Vostro account of the correspondent bank of the partner country.

4. Documentation: The export / import undertaken and settled in this manner shall be subject to usual documentation and reporting requirements. Letter of Credit (LC) and other trade related documentation may be decided mutually between banks of the partner trading countries under the overall framework of Uniform Customs and Practice for Documentary Credits (UCPDC) and incoterms. Exchange of messages in safe, secure, and efficient way may be agreed mutually between the banks of partner countries.

5. Advance against exports: Indian exporters may receive advance payment against exports from overseas importers in Indian rupees through the above Rupee Payment Mechanism. Before allowing any such receipt of advance payment against exports, Indian Banks shall ensure that available funds in these accounts are first used towards payment obligations arising out of already executed export orders / export payments in the pipeline. The said permission would be in accordance with the conditions mentioned in para-C.2 on Receipt of advance against exports under Master Direction on Export of Goods and Services 2016 (as amended from time to time). In order to ensure that the advance is released only as per the instructions of the overseas importer, the Indian bank maintaining the Special Vostro account of its correspondent bank shall, apart from usual due diligence measures, verify the claim of the exporter with the advice received from the correspondent bank before releasing the advance.

6. Setting-off of export receivables: 'Set-off' of export receivables against import payables in respect of the same overseas buyer and supplier with facility to make/receive payment of the balance of export receivables/import payables, if any, through the Rupee Payment Mechanism may be allowed, subject to the conditions mentioned in para C.26 on Set-off of export receivables against import payables under Master Direction on Export of Goods and Services 2016 (as amended from time to time).

7. Bank Guarantee: Issue of Bank Guarantee for trade transactions, undertaken through this arrangement, is permitted subject to adherence to provisions of FEMA Notification No. 8, as amended from time to time and the provisions of Master Direction on Guarantees & Co-acceptances.

8. Use of Surplus Balance: The Rupee surplus balance held may be used for permissible capital and current account transactions in accordance with mutual agreement. The balance in Special Vostro Accounts can be used for:

(a) Payments for projects and investments.

(b) Export/Import advance flow management

(c) Investment in Government Treasury Bills, Government securities, etc. in terms of extant guidelines and prescribed limits, subject to FEMA and similar statutory provision.

9. Reporting Requirements: Reporting of cross- border transactions need to be done in terms of the extant guidelines under FEMA 1999.

10. Approval Process: The bank of a partner country may approach an AD bank in India for opening of Special INR VOSTRO account. The AD bank will seek approval from the Reserve Bank with details of the arrangement. AD bank maintaining the special Vostro Account shall ensure that the correspondent bank is not from a country or jurisdiction in the updated FATF Public Statement on High Risk & Non Co-operative Jurisdictions on which FATF has called for counter measures.

11. The above instructions shall come into force with immediate effect. AD banks may bring the contents of this Circular to the notice of their constituents and customers concerned.

12. The directions contained in this circular have been issued under sections 10(4) and 11(1) of the Foreign Exchange Management Act (FEMA), 1999 (42 of 1999) and are without prejudice to permissions / approvals, if any, required under any other law.

Yours faithfully,

(Vivek Srivastava)
Chief General Manager

ACKNOWLEDGMENTS OF REFERENCES

Information and material available in public domain and on the websites of the following have been used in the preparation of this publication and the same is duly acknowledged: -

- Reserve Bank of India
- Clearing Corporation of India Ltd.
- India Exim Bank
- Directorate General of Foreign Trade
- Department of Financial Services
- Department of Economic Affairs
- Other material available in general in various reputed publications/journals/websites of industry bodies related to the subject.

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