FCNR(B) Deposits

Mains: *GS III – Economy*

Why in News?

Recently, the RBI introduced a special swap facility in June 2026 to encourage NRIs to place funds in Foreign Currency Non-Resident (Bank) or FCNR (B) deposits.

What is the background?

- **Confidence of NRIs** – India's foreign exchange reserves and external-sector stability are closely linked to the confidence of non-resident Indians (NRIs) and global investors.
- **Depreciation of Rupee & RBI's Role** – When the rupee faces depreciation pressure, particularly because of elevated crude oil prices and higher demand for foreign currency, the Reserve Bank of India (RBI) may adopt measures to augment foreign exchange liquidity.
- The response was significantly stronger than the initial target: Indian banks mobilised more than **$127 billion** through these deposits, compared with an initial target of around $50 billion.
- The RBI subsequently closed the window for fresh FCNR(B) deposits on **August 31, 2026**.
- **Crucial Question Raised** – While the scheme provides banks with foreign-currency funding and strengthens India's foreign exchange reserves, it also raises an important question: **Who ultimately bears the currency risk associated with these deposits?**
- The answer is nuanced. The RBI's special swap arrangement substantially shields banks from currency risk on the **principal amount**, but banks continue to bear the foreign-exchange risk associated with **interest payments** unless they hedge that exposure themselves.

What are FCNR(B) deposits?

- **Definition** – FCNR(B) deposits are **foreign-currency-denominated term deposits maintained by NRIs with Indian banks**.
- Unlike ordinary rupee deposits, the principal and interest are denominated in a permitted foreign currency.
- **Significance** – Their importance lies in the fact that they provide Indian banks with a source of foreign-currency funding while allowing NRIs to avoid direct exposure to fluctuations in the rupee for the deposited principal.

- The special RBI swap facility was designed to make such deposits more attractive to banks and thereby encourage greater mobilisation of foreign currency during a period of pressure on the rupee.

How does the RBI's swap facility work?

- The central feature of the arrangement is that the **RBI assumes the foreign-exchange risk associated with the principal amount of the FCNR(B) deposits through the swap mechanism**.
- In simple terms, banks receive foreign-currency resources through the deposits, while the RBI provides a mechanism that protects banks against adverse movements in the rupee-dollar exchange rate on the principal.
- Thus, if the rupee depreciates substantially over the maturity period, banks are not required to bear the entire additional rupee cost associated with the principal repayment.
- According to estimates cited by financial institutions, the RBI bears a hedging cost that could be as high as around **3%**, with SBI Research also using an average hedging cost of approximately 3% per year in its calculations.
- Therefore, the currency risk on the principal has effectively been transferred from commercial banks to the central bank.

How does the RBI manage the cost?

- The RBI does not merely assume a cost without obtaining corresponding foreign-currency assets.
- The foreign currency mobilised through the FCNR(B) deposits adds to India's foreign exchange reserves.
- SBI Research estimated that the RBI had recouped around **$31.2 billion of foreign-currency assets by August 7, 2026**, equivalent to about 55% of the amount mobilised at that point.
- A part of these foreign-currency assets could potentially be invested in US securities and other foreign assets to generate returns.
- BofA Securities estimated that the RBI could earn around **4.5–5%** on the foreign reserves generated through these deposits.
- If the return on these assets exceeds the hedging cost, the RBI's net cost of undertaking the swap could remain limited.
- For instance, if the hedging cost is around 3% while the foreign-currency assets generate a return of 4.5–5%, the income from the reserves could potentially offset the cost of protecting the principal.
- SBI Research, assuming mobilisation of around **$65–70 billion** and an annual hedging cost of 3%, estimated a notional annual cost of approximately **$2.1 billion**.
- Over five years, this would amount to around $10.5 billion if the cost remained unchanged.
- Even then, the estimated five-year cost would be relatively small compared with India's foreign exchange reserves, which were around **$700 billion**.

What currency risk do banks still bear?

- The RBI's swap arrangement does **not automatically cover the interest payments** that banks must make to FCNR(B) depositors.
- This creates a separate foreign-exchange exposure for banks.
- Suppose a bank has to pay **$1 million as interest** on maturity. If the exchange rate is ₹95 per dollar, the bank would require ₹9.5 crore to purchase the required dollars. However, if the rupee depreciates and the exchange rate reaches ₹100 per dollar, the same payment would require ₹10 crore.
- Thus, the bank would incur an additional rupee cost of ₹50 lakh.
- A bank that has hedged its foreign-currency interest exposure would be protected against such adverse exchange-rate movements. Conversely, a bank that leaves the exposure unhedged would have to bear the higher cost.

Why are some banks not hedging the interest exposure?

- **Higher cost of hedging –** Hedging the foreign-exchange exposure associated with interest payments over three-to-five-year maturities can cost banks around **3% annually**.
- Since the interest is payable at maturity, banks must decide whether the cost of locking in protection today is justified.
- Foreign banks have generally been more inclined to hedge such exposures, while several state-owned banks and some private-sector Indian lenders have reportedly left them unhedged.
- Some banks may instead prefer to purchase dollars in the spot market when the interest payment becomes due.
- This strategy avoids the immediate cost of long-term hedging but exposes the bank to the possibility of a significantly weaker rupee in the future.

What happens if the rupee depreciates sharply?

- Unhedged interest exposure can become important if the rupee undergoes substantial depreciation.
    - **For example**:
    - Interest liability = **$1 million**
    - Exchange rate at ₹95/$ = **₹9.5 crore**
    - Exchange rate at ₹100/$ = **₹10 crore**
- The bank would therefore need an additional ₹50 lakh to meet the same dollar-denominated liability.
- If a large number of banks simultaneously face such obligations, they may enter the foreign exchange market to purchase dollars.
- This could increase **dollar demand** and, under certain circumstances, create additional depreciation pressure on the rupee.
- Therefore, although the RBI's swap facility reduces the immediate currency risk faced by banks, it does not completely eliminate foreign-exchange risk from the financial system.

What are the implications for India's external sector?

- **Strengthens foreign exchange reserves –** Greater foreign-currency mobilisation improves India's capacity to meet external payment obligations and manage episodes of market volatility.
- **Provides foreign-currency funding to Indian banks –** This can reduce dependence on other sources of external funding.
- **Improve confidence in the rupee –** Higher reserves provide a buffer against external shocks such as elevated crude oil prices, capital outflows and global financial tightening.

What are the risks associated?

- The RBI assumes a significant contingent exposure through the swap mechanism, while banks that do not hedge their interest liabilities remain vulnerable to future exchange-rate movements.
- A sharp depreciation of the rupee could therefore increase the cost of servicing these dollar-denominated liabilities.

What could be done?

- Banks should strengthen their **asset-liability management**, carefully assess their open foreign-exchange positions and appropriately hedge their future interest liabilities.
- The RBI, meanwhile, must continuously monitor the fiscal and financial implications of its swap exposure and ensure adequate transparency regarding associated costs and returns.
- At the broader level, India should continue reducing structural external vulnerabilities through **export diversification, greater energy security, stable capital inflows and prudent external debt management**.

What lies ahead?

- For India, the FCNR(B) experience underlines a larger lesson: strengthening foreign exchange reserves is important, but the quality of foreign-currency risk management is equally crucial for long-term external-sector stability.

Reference

The Hindu| FCNR(B)