

SMEs account for 25% of derivative MTM losses

Banking Bureau

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The latest report published by Fitch Ratings indicates that small to medium enterprises account for about 25% of mark-to-market (MTM) losses booked in 'structured' and 'exotic' foreign exchange (FX) derivative contracts entered by the Indian corporates.

The report also suggests that some of these contracts could turn into actual losses for the banks on account of defaults or disputes with the corporates. As far as large corporates are concerned, the likelihood of default due to such contracts is expected to be low in spite of high concentration of risk.

Fitch has reviewed the potential counterparty credit exposure that the Indian banking system may face due to MTM losses in derivatives transactions by the corporates and has estimated the current MTM losses on FX derivatives in the range of \$3-3.5 billion.

According to Fitch, MTM losses could vary from bank to bank, depending on business size, nature of contracts and mix of business between SMEs and the large

corporates.

Ananda Bhoumik, senior director, Fitch Ratings said, "The key risk could arise from any default by larger corporates, given the big-ticket size per client. These corporates however possess superior financial flexibility as well as high inclination to protect their reputation and maintain healthy relationships with their bankers."

The report suggests that banks need to further refine their derivatives underwriting policies, including practices for assessing potential future exposures while also adopting a more conservative approach towards capital allocation. Since product risk could differ widely depending on the structure, a risk-adjusted capital allocation policy may be more appropriate in future.

So far, Axis Bank and Kotak Bank have each announced provisions of less than \$20 million against such exposures, primarily arising from defaults by the SMEs. The majority of open contracts in the system are expected to mature over the next 12 to 18 months, when a clearer picture on the provisions that banks need to make would emerge.