Foreign Exchange Regulations – a review

Good evening, ladies and gentlemen. I am happy to be here at the annual general meeting of the FEDAI. As we never tire of mentioning, the role of FEDAI is unique. It is not merely a self regulatory organization in the sense of complementing regulation, its own regulations have a binding nature to the extent they are issued under directions from RBI. As a self regulatory organization, we look to FEDAI to promote better customer service, efficient market practices by encouraging high standards of conduct, promoting compliance with the spirit of RBI regulations integrity and professionalism. Furthermore, the role of FEDAI encompasses the entire area of foreign exchange which includes besides foreign exchange trading all aspects relating to goods, services, non-residents etc.

In today's address, I propose to review the entire gamut of foreign exchange regulations from a balance of payments perspective. The destination is clear. However, a review of this nature gives us a better understanding of the how the regulatory environment has evolved and also indicates how to move forward.

Current account transactions

The whole objective of markets including foreign exchange markets should be to support economic activity and raise the potential for economic growth. International trade in goods and services (current account transactions) provides this stimulus. The focus of exchange control regulations will, therefore, have to facilitate transactions in international trade in goods and services. There has been significant liberalization of the trade account in respect of export/imports as well as invisibles. While the repatriation requirement for export earnings continues guided by the macroeconomic situation, exporters can hold export proceeds in foreign currency in India in EEFC accounts as per regulations. Having regard to the liberalised approach in trade matters, specific steps were taken to allow exporters greater flexibility and freedom in the matter of seeking

regulatory compliances. The system of self write off and self extension of due date for export realisation for exporters was introduced followed by raising the threshold limit for GR declaration. Reliance has therefore been placed on simplifying procedures for the genuine exporter. Similarly, exporters can avail of foreign currency or domestic credit as per their choice and banks are not constrained from raising foreign currency resources for this purpose. In fact our data shows that substantial foreign currency resources have been raised by banks for this purpose and the aggregate foreign currency borrowings therefore on an average exceed 50 percent of Tier I capital. In regard to invoicing, there is no restriction on invoicing in any currency.

In regard to imports too there are no restrictions on payments for bonafide imports. Importers are allowed to avail of trade credit up to one year for imports of raw materials and up to three years for capital goods. In regard to small value imports we have recently liberalized and delegated follow-up for bills of entry less than US$100,000 to authorized dealers. This ensures that genuine importers are not put to difficultly. Similarly for import of services, there is no need for RBI approval beyond indicative limits and authorized dealers are allowed to permit remittances by verifying the documents. Overall, measures for simplification of procedures have been made subject to KYC and Anti Money Laundering guidelines.

A number of initiatives have been taken towards procedural simplification with an objective of reducing the transaction cost. In the case of individuals, foreign exchange for current account transactions such as education, medical, travel, emigration, maintenance of close relatives abroad can be drawn from the Authorised dealer based on simple declaration up to certain indicated limits. The focus of external sector reform measures has therefore been to dismantle controls and provide an enabling environment to all entities engaged in external transactions.

Capital account transactions

When we come to the capital account we enter into a much more complex area. In emphasizing the advantages of deregulation, globalisation and economic reforms, a word of caution is necessary; that for a society like India, which is complex and diverse, comprising different states with different levels of development, social disruption has to be avoided. The total cost of the social or political disruption or market disruption has to be weighed against the flow of benefits whenever we talk of economic reforms. So in that sense again, it involves balancing between benefits over a period and costs of immediate disruptions.

We therefore have to take an integrated view of the domestic financial as well as the fiscal situation and the imperatives of the international financial architecture in capital account liberalization and our carefully calibrated capital account liberalisation precisely captures this objective. In this regard we need to make the following distinctions:

(i) non-residents and residents; under residents, households, corporates and Fis

(ii) debt and equity

(iii) inflows and outflows

Accordingly, our preferred policy orientation is towards hierarchy of capital flows emphasizing the importance of non-debt creating flows. In pursuance of this approach, a sequenced liberalization of current and capital accounts has been undertaken with a focus on encouraging these flows with free repatriability and international rates of taxation but with defined processes of approval/registration and reporting accompanied by sector specific ceilings. In regard to equity investment for non-residents, at present, FDI is permitted under the automatic route subject to specific guidelines except for a small negative list. There are six sectors where investments are prohibited and eleven sectors where investments

require prior approval of Government. Seven sectors are subject to sectoral caps. Similarly the policy on portfolio flows is quite liberal and in fact India has received large flows on portfolio account. The portfolio flows are permitted through two channels, NRI and FII. The ambit of sectors where such flows are permitted has been increased in a phased manner, the recent addition being permission for FIIs to invest in security receipts issued by ARCs.

The policy relating to outward remittances for residents is to give freedom to corporates to invest in companies overseas and establish either reenfield projects or acquire companies. The objective is to create an enabling environment for Indian companies to become multinational in nature which eventually leads to greater international trade in goods and services. In furtherance of this objective, several measures are being considered including proposal to allow all forms of guarantees by corporates under Automatic Route subject to the overall limit, extending the scope of the general permission for ESOPs and repurchase by issuing companies, proposal to allow disinvestment under the Automatic Route, revision of formats of APRs and Statutory Auditors Certificate.

In regard to debt flows, we need to take into account the balance sheet approach and how risks apply to different sectors and maintenance of monetary and financial stability. This requires that any policy should not unduly constrain independent monetary policy making. Recent literature on “debt intolerance” emphasizes that developing countries have historically run into problems at much lower debt to output ratios rather than advanced countries. The focus of a balance sheet approach is therefore of particular relevance for emerging market economies. There is also need to reckon the possibility of balance sheet problems in one sector spilling over into other sectors often snowballing in the process. Problems can originate in the corporate sector (as in some Asian economies in 1997-98) or in the fiscal sector (as in Russia 1998, Turkey in 2001

and in certain Latin American countries) with the banking sector playing a key role in all these episodes. Similarly, if banks tighten their lending to prevent the asset portfolio from further deteriorating this further complicates the situation of a corporate or a government in need of fresh financing or debt roll overs. Furthermore, in assessing the balance sheet risks one has also to take into account the contingent liabilities. In fact the off balance sheet exposures both credit substitutes and derivatives can substantially alter the overall risk exposure.

Our external commercial borrowings policy therefore seeks to address some of the above issues. The whole process of permitting such external debt may be either through the automatic route or non-automatic route, but slowly the automatic route is being expanded and the non-automatic route reduced. Again, in the capital account apart from the government's there are three balance sheets that we take into account whether for residents or non-residents: The balance sheet of the households, the corporates, and the financial intermediaries. Though in theory, everything may be integrated, in our phase of development, definitely these three are distinct in terms of their immediate reactions to market forces. That is the reason, the recent External Commercial Borrowings (ECB) policy makes a clear distinction between financial intermediaries and corporates and entities having an element of sovereign gurantee. So, depending on the situation and the nature of balance sheets, one has to define the capital account convertibility.

Procedural simplifications

In recent years, the Reserve Bank has delegated authority to authorised dealers to such an extent that there is hardly any need for the individuals to approach the Reserve Bank for any approval. However, we have come across instances where the liberalised procedures have not permeated to the grassroot level in banks possibly due to lack of knowledge about various rules and regulations and also procedures to be followed for various types of forex transactions. In some

instances, banks show a distinct indifference to dealing with individual transactions either because of the transaction cost or charge adverse exchange rates and high commissions. The RBI is examining measures to further enhance the level and quality of customer service to individuals by reviewing the scope of activities of entities currently eligible to undertake forex transactions. Furthermore, with a view to provide comfort to the citizens and corporate community by minimizing transaction costs, while taking severe view of willful, *malafide* and fraudulent transactions, it has been decided to put in place the procedures for compounding of contravention under FEMA. The Government of India has, therefore, in consultation with Reserve Bank placed the responsibilities of administering compounding of cases with the Reserve Bank, except under Section 3 (a) of FEMA. Directorate of Enforcement would continue to exercise powers of compounding under clause (a) of Section 3 of FEMA (dealing essentially with Hawala transactions).

Issues to be addressed in derivatives transactions

In the area of derivatives, numerous risk management instruments have been allowed in a phased manner though a lot of issues are to be addressed here which may not be possible unless all stakeholders put in a sincere and combined effort. The major concern is on structured products both in regard to the products themselves as well as the accounting and valuation. This problem becomes more acute in case of forex related instruments since it is essentially an OTC market. We are already working on restructuring the valuation and accounting aspects, in consultation with ICAI, and would also invite the industry comments before finalizing the same. Ideally, the guiding principles in regard to derivative operations would be:

- No structured product should contain embedded derivative structure, which is not otherwise allowed on a standalone basis.
- Except under specified exceptions, the derivative structure should not permit any leeway that is not allowed for the cash market.

- The structure should not result in the 'dollarisation' of the balance sheet of the banks.

I must also add that any such framework for only the banking sector would be just the job half done. The ultimate users, the corporates, have to be prepared for the disclosures and recognition principles in line with International Standards. I understand that ICAI is working on this but the FEDAI as an industry association must take up with them for much greater disclosure by corporates of all their derivative transactions. The draft now proposed by ICAI provides recommendatory guidance rather than making it obligatory and it is for organizations like FIMMDA and FEDAI to ensure that this happens. Any further liberalization will be subject to appropriate accounting and disclosure standards being adopted by corporates.

The "appropriateness standard" ensures that banks use the same principles for taking credit decisions in respect of complex derivative transactions as they do for non-derivative transactions. Banks are expected to evaluate the purpose of the derivative transaction and make an assessment as to whether it is appropriate to the customer's needs and level of sophistication. Also whether the Boards of companies understand the risks.

It would be pertinent to mention here about the recent report of the Counterparty Risk Management Policy Group. An initiative of the major international players in the financial market, the report is directed at complementary measures that will further reduce the risks of systemic financial shocks and limit their damage when, rarely but inevitably, such shocks occur. A similar initiative could be worthwhile in the Indian context too and could go along way further streamlining the regulatory framework. FEDAI and FIMMDA should take up this initiative.

I wish the deliberations all success. The RBI welcomes suggestions from FEDAI for further simplification of FEMA regulations to facilitate genuine trade transactions.