*Administering FEMA – Evolving Challenges**

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DG Shri H. R. Khan, Chairman, Foreign Exchange Dealers Association of India, Officials from the Authorised Dealer Banks, and my colleagues from the RBI from all over the country.

1. A very good morning and welcome to this historic city of Agra. It is customary in these annual gatherings to take stock of the developments in the area of foreign exchange management over the preceding one year and discuss the context and content of the in-the-pipeline changes contemplated. The last one year since we met in December 2012 has been quite tumultuous and challenging but we have been able to hold our heads above water through appropriate policy responses. Now that FEMA is in its teens, let me attempt a self appraisal of how we have brought up or managed the baby (read FEMA), that was delivered at the turn of the century. Let me start with a few searching questions. Have we, during the past fourteen years, been able to charter the course we set out for ourselves when Foreign Exchange Management was enacted in 1999? Do we find ourselves where we envisaged ourselves to be? Where do we go from here? While I attempt to answer these questions, please take them as more of an introspection rather than a judgment.

2. Let us first look at the developments during the past year that would provide a setting for these questions. The dollar-rupee exchange rate acts as the barometer of the external sector. After exhibiting relative stability after the post-Lehman turbulence and range-bound two-way movement till about August 2011, US debt cap problem and subsequent downgrade sent Rupee on a depreciating spree till almost end 2011. Rupee depreciated by about 20 per cent during this period. It recovered significantly during the first quarter of 2012 due in some measure to the action that we had taken in mid-December 2011 to curb speculation and panic reaction by market participants. The Rupee started depreciating again in the second quarter of 2012, this time due to sovereign debt problem of the European peripheral countries and by the end of the quarter, Rupee had depreciated by about 16 per cent. After relative stability of close to a year thereafter, Rupee exhibited sharp depreciation again after May 2013 on the back of fear of the US exit from the asset purchase program the so called taper, accentuated by some geo-political factors precipitating at that time. Rupee has retracted from the lows it had reached, but the exchange rate often exhibits bouts of volatility.

3. External factors have no doubt played an important role in determining the path not only of Rupee but also of the currencies of most emerging market economies. For instance between May and August 2013, the most volatile phase, when Rupee depreciated by about 21 per cent, Brazilian Lira too depreciated by about 16 per cent, Indonesian Rupiah by 14 per cent, South African rand by 13 per cent, Turkish Lira by 13 per cent and Thai Baht by 9 per cent. While such company may provide some comfort to us, it does not mitigate the pain: the impact of heightened volatility, sharp movements and disorderly market conditions on the real sector cannot be overemphasised.

4. The impact of the global factors on the Rupee is only a part of the story. On the domestic front, the economy is not exactly in the best of health. The fiscal expansion to deal with the adverse impact of the global financial crisis and the reduced tax buoyancy on the back of a relatively slowed-down economy has left the fiscal position in a less than optimal state. The inflationary pressure continues. Most importantly, the current account deficit has burgeoned to 4.6 per cent for the last fiscal. Of course, the current account balance has shown improvement since October last year with

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a significant reduction in trade deficit (48 per cent), export growth (13.5 per cent) and reduction in imports (14.5 per cent). It is expected that the current account deficit will be within 3 per cent to 3.5 per cent this fiscal year and compared with the last year, much easier to finance.

5. Let me briefly recall an earlier episode when the Rupee exhibited heightened volatility, but in the other direction. After reaching a sub-47 level trough in July 2006, it steadily appreciated till February-March 2008, even after the tremors of the global crisis had started getting noticed. During this period, momentum of Rupee appreciation could be arrested only through aggressive intervention by the Reserve Bank. During 2006-07 and 2007-08, the RBI purchased US$ 26.8 and US$ 78.2 billion respectively. The direct (fiscal) cost of sterilisation operations to contain the expansionary impacts of the RBI's interventions was significant, at about ₹8,000 crore during 2007-08, which goes to show, even with the benefit of hindsight, that intervening in the market to buy foreign exchange in the face of surge in inflows is not necessarily an easy decision.

6. The volatility of the exchange rate, particularly episodes of large unidirectional movement either way, calls for an effective set of policy tools to deal with it. I do not intend to go into the larger questions of whether the exchange rate movements need to be dealt with at all and if so, what constitutes an optimal policy choice. For the purpose of the present discussion, suffice to say that some form and extent of capital account management is an option to deal with episodic or structural vulnerabilities, which has gained wide acceptability amongst academics and policy makers. This brings us to the core of our discussion today: the nature and implementation of the regulatory regime for foreign exchange management in India.

7. Regulation of foreign exchange transactions has a long history. For a newly independent nation trying to unshackle itself from foreign political and economic domination, the first legislation, the Foreign Exchange Regulation Act (FERA), 1947, was primarily concerned with regulation of inflow of foreign capital into India, increase in non-resident interest and deployment of imported capital. India faced an acute foreign exchange crisis in the 1960s. It may be recalled that perhaps the most critical use of foreign exchange at that time was for import of food grains; during most of 1960s over seven per cent of food grain requirement had to be imported. In this backdrop, FERA, 1947 was replaced by Foreign Exchange Regulation Act, 1973. Given the importance of foreign exchange, it is no wonder that the purpose of the new legislation as stated in the preamble to Act was '*....for the conservation of the foreign exchange resources of the country and the proper utilisation thereof....*' and mandated that any contravention of the provision of the Act was treated as a criminal offence punishable with imprisonment. However, by the late 1970s Green Revolution had addressed our dependence on imported food grains and buoyant remittances from diaspora Indians had blunted the urgency of foreign exchange scarcity. The liberalisation of the exchange control regime was started in the mid-1980s and gathered momentum in the 1990s. The liberalisation process ultimately culminated in replacement of FERA, 1973 with the Foreign Exchange Management Act (FEMA), 1999.

8. What did FEMA involve? For an economic agent or a market participant, the Act per se did not bring any sea change in the way he was dealing with his foreign exchange requirements. Please recall that we had already attained full convertibility on the current account and compliance with Article VIII of the IMF. Significant capital account liberalisation had already taken place to enable us to contemplate full capital account convertibility in 1997. Though FEMA did several things, the most important was that it changed the way we should look at issues relating to foreign exchange transactions. It heralded the move away from conservation/restriction of foreign exchange transactions to their facilitation. The preamble to the Act read: '*An Act 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.' The earlier discussion relating to FERA, 1947 and FERA, 1973 had underscored the point that laws or regulations relating to foreign exchange has to respond to the evolving economic situation. The objective and content of FEMA made it explicit. While FEMA formalised the current account convertibility with the Common Law principle 'all that is not forbidden is permitted', it did the reverse with respect to capital account transactions: 'all that is not permitted is forbidden'. I shall discuss this at some length later.

9. The regulatory framework provided under FEMA has another important ingredient – it casts a great responsibility on the 'Authorised Persons' the immediate and necessary counterparty to every agent/participant for any foreign exchange transaction. In the FERA regime, their job was pretty much simple; they just had to carry out a transaction as per the RBI permit. As and when we attain full capital account convertibility, their job will perhaps be simpler. But in the regime that obtains now, they have the difficult but important task of making a judgement on permissibility of a transaction. Recognising this, FEMA empowers 'authorised persons' to satisfy themselves about any foreign exchange transaction that the customer may wish to carry out, but at the same time provides that in case an 'authorised person' forms an opinion that a transaction is not permissible, it has to do so in writing and giving reasons.

10. Let me go back to the preamble of FEMA. As we have seen an important part of the objective of FEMA is to facilitate trade and payments. With current account fully convertible, almost entire focus of the regulatory framework under FEMA is on the capital account transactions. The question then is this. Is the regulatory framework that faces an economic agent or a market participant – be it an investor or an investee, a lender or a borrower – conducive enough to facilitate various capital account transactions? Lest I am misunderstood, let me clarify that I am not advocating a greater degree of capital account openness or being more permissive in respect of this or that class of capital account transactions. The pace of capital account liberalisation will be dictated by a host of factors including macroeconomic conditions, financial stability issues and so on. My limited point is that once the policy framework has been spelt out, the implementation has to be such that anyone – a resident or more importantly a non-resident – contemplating a capital account transaction knows clearly and unambiguously what can be done, how it can be done and within what timeframe it can be done. I do not think we have succeeded too well in this objective, at least not as much as we should have. Let me elaborate.

11. Let us start with the regulatory framework. Excluding the 26 original notifications containing regulations pertaining to mostly capital account transactions, there have been a total of 263 notifications amending the regulations originally made or subsequently amended. Another dozen or so amendments are in the pipeline. After FEMA was introduced, the number of directives issued to the 'authorised persons' was 36 in 2001-02; it had increased to 138 during 2011-12, 122 during 2012-13 and as many as 77 in less than 5 months in the current year. The two gigantic volumes of Taxman's Exchange Management Manual – in small and close prints – look as formidable as any elaborate commentary on the most complex law. Indeed, it will not surprise me if someone points out an inconsistency or contradiction between two different directions or notifications. So have we simplified or complicated? Is it time for a comprehensive review? To my mind, it is an emphatic yes.

12. An important factor in this context is that capital account management has often been used as an instrument in dealing with rupee volatility. When, during 2006-2008, we were inundated with capital inflows and market intervention was unequal to the task of stemming sharp appreciation of the Rupee, we took measures to stem inflows and spur outflows. For

instance, we reduced interest rates on non-resident deposits, discouraged ECBs, and encouraged capital outflows. Again, between December 2006 and September 2007, the annual limit for almost no-questions-asked remittance facility for individuals (under the Liberalised Remittance Scheme introduced in 2004) was raised in three stages from US$ 25,000 to US$ 200,000. This facility was used by several people to pool the remittance allowed to each of their family members – a term left undefined in FEMA or the regulations framed thereunder – to buy properties abroad. Indian corporates setting up subsidiaries or joint ventures abroad were permitted to remit up to four times their net worth under the automatic route. I mention these two because these were the ones that were modified in the wake of sharp depreciation of the Rupee in August 2013, a step which was seen a few commentators as harbinger of capital controls.

13. Similarly, when Rupee exhibited a strong depreciating trend creating a panic-like situation in the market, we have responded with some tweaking of the capital account restrictions. For instance, we have expanded the scope of external commercial borrowings in regard to end use and eligible borrowers. We have increased the limit for FIIs' investment in sovereign and corporate debt. We have also deregulated or increased the interest rates on non-resident deposits. Recently, we even encouraged FCNR deposits and banks borrowing from their branches, principals, correspondents and international/multilateral institutions by offering a concessional swap facility. The point that I wish to make is that since capital account measures have been actively used for dealing with turbulence in foreign exchange markets, has it perhaps contributed to a complex and if I may say so, a time-inconsistent regulatory framework? Does this approach therefore require re-calibration after a review?

14. The second issue I wish to emphasise on is the evolution in the way business is done and financial innovation. Let us remember that much of financial innovation is indeed what is often called regulatory bypass. Market participants always explore ways to circumnavigate around the regulatory roadblocks, to which the regulators respond with a lag by erecting more roadblocks. In this game, it is inevitable that the regulatory framework ends up being complex. While too little regulation, particularly in the financial sector, runs the risk of financial instability, too much regulation throttles enterprise, makes innovation impossible and squeezes the ease of doing business. As T. S. Eliot observed, *albeit* in a different context, ' the danger of freedom is deliquescence; the danger of strict order is petrification'. So, the question is: how to achieve the right balance?

15. Let us take the area of inbound foreign investment for example. The two ways of investment in an enterprise are either through direct investment or through portfolio investment. Direct investment is defined in terms of 'lasting interest' which implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. A classic way of foreign direct investment would be when a non-resident entity sets up a wholly owned subsidiary or forms a joint venture in the host country. The equity shares are acquired simultaneously as they are created. What about a non-resident acquiring a lasting interest in a resident company through mergers, acquisitions and take-overs? Suppose a non-resident FDI investor wishes to increase its stake by progressively buying up shares in the stock exchange within the framework provided by the security regulator; should it be treated as FDI or portfolio investment? Recently when the Anglo-Dutch multinational Unilever increased its stake in Hindustan Unilever by about 14.8 per cent at a cost of US$ 3.6 billion through an open offer, the extent of equity shares tendered by Foreign Institutional Investors was excluded from FDI in our system, thanks to the reporting system set up in line with the regulatory provisions.

16. In the original FEMA regulations, it was provided that it was in order to issue a partially convertible debenture against foreign direct investment. In 2006-07, when external commercial borrowing was discouraged, companies responded with an obvious dodge: a partially convertible debenture with a nominal part slated to be converted to equity was used to camouflage a commercial borrowing. We responded by excluding a partially convertible debenture from the list of securities that can be issued against FDI and to be treated as a debt. I am afraid the game is not yet over because the vice of treating a partially convertible debenture as debt is that someday, when appropriate incentives are there, it can be used to camouflage an equity investment.

17. What about portfolio investment? It is true that there has not been much change in the regime as far as portfolio investment in equity is concerned even as the limit of investment in fixed-income market has been progressively increased. This is a very fertile segment. A recent study indicates that, as of 2012, global pension assets in 13 mostly developed countries total US$ 29,754 billion. You can add the other classes of large investors: private trusts, university endowments, and so on. There is significant potential for tapping these sources. Studies seem to indicate that there is a significant extent of home bias in the investment strategy of the manager of these funds, particularly in regard to bond investment. Thus, it may not be sufficient to lubricate our markets in the hope that foreign investors would evince a great deal of interest. A time has come perhaps for us, within the broad contours of our capital account management, to take our assets to off-shore markets through appropriate institutional framework. A starting point has been made by permitting IFC to issue Rupee denominated bonds overseas. Depending on experience gained, this arrangement can be further opened. Similarly, the Sahoo Committee to review the regulations relating to issue of DRs, is expected to address the issue of 'home bias' of the overseas investors.

18. Let me now turn to another area – External Commercial Borrowings. Have regulations evolved to facilitate or hamper business? For instance, should we have a more liberal access regime for entities who are forex earners and thus have a natural hedge? Should we have a more rigid rules for others? Another related issue. The thumb rule that we have followed in our approach is not to permit the Indian banking system to guarantee the forex loans raised by resident entities. Is this the right approach? Or should this decision be left to the commercial judgment of banks and their ability to price the risk, leaving the stability related issues to be addressed through appropriate micro-prudential measures such as risk weights and capital charges and disincentives for evergreening by other means?

19. That brings me to the more esoteric world of foreign exchange derivatives. Though the market in its current shape is a little more than two decades old, it has taken great strides in terms of volumes, participants and infrastructure. Yet, times are pregnant with possibilities of developments in several directions.

20. Derivatives are essentially inter-temporal transactions contingent on a future view of the state of the world. When in the underlying cash market, the exchange rate exhibits great deal of volatility, it is natural that there will be a spurt in activities in the derivatives market for different motivations: for hedging actual exposures, for arbitraging and also for speculation. So far we have responded by restricting the freedom of market participants to enter into derivative transactions with a view to curbing speculation and panic-driven trades. Looking ahead, we shall perhaps have to build a robust market which will provide ample opportunity for all kinds of trades, even speculative ones, without upsetting the apple cart.

21. Hedging is an agent's choice, depending on his risk appetite. The market must provide adequate instruments suiting every market participant's hedging strategy. As of now the instruments available are the linear derivatives and the plain-vanilla options.

Hedging is not cost-free. There is a view that an agent must have the freedom to choose which risk to what extent he should hedge and instruments he uses to hedge. In this context, it is necessary to introduce different styles and structures of options which will enable the market participant to optimise on his hedging strategy. For this to happen, it is imperative that the risks and pay-offs of these instruments are properly understood and in this the Authorised Dealers as market makers play a very constructive role. As Robert Shiller remarked, 'Achieving radical financial innovation is never easy. Doing so requires careful attention to design, experimentation to find the right design, and extensive marketing, and it requires cooperation from more of our society than just the isolated innovating firms…..'[1]

22. The other aspect of foreign exchange derivative market is the ever increasing off-shore segment. Though we do not have definitive information about the nature or impact of the NDF market, the fact that it has been growing in size is not disputed. In times of exchange rate volatility, the discussion of NDF becomes animated and a large part of the blame for the volatility is laid at its door. Be that as it may, with increasing financial integration with the global economy and ever growing body of investors with an Indian interest, it is no wonder that rupee should attract global attention. The home country bias for the bond and equity investor is to a large measure due to exchange rate risk; perhaps even the hedging market too has a home country bias. We have to make all efforts to bring that market on-shore. But the market that can entice them has to be complete and flexible with less restrictions on entry or exit. Can we lay out an action plan to achieve this objective in an efficient or largely non-disruptive way? This also throws up the challenge of synchronising the rules of the game for OTC *vis-a-vis* exchange traded markets.

23. I have discussed about the crossroads at which we stand and the dilemmas we face in so far as the foreign exchange management framework is concerned. Please appreciate that the central theme running through all these issues is the same – the one that FSLRC has also flagged and which is not specific to FEMA regulations alone. Is it time for the country to move away from rule based regulations to principle based regulations aimed at addressing stability and market abuse/failure concerns? A principle based regulatory framework has its own challenges. The greatest challenge perhaps is to ensure that the myriads of different variations of cases that are covered by a single principle are dealt with in a uniform manner by the various agents of the regulators, in this case the authorised dealers. As I have mentioned earlier, the responsibility of the authorised dealers in the present regime is substantial; in a principle based regime it will increase manifold.

24. Let me now conclude. What I have tried to communicate that a regulatory regime for foreign exchange management, within the four corners of the broader policy framework, has to be dynamic enough to accommodate the evolving nature of doing business. In an attempt to accommodate the external factors including the external sector vulnerabilities, the regulatory framework has perhaps become complex and uninviting for enterprise and investors. Efforts are already afoot to consolidate and rationalise the regulatory framework even as to make it robust enough to tend to our ever-changing future needs. Authorised Persons, as the interface between the regulator and the various stake holders and with great responsibility on themselves in smooth administration of the regulations, have a critical role to play. There is a difficult but interesting journey ahead. Bon Voyage and safe landing for all the stake holders.

Thank you

[1] Shiller, Robert, Radical Financial Innovation in Entrepreneurship, Innovation and the Growth Mechanism of the Free Market Economies, in Honor of William Baumol, Princeton University Press (2004).