

Forex Market Development – Issues and Challenges – Thoughts of a Returning Forex Market Regulator*

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I am delighted to be in your midst after a long gap of a decade. The occasion brings back reminiscences of late 1990s and the early years of this century when the forex market in India was quite different from what exists today. A nascent market that it was, needed a lot of hand-holding from the Reserve Bank. The Rupee was always moving down a one-way street and every bout of volatility – plenty those days, for example, on account of the South East Asian crisis, nuclear sanctions, Kargil flare-up, 9/11 attack, attack on Indian Parliament, *etc.* hogged the headlines in the newspapers. Volatility was synonymous with rupee depreciation and a species called 'rupee appreciation' was not even born or even conceived those days. The Reserve Bank's only task was to wage a battle against the villain of depreciation with the meagre reserves at its behest. This situation made the battle more interesting for the onlookers and hence every episode of volatility was packed with as much thrill as a 20-20 game.

2. By the end of 2002, the Indian growth story had taken firm roots and capital inflows had resumed, as indeed to the other emerging market economies. The world was also entering into an era of abundant dollar liquidity with the Fed Fund Target rate falling from 6.5 per cent in January 2001 to 1.75 per cent in January 2002, then to 1.25 per cent in January 2003 and finally, to 1 per cent by July 2003. It is a different thing that seeds of a crisis that would overtake the global financial system five years later were allegedly being sown and nurtured by the overhang of cheap global liquidity. But, the markets and market participants were relaxed and we at Reserve Bank were mostly concerned with dealing with the after-effects of capital inflows. The last decade saw unprecedented expansion of the financial markets,

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in terms of both innovative new products as well as the scale of activity. The Indian markets witnessed huge capital inflows, exerting sharp upward pressure on the Rupee, fuelling expectations and warranting massive intervention by the Reserve Bank. The tide soon turned, however. The onset of global financial crisis post-Lehman caused large capital outflows leading to all-time low for the Indian Rupee (INR). The experience of the last couple of years or so is too recent in all our memories and it would be unnecessary to repeat the same here. Let me mention that even as I speak, the global financial markets are in a state of turbulence with risk aversion and uncertainties resurfacing across the globe in the backdrop of faltering US recovery, the obstinate sovereign debt problem in the EU zone and the downgrade of the US sovereign rating by one of the three large credit rating agencies. I would like to mention two other important developments in this context. Firstly, the conventional thinking on capital controls has undergone a change with wide acknowledgement that capital controls can serve useful public purpose in certain circumstances. Second, the regulators worldwide have initiated steps to refurbish the market infrastructure, particularly for the Over-the-Counter (OTC) derivatives, opaqueness of which is often the reason ascribed for the crisis.

3. As of now, it is not clear how long it would take for the uncertainties to recede from the global financial markets and what would be the final shape of the regulatory framework and market infrastructure. Nevertheless, the vulnerability of the Indian financial system or any system for that matter to pro-cyclical and uncertain capital flows would remain. Therefore, even as our capital account is virtually open in a *de facto* sense for individuals and non-financial firms, further opening of the capital account particularly for the financial firms has to be dealt with in a carefully calibrated manner. An instructive way to guide our

thoughts would be to distinguish between strategic controls and tactical controls on capital flows. Strategic controls, in so far as they relate to capital inflows, would involve defining a pecking order of flows (*e.g.*, in the Indian context the order is foreign direct investment, portfolio investment and debt) and provide a credible framework of rules of the game which can be used by foreign investors to decide their investment strategy. On the other hand, tactical controls would be situation-specific – to be imposed when particular circumstances arise and withdrawn when they abate. The exact combination and extent of the control, however, is dynamic and would have to be determined by the country context and international milieu.

4. It is against this backdrop that I wish to share my thoughts with you on a few major themes that would guide our endeavours for development of markets in the next few years.

5. During the past few years, the US\$-INR exchange rate dynamics have been driven mainly by capital flows. In view of the savings-investment gap on the one hand and persistent current account deficits on the other, capital inflows are necessary for sustaining the growth momentum. Apart from the growth perception of the Indian economy, risk appetite of the global investors and prevailing global liquidity conditions have driven the magnitude and direction of capital flows. While the growth trajectory of the Indian economy has been reasonably stable, the other factors mentioned above have swung from one extreme to another during the last few years resulting in sharp appreciation, depreciation and volatility of the Rupee. Needless to mention, volatility in a key macro-variable like the exchange rate affects optimal decision-making of the economic agents in the real sector. As stated in the preamble to the Foreign Exchange Management Act, 1999 the Reserve Bank is committed to maintaining orderliness in the foreign exchange market and in fulfilment of this responsibility, the Reserve Bank has intervened in the foreign exchange market, whenever necessary, only to curb excessive volatility and restore orderly conditions.

6. Over the years, the Reserve Bank has made available a wide range of hedging tools to enable firms

to manage foreign exchange risk. It is heartening to note that diverse market participants, firms and individuals are actively managing their foreign exchange risk and have become accustomed to dealing with exchange rate volatility effectively. One of the major developments in recent years is the introduction of exchange-traded currency futures and options, which have registered significant growth in volumes since their introduction. The increase in the currency futures volume, in a sense, is expected, in view of cash settlement, no requirement of underlying exposure and absence of any restriction on cancellation and re-booking. However, open interest in the futures, which captures the extent of its use by the end-users for hedging, is far lower in comparison to the amount of outstanding forward contracts. Is this a pointer to the fact that notwithstanding many advantages that exchange-traded products offer, OTC market is going to be the preferred domain of operations for the end-users in respect of, the forex derivative products where transactions are in the nature of relationship banking?

7. As far as OTC markets are concerned, the first theme I wish to discuss relates to the appropriateness of transactions between the banks and their clients. As I mentioned earlier, forex transactions between banks and clients are a part of the relationship banking. Secondly, often the corporate does not need derivative products to profit from its position but to reduce or eliminate the uncertainty from their future cash flows. Thus, the use of a derivative product by a corporate would have to be dictated by the character of its exposures, nature of the uncertainties and the risk appetite or aversion as embodied in its risk management framework. We often notice that the volatile foreign exchange market, or any other market for that matter, entices ordinary mortals to throw their hat into the ring and make money on the side, mechanically projecting the immediate past. The banks owe it to their clients to ensure that they do not fall prey to such temptations and the derivative positions they contract are 'appropriate'. While we have issued comprehensive guidelines on the subject, I would like to impress upon you the imperative of this aspect from the perspective of credibility of the OTC market, financial stability and above all, stable relationship

banking. In the same breath, I would like to exhort the corporates (who are also members of the FAI) to put in place a strong governance framework, which will ensure comprehensive understanding of the product to be contracted, proper oversight of the financial products that are being bought by their dealing rooms, assess the inherent risk characteristics of these products and have a strong system of checks and controls, which can prevent any dealing room from running astray.

8. This brings me to my next theme, *i.e.*, improvements in the OTC market infrastructure. As you are aware, the Pittsburg declaration of the G-20 mandates that all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through Central Counter Parties (CCPs) by end-2012. Further, OTC derivative contracts should also be reported to trade repositories. The Financial Stability Board's report 'Implementing OTC derivative market reforms' (October 2010) addresses the practical issues concerning standardisation, central clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions to trade repositories that authorities may encounter in implementing. However, there are strong views in favour of the OTC products. Their bespoke nature imparts flexibility to cater to specific requirements of any market participant. Further, the OTC market acts as a nursery for new products and has remained the major source of product innovation. Again, in a market that is essentially wholesale in nature and confined to a few large participants, an OTC trade may offer cost/price advantage in comparison with its exchange-traded alternative. As we know, standardising products is a pre-requisite for moving them to exchanges and this can pose challenges. If not carefully orchestrated, the exchanges themselves can pose vulnerabilities and systemic challenges. Lastly, the oversight of such exchanges has to be robust and effective.

9. Let me now dwell on the developments in our own forex market as regards centralised clearing and reporting of OTC transactions. Even before the onset of the crisis and emergence of the new line of thinking, Reserve Bank has been alive to the need for a robust trading and settlement infrastructure and has taken

several initiatives in this direction spanning various market segments. As you are aware, the Clearing Corporation of India Ltd. (CCIL) has been providing guaranteed settlement facility for all US Dollar-Indian Rupee, inter-bank Cash, Tom, Spot and Forward transactions by becoming the central counterparty to every trade accepted for settlement, through the process of novation. The risk mitigation efforts sought to be put in place for this guaranteed settlement were extensively discussed with Fed Reserve in the spirit of co-operative oversight as was brought out in the Lamfalussy report.

10. The benefits that have accrued from this mechanism could be seen from the data for the month of July 2011. During this month, the total US\$-INR deals (including forwards) settled through CCIL was USD 3.4 trillion with a netting benefit of 95 per cent. This netting benefit as you would recall was specifically useful during the global financial crisis wherein liquidity lines had virtually dried up. Due to this arrangement, the banks in India did not face much of liquidity and funding shortage during the financial crisis.

11. We have since permitted CCIL to start centralised clearing of forex forwards. I understand that, at present, there are 77 member banks who are members of the US\$-INR spot segment but only 35 of them are member of Forex Forward segment. The feedback we get on the reasons for the reluctance of banks to join the guaranteed settlement is linked to margining requirements and low exposure limits set by banks against CCIL. This is surprising to say the least. Probably the banks perceive the benefits in terms of reduced risk weight and release of exposure limit accruing from centralised clearing not commensurately attractive *vis-à-vis* the cost of margins. In the current thinking, this approach becomes difficult to accept as this limited participation by banks reduces the netting benefits of centralised clearing. Given our experience of the successful CCP arrangement that we have in place and the G-20 initiatives for centralised clearing of OTC derivatives, the Reserve Bank may consider mandating that all forex forward and US\$-INR trades be necessarily settled through guaranteed central clearing mechanism.

12. If the Reserve Bank is required to take such a decision, there is a need to guard against the compromise in the margining process since risk management through margining system assumes critical importance for a CCP. Compromise on stringency of margin requirements due to commercial/profitability considerations and the 'race to bottom' approach towards margining has systemic implications. CCIL's margining processes have therefore been reviewed and streamlined. CCIL will now allow members to use marked to market (MTM) gains as MTM credits. Initial margin and spread margin will be calculated using VaR for all settlement date-wise net US\$ dollar positions and all settlement date positions will be considered as a single portfolio. International efforts are also afoot to mandate reporting of OTC trades to a trade repository where ever CCP arrangements are not found feasible. Trade Repository (TRs) are Financial Market Infrastructures that maintain a centralised database of OTC derivatives transaction data. TRs, therefore, are in a position to provide information – both to the regulators as well as to the market. By doing so, TRs enhance the transparency in OTC markets and promote financial stability. Even prior to the onset of global financial crisis and the global initiatives, the Reserve Bank through regulatory mandate had tasked CCIL to collect and collate transaction level data for interest rate swaps. Though the CCIL does not yet offer any post-trade life cycle management services, it has all the information that a trade repository typically has and in this sense is perhaps the world's first trade repository for interest rate swaps. Reserve Bank had also set up a Working Group consisting of various stakeholders including CCIL and market participants to work out the modalities for an efficient, single-point reporting mechanism for all OTC interest rate and forex derivative transactions. The public consultation period is over and the recommendations are being examined.

13. In recent years, non-deliverable forward (NDF) markets have become, as it were, the talk of the town. I wonder whether the choice of venue for this assembly has been influenced by this fact. The BIS Triennial Central Bank Survey 2010 estimates that aggregate daily INR market, off-shore and on-shore included, at about US\$ 36 billion. Given the size of the on-shore INR

market then, we guess on sheer deductive logic that the NDF market has witnessed rapid growth over the years with average daily turnover somewhere around \$16 billion during the survey period.

14. The NDF market in different currencies came into existence with increased globalisation which led to the fact that there were economic agents with direct or indirect exposure to a currency but limited or no avenue to hedge the risk either due to regulatory restrictions in the host country or non-availability of hedging products or markets or simply because of cumbersome nature of entering into a hedging contract in an unfamiliar country. Evidence seems to suggest that even when, in some jurisdictions, the regulatory regime was relaxed and full access to the domestic market was available to the non-residents, the NDF market continued to be significant, presumably due to the fact that it afforded the interested non-residents ease of transaction and a familiar market. The question that then arises is that whether there is a linkage between the NDF market and the on-shore market and how exactly does the NDF market affect the domestic market. At the outset, we must recognise that after all, both NDF and on-shore rates are influenced by the identical set of economic and geo-political developments at home and abroad and there is no *a priori* reason to believe that the two rates will respond differently to the same set of events, except for the difference in time zone leading to difference in the time the prices capture market action.

15. That said it is true that trans-national entities with presence in India and abroad can provide a link between the two markets and can be instrumental in arbitraging away any emergent differences between the two markets. As far as the question of NDF market influencing the domestic market is concerned, as long as the movements in the domestic rates are adequately explained by economic and geo-political factors, the most important of which in recent times have been the capital flows and movements in major currencies, there is no reason to debate the issue further.

16. A related issue that has been raised in recent times is the internationalisation of the INR. With our progressive integration with the global economy, both

in trade as well as capital account, and the enduring growth prospect, the Indian economy has captured interests world-wide. It is but natural that the investor community across the globe would like to buy stake in the growth story that is India either by way of direct investment in industry or the equity market or even debt. Doesn't it follow as a corollary that the INR should also become an object of their attention? However, as an economy moves along the path of liberalisation and globalisation, ideally the endeavour must be to bring on-shore all genuine hedging requirements of non-resident entities. A connected issue is invoicing in INR. We are well aware that this is yet to catch the fancy of the market participants on a sustained basis. A one-way movement of INR certainly increases its invoicing flavour amongst the probable beneficiaries. But the true test of a currency of invoice is the country's macro-economic strength. The ease with which the currency and related risks can be hedged would be a key determinant in accessing the product. All that I would like to emphasise is that the Reserve Bank would endeavour to create an enabling environment. We have recently moved a step forward by allowing hedging opportunities to non-residents. The experience gained will certainly facilitate evaluation and moving ahead.

17. I believe a congregation of this nature must go beyond deliberating issues of proximate concerns. A strategic element/flavour would add value to the deliberations and aid in delineating the future trajectory of regulations. Moving towards this vision, I suggest a futuristic question on this occasion to the market participants – an intellectual debate. What are the attributes of a reserve currency? Is fuller capital

account convertibility of the currency a prerequisite? Where does INR stand in this regard? I would like the Annual meet to have a robust discussion, may be in a more sober mood.

18. Let me now conclude. I have highlighted the following issues that will guide our efforts in development and regulation of forex market in the foreseeable future.

- a. Further development of the forex market has to be looked alongside the progress on capital account liberalisation which in turn is dictated by broader macroeconomic concerns and emergent international environment.
- b. The Reserve Bank has been actively pursuing improvement in the OTC market infrastructure and is committed to making further efforts to ensure compliance with the global best practices.
- c. The OTC forex market in India is a part of the relationship banking and, thus, the banks have a responsibility to ensure the appropriateness and optimality of the transactions from the customer's view-point.
- d. International interest in INR and emerging off-shore markets are consistent with progressive globalisation of the Indian economy and the efforts must be to bring all genuine users seeking to hedge underlying exposures on-shore.

19. Thank you once again for inviting me to this conference and for your patience.