*Evolving Regulations and Emerging Market Challenges – The Indian Context**

G. Padmanabhan

It is a pleasure to once again address the practitioners of foreign exchange at this Seminar organised by the Foreign Exchange Dealers Association of India in the beautiful city state of Singapore. Let us hope that the events that follow in the Indian forex market would be largely different from the events that followed after my last address in this city. The issues that you have flagged for discussion are very topical and therefore I shall comment on each of them.

A. Global regulatory changes affecting forex markets

2. In the aftermath of the 2007-2008 global financial crisis, the regulatory landscape of the financial markets around the world is going through significant changes. The repeal of the Glass-Steagall Act that separated investment banking from commercial banking in the USA in 1999 is considered by many as a major reason that precipitated the global financial crisis. Accordingly, several jurisdictions around the world including the US have either already taken or have proposed to initiate steps to construct a firewall between consumer and investment banking. The important initiatives in this direction are the Volker Rule under the Dodd-Frank Act of the USA (Section 619 of the Act), the Independent Commission on Banking (ICB) in the UK, headed by Sir John Vickers and the High-level Expert Group (HLEG) on reforming the structure of the EU banking sector, chaired by Erkki Liikanen. All three models recommend separation between deposit-taking activities and trading/investment bank functions. Whilst each regime advocates a ring-fence model, they offer slightly different approaches. Let me amplify.

3. Volcker Rule restricts deposit-taking banks from engaging in proprietary trading, prohibiting them from engaging in more complex activities that are prone to conflicts of interest, in order to safeguard the core of the banking system, *i.e.,* commercial or traditional banking (deposit taking and lending). The rule prohibits any banking entity from engaging as principal in short-term trading in securities, derivatives, or commodity futures, *i.e.,* activities that may not be compatible with the risk profile of the banking entities, but allows exemptions for market-making, hedging, trading in US government securities, and other activities (Note that the US Government securities have been accorded a special status here !). There is a concern that it would be a challenging task to separate proprietary trades from permissible trades. Under the Volcker Rule the reporting and compliance regime is expected to assume greater significance. The rule applies to all US banks and bank-holding companies and all foreign bank-holding companies with US subsidiaries or branches. The Volcker Rule prescriptions can affect the operations of the US banks operating in India as they are active players as market makers in domestic foreign exchange market, Government securities market and interest rate swap market. Very clearly, this rule if and when operationalised (in the present form), will change the entire depth and breadth of the Indian markets. An important fall-out of this rule could well be the decline in liquidity in these markets and the resultant cost escalation for market participants.

4. The ICB or Vickers report has recommended ring-fencing of retail bank operations of large UK banks into separate legal subsidiaries. It suggests that only mandated services (and the related ancillary services) of acceptance of deposits from and providing of overdraft to individuals and SMEs can be offered by the ring-fenced entity. UK government in response to the Vickers report released a white paper in June 2012 for consultation on how it plans to implement the

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recommendations/in which it has proposed, *inter alia*, that the ring-fenced banks would not be allowed to originate, trade, lend or make markets in derivatives except for managing their balance sheet risks. It has, however, also proposed that simple derivative products may be offered by the ring-fenced banks to their customers subject to certain conditions. It seems that Indian banks operating in UK and UK banks having branches in India will be impacted.

5. Adopting a slightly different approach, the HLEG (Liikanen report) has advocated separating out the trading activities beyond a threshold on a stand-alone basis from the deposit-taking bank. It proposes to do that by assigning proprietary trading and other significant trading activities to a separate legal entity in the same banking group without giving up the universal banking model that has remained a unique feature of European banking system. The idea is to prevent the bank deposits that carry some sort of guarantee from supporting risky trading activities.

6. In a nutshell, while Vickers and Liikanen allow for the ring-fenced entities to be separate and independent parts of the same group, the Volcker Rule disallows proprietary trading anywhere within a group which includes a deposit-taking bank. There are also differences of approach in terms of the range of activities that can be undertaken by and between the ring-fenced entities.

7. The crisis also brought to the forefront some of the issues associated with the OTC derivatives that were hitherto on the backburner. It was believed that the complexity and opacity of the OTC products were the root cause of the crisis since they facilitated excessive risk taking by the market participants. Lack of adequate infrastructure for clearing and settlement and lack of information on risk concentration residing with counterparties are also factors believed to have led to aggravating the crisis. There is a growing consensus amongst regulators as well as market participants that there has to be a Central Counterparty (CCP) mechanism for clearing and settlement of OTC derivative transactions as well as mandated reporting of OTC derivatives trades to designated trade repositories. A well-regulated, supervised and sufficiently capitalised CCP mechanism for clearing and settlement of OTC derivatives can reduce interconnectedness between financial entities to a large extent. Moreover, the problem of excessive risk-taking can be addressed through imposition of appropriate margins and collaterals. G-20 leaders in 2009 had agreed on the reform agenda for OTC derivative contracts like, increasing standardisation, promoting trading on exchanges or electronic trading platforms, moving to central clearing, reporting to trade repositories and higher capital requirements for non-centrally cleared contracts. However, keeping in view that the above steps will cause the risks to become concentrated in the CCP, the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) set out the Principles of Financial market infrastructures (PFMI) in April 2012 for addressing risks related to systemically important financial infrastructures, including the CCPs.

8. How has the world moved as regards the implementation of the recommendations of the various Committees? The deadline for implementing OTC Derivatives market reforms was December 2012. Various jurisdictions are in different stages of implementation of the reform recommendations. Delays in adopting legislative and regulatory frameworks are contributing to regulatory uncertainty which is further compounded by the potential for conflicts, inconsistencies, duplication and gaps in the application of jurisdictions' rules to cross-border activity. The fifth progress report on implementation of the OTC derivatives market reform, published by the Financial Stability Board (FSB) in April 2013, has reported that, EU, Japan and the USA, which account for the largest volumes of OTC derivatives activity, are among the most advanced in implementing legislative and regulatory reforms, with several key regulatory measures either already enforced or likely to be in force by mid-2013. The recent guidelines issued regarding

reforms in the OTC derivatives segment by the EU include the Markets in Financial Instruments Directive (MiFID-II), Markets in Financial Instruments Regulation (MiFIR) and European Market Infrastructure Regulation (EMIR). A number of other jurisdictions have reported that they expect regulatory measures related to trade reporting to come into force over the course of this year, and a few jurisdictions expect clearing requirements to come into force in 2013–2014. Many jurisdictions have adopted rules to implement the Basel III capital framework for banks, including higher capital requirements for non-centrally cleared transactions.

9. The new regulatory requirements may have a substantial impact on the work flow for the market participants including the end users. These regulations also have exceptions for some category of participants and products. The end users must determine what is necessary to comply with the regulations from which they are not exempted. They must meet certain criteria in order to qualify for available exemptions and will need to be aware of the activities that could prevent them from qualifying for the exceptions in the future. Depending on the extent to which the end users engage in OTC derivatives, the costs associated with preparing for the above could be significant. Some of these initiatives have also raised concerns about the possibilities of extra territorial regulatory jurisdiction leading to regulatory clashes and disruptions for market participants. Further, as Annat Admati & Martin Hellwig point out ('The Bankers New Clothes' -2013) and I quote, ''these proposals presume that concerns about depositors and the payment systems are, or, should be, the major reason for governmental interventions to banking.....This approach has two weaknesses..First, protection of depositors and the payment system is not the only reason that might induce governments to bail out banks. Second, commercial banking activities can also be a source of risks that cause banks to fail unless they are bailed out''

10. In summary, the common theme of all the proposals in the pipeline is one of putting sand in the wheels of the market. This is a far cry from the situation of the pre-crisis days, when pundits advocated complete freedom for markets in order to improve the resource allocation efficiency. It is perhaps very appropriate for all of us to remind ourselves, in foras like these, how changes could be swift and far-reaching that we may barely have time to react to!

B. Internationalisation of Renminbi and India

11. Now let me turn to the second issue, *i.e.*, internationalisation of Chinese currency Renminbi (RMB). India and China are two of the largest and fastest growing economies in the world. Notwithstanding the recent slowdown in these two economies, primarily on account of weak global economic environment, the prospects of both these economies in the medium to long-run are still considered bright.

12. Given a choice, I am sure, most of the countries would like to see their currencies as an international currency as the benefits far outweigh the associated risks[1]. While the benefits could be in terms of reduced transaction costs, seigniorage, macro-economic flexibility in terms of ability to finance external payment deficits in own currency, the associated reputational gain, *etc.*, the costs involved could be in form of sharp appreciation of currency as the currency gains recognition as an international currency that can also be used as a preferred reserve currency by the monetary authorities, and constraints on domestic monetary policy implementation.

13. However, internationalisation of currency is easier said than done. Even the US Dollar had to wait for almost three decades after the World War II till the collapse of the Bretton-Woods agreement before attaining the status it enjoys today as the mostly widely accepted international currency. There are certain well-accepted pre-requisites for a currency to attain the status of an international currency. Chinn and Frankel (2005) developed a list of functions of an international

[1] The Benefits and costs of an international currency: Getting the calculus right; Benjamin J. Cohen, June 2011

currency. According to them, an international currency has to be capable of playing roles of store of value, medium of exchange and unit of account for both residents and non-residents alike. More specifically, it should be possible of being used for private purpose for trade and financial transaction invoicing. Moreover, there should be freedom for non-residents to hold financial assets/liabilities in that currency and tradable balances in that currency at offshore locations . From an official/institutional perspective, it should be possible to hold official reserves in that currency, use it as a vehicle currency for foreign exchange intervention and anchor currency for pegging. Therefore, an international currency has to be essentially a freely convertible currency with ability to attract significant volumes of international trades across regions by way of invoicing. In addition, the currency has to possess a greater degree of stability in its exchange rate determined by the market forces and a deep and liquid market with availability of wide range of hedging products. Needless to add, it would also require to be supported by an an efficient banking system and world class market infrastructure. Going by the above characteristics of an international currency, one can argue that perhaps US Dollar and Euro are the only two currencies which can be truly considered as international currency at present, notwithstanding the recent debt related problems being faced by some of the major and peripheral Eurozone countries. As compared to the share of US Dollar and Euro that together account for almost three-fourth of global trade invoicing, the share of other major currencies as well as Chinese and Indian currencies is quite small.

14. Having stated the above, it needs to be recognised that in recent times, Chinese authorities have taken a number of steps aimed at internationalising RMB. Without going into the details of all these measures, I would briefly touch upon some of the major ones. As we understand, RMB is being used in trade and other current account transactions with Vietnam, Laos, Myanmar, the Central Asian states, Russia, and so forth. The development of offshore market and currency internationalisation go hand in hand. In this regard, China has taken a number of steps towards developing an offshore market for RMB in Hong Kong which is an international financial centre. The active offshore deliverable RMB market in Hong Kong provides services such as international trade settlement in RMB, financing, RMB denominated bond issuance, *etc.* After the implementation of the pilot programme of cross-border trade settlement in RMB in 1999, there has been a rapid growth in cross-border RMB settlement volumes in Hong Kong. China has also undertaken a number of measures pertaining to the development of onshore market. This includes the widening of the RMB's daily trading band against the US dollar from half per cent to one per cent above and below the reference rate in mid April 2012. This was motivated by the growing ability of the domestic participants to manage exchange rate movements and reflected the desire to accommodate greater flexibility in the exchange rate in the future. The People's Bank of China (PBOC) has entered into a series of bilateral currency swap agreements whereby the PBOC and other central banks (over 20 in number) have agreed to exchange the RMB with the respective counterparty currencies.

15. The size of the Indian economy of around US$ 1.8 trillion is one of the largest in the region and despite some moderation in the growth in the past couple of years, it is still one of the fastest growing countries in the world. The value of the Indian rupee is market-determined without being pegged to any currency. India's foreign exchange reserves are amongst the largest in the region. All these factors make the Indian rupee a natural candidate for being considered for greater internationalisation, especially greater use of rupee for trade invoicing. Comparisons are bound to be made between Renminbi and Indian Rupee on the issue of Internationalisation.

16. Indian Rupee is not fully convertible at this stage. While the current account has been made fully convertible, we have consciously followed a calibrated approach towards capital account convertibility. Despite

showing increasing trends during last few years, India still accounts for a very small proportion of the global foreign exchange market turnover. Though Rupee invoicing is permitted under extant FEMA regulations, almost the entire bulk of international trade in India continues to be denominated in the US dollars (the share of dollar invoicing in exports and imports during quarter ended December 2012 stood at 90 per cent and 83.6 per cent, respectively). We also need to recognise other structural bottlenecks that come in the way of transforming Mumbai as an international financial centre similar to Hong Kong.

17. It is also important to understand that unlike China, which runs large current account surpluses, India has generally been a current account deficit country. In view of the large current account deficit, the exchange rate of the rupee is susceptible to the debilitating influence of large capital movements, especially during crisis periods. Our accumulated reserves are in a sense 'borrowed' reserves and not 'earned' reserves in true sense. The sense of self-insurance by having enough reserves can often prove to be misplaced, especially, during times of sudden reversal of capital flows. This does not mean that we should not aspire to see the Rupee as an international currency. The growing importance of India in world economic affairs has also led to the talks of Indian Rupee as an international currency. According to an IMF Staff Discussion Note on *'Internationalisation of Emerging Market Currencies: A Balance between Risks and Rewards'* (October 2011), the Indian rupee, the Brazilian Real, the Chinese RMB, the Russian Rouble and the South African Rand have been identified as the key emerging market (EM) currencies with potential for internationalisation. According to the IMF's note, all these economies have significant regional importance and economic weight and, despite severe data limitations, there is evidence that the use of these EM currencies in international transactions has increased markedly in the past few years.

18. In order to promote Rupee invoicing for trade related transactions, the Reserve Bank of India has taken several steps in recent times. Non-resident importers and exporters have been allowed to hedge their currency risk in respect of exports from and imports to India, invoiced in Indian Rupees by availing the facility either directly from authorised dealer banks in India or through their banks located in their country. But our efforts to promote invoicing in the domestic currency have met with limited success so far.

19. Currently, India has a bilateral swap arrangement with Japan which enables both countries to swap their local currencies (*i.e.*, either Japanese yen or Indian rupee) against US dollar for an amount up to US$ 15 billion. However, unlike the Bilateral Swap Arrangements (BSAs) entered into by China with EMEs, where the use of dollar has been precluded, the arrangement between India and Japan envisages the use of US dollar for swap transactions. We are also focussing on select low risk but macro-economically beneficial areas, such as, progressive use of Indian Rupee in trades with select trade partners.

20. The Reserve Bank of India shall continue its endeavours towards internationalisation of the rupee in a careful and gradual manner. I would urge the esteemed panel and other participants to discuss on China's progress so far and takeaways from the same from India's point of view as also other measures that could be initiated within the overall regulatory framework currently in place. At the same time, if there is scope for further relaxation in the existing facilities, the Reserve Bank of India can certainly consider that as well. Let me now turn to the last part of my address, the derivatives market development in the Indian context.

C. Market Development in India – Forex Derivative Segment

21. The economic liberalisation that started in the early nineties facilitated the introduction of derivative products based on interest rates and foreign exchange in India. While the migration to a market-determined exchange rate regime and current account convertibility

allowed increased integration between domestic and international markets, it also exposed domestic markets and the end-users to a greater degree of volatility. In order to manage the currency risk, it was felt necessary to make a menu of derivative products available to the end-users. Accordingly, the Reserve Bank of India introduced a wide array of hedging instruments. To begin with, products traded over the counter were introduced followed by the exchange traded futures and options. Apart from the conventional hedging products, cost reduction structures had also been permitted in the Indian market. As far as OTC derivative products are concerned, the fundamental requirement of existence of an underlying commercial transaction for entering into a OTC derivative contract, both on current and capital account, has been put in place and the banks have been given the responsibility to satisfy themselves about the genuineness of the underlying exposure through verification of documentary evidence while offering such derivative products.

22. Keeping in view the developments in the domestic and international financial markets, the extant guidelines on OTC foreign exchange derivatives were revised in December 2010. The revised guidelines laid more emphasis on the suitability and appropriateness aspects of the products being offered. As certain instances of miss-selling surfaced, the Reserve Bank of India restricted cost reduction structures to be offered only to corporates who possessed minimum prescribed net worth and followed accounting standards AS 30/32. In addition, the corporates buying such products were required to have a well laid down risk management policy that clearly included, *inter-alia*, guidelines on risk identification, management and control, prudent accounting and disclosure norms. The rationale for putting in place such restrictions was to limit offering of such products to only those corporates who understood the nature of the risks inherent while entering into such transactions.

23. Another issue of concern to us is the extent of unhedged forex exposures in the corporate balance sheets. Though hedging is not mandatory for a corporate, however, keeping in view the potential adverse impact of large unhedged exposures on financing banks' balance sheets and the financial system, especially in times of excessive volatility, banks have been advised to evaluate the risks arising out of unhedged foreign currency exposure of the corporates and price them in the credit risk premium while extending fund based and non-fund based credit facilities to them. Banks have also been advised to consider stipulating a limit on unhedged position of corporates on the basis of policy approved by the Board of the banks. The above measures need to be strengthened by requiring the corporates to put in place a risk management policy for their unhedged forex exposures. We have observed that despite our repeated efforts to sensitise both banks and corporates on the matter, adequate measures have not been put in place. It was therefore decided to increase the risk weights and provisioning requirements on banks' exposures to corporates on account of the corporates' unhedged forex exposure positions.

24. Another related issue that banks and corporates have discussed with us is the non-availability of long-term hedging products to the corporates. While OTC forward market is liquid enough up to one year, the exchange traded market, which I would come back to, is liquid only in the near month segment. If the interest rate parity holds good, forward rate should reflect the interest rate differentials. Otherwise, it becomes more a function of demand and supply. While there has been no regulatory restriction on booking of long-term forwards beyond one year, market participants generally prefer booking short-term contracts (maximum tenor up to one year) and then roll it over till the maturity of the exposure. This strategy partially addresses their long term risk, substituting the exchange rate risk with the less volatile forward premium. Inter-bank market also uses MIFOR curve which is the implied rupee curve for pricing long-term forwards. A long-term forward contract requires taking a view of long-term interest rates in both domestic

currency as well as foreign currency. While in case of US Dollar, the inter-bank term rates are available through active swap market, the term money or the term swap market for tenor beyond one year is not liquid enough in India, thus, making it difficult for the market to price the forwards beyond one year. The interest rate swap market, which is quite active up to five year, is predominantly an overnight indexed swap market with floating leg linked to the overnight uncollateralised inter-bank call rates rather than inter-bank term rates. How can this problem be addressed? An important prerequisite would perhaps be a well-developed term money market and an interest rate swap market based thereon. Further opening of the capital account that would facilitate capital flows based on interest rate view may also help.

25. Let me now briefly touch upon the currency futures market in India. Exchange traded products provide the benefits of transparent pricing and robust risk management by way of CCP mechanism and margining requirement. Currency futures on exchanges were introduced in India in 2008 with a view to increasing the depth and breadth of the currency derivatives market, in turn helping to provide an effective risk management framework to users. Subsequently, European style USD-INR options were introduced in 2010. The biggest challenge in designing a framework for exchange traded currency derivatives in India was the prevailing regulatory system for the OTC products. While for entering into an OTC derivative, the presence of an underlying exposure is a regulatory requirement, it was considered not feasible to insist on this requirement for the exchange traded derivative products. Currency futures market in India has shown significant growth since their introduction. The reason for such growth could be due to non-requirement of underlying exposure, no restriction on cancellation and re-booking of contracts and cash settlement. Has the exchange traded market indeed helped the real sector in providing an alternative for hedging the currency risk or is it being driven by speculative interests? Though the exchange traded market volumes have picked up, the OTC market occupies a larger market share. Our understanding is that hedgers generally prefer OTC derivatives for these can be customised to individual needs and also does not involve cash flows related to daily MTM margining. The fact that final delivery has to go (or be made) through banking channel also adds to the attractiveness of the OTC derivatives. Currently, the liquidity in exchange traded market is confined to very short-term. If such products are to be positioned as a credible hedging product then the liquidity has to extend beyond short-term. That brings another related issue as to how best can both OTC as well as exchange traded markets co-exist with scope for product alignment for greater efficiency. Is there a way, wherein exchanges can arrange for the ultimate delivery at the time of settlement if the contract is a physically settled one and similarly, can banks offer OTC derivatives upto a suitable cut off amount without insisting on any underlying for hedging any economic or likely exposure at a future date?

26. Banks were initially allowed to participate in both the markets subject to certain position limits on the exchanges and within the overall position limits fixed for individual banks. As you would recall, the Reserve Bank of India had imposed a host of restrictions on both banks as well as corporates in December 2011 and subsequently in 2012 that were considered necessary for curbing their speculative behaviour. As the situation improved, many of these restrictions have been either relaxed partially or removed. However, the restriction that positions undertaken by the banks in the exchanges cannot be netted/offset by undertaking positions in the OTC market and vice-versa, and the positions initiated in the exchanges has to be liquidated/closed in the exchanges only, remains. Reserve Bank of India has been constantly monitoring the developments in both the OTC and Exchange traded markets closely and we continue to believe that there has to be a level-playing field between both these markets.

27. As far as reporting of derivative transactions is concerned, a system has already been put in place wherein the banks are required to report the aggregate details of transactions in forward contracts, currency swaps and currency options to the Reserve Bank of India periodically. Though CCIL has put in place guaranteed settlement mechanism for FCY-INR forward transactions since December 2009, not too many banks are using this facility currently, apparently due to lack of clarity on the rules relating to the credit valuation adjustment (CVA) risk capital charge for over-the-counter derivatives. Taking into account the concerns of the banks, the Reserve Bank of India has deferred the introduction of mandatory forex forward guaranteed settlement through central counter-party and has also postponed the implementation of Basel-III regulations for the currency derivatives segment to January 2014, pending resolution of norms regarding trade settlement.

28. In 2012, trade repository became operational in India when the Reserve Bank of India advised that all/selective trades in OTC foreign exchange and interest rate derivatives between the banks/market makers (banks/primary dealers) and their clients should be reported on the CCIL platform subject to a mutually agreed upon confidentiality protocol. The reporting arrangement covering OTC foreign exchange derivative trades between AD banks and their clients has been operationalised with effect from April 2, 2013 in respect of FCY-INR forwards, FCY-FCY forwards, FCY-INR options and FCY-FCY options.

29. Now let me conclude. I had picked up three broad issues to share my thoughts. I hope these issues would be debated further during the course of the day and issues for resolution flagged. I had started my talk hoping that the aftermath of this Conference would be better than last time when the RBI had to impose many restrictions to curb volatility. In the recently released Report of the Technical Committee on Services/Facilities for the Exporters, the entire gamut of existing facilities to the exporters were reviewed and several recommendations made for the improvement of services/facilities to the sector. In this regard, policy measures were also suggested for risk mitigation for the exporters including use of hedging instruments. In the backdrop of the Committee's Report, I would like to make the following announcements.

30. We have decided in principle to relax a few things that we hope will cheer the market. The facility of rebooking of cancelled contracts is being increased from the present limit of 25 percent to 50 percent and made symmetrical for both exporters and importers. The Committee had noted that hedging process in the OTC market involves tedious documentation. The Committee was of the view that the quarterly duration for declaration of forward contracts booked by the exporter and certified by Statutory Auditor may be replaced with a quarterly self certified declaration by the exporter and an annual Statutory Auditor certified declaration. This recommendation has also been accepted for implementation. Further, the documentation for booking of forward contracts upto USD 200,000 is also being simplified. Let me hasten to add that these facilitations have nothing whatsoever to do with RBI's perception about the exchange rate as some of practitioners had reportedly believed/stated when we relaxed the restriction on net open position limits of banks. Reserve Bank will continue to manage the exchange rates as hitherto, targeting on curbing excessive volatility rather than any specific levels.

31. Thank you for your attention and wish you all the best as you return to the jobs you best know after this Seminar.