V DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

The Reserve Bank continued with its efforts to further develop financial markets and strengthen their regulation. Initiatives in this respect included introduction of inflation indexed bonds and cash-settled interest rate futures. It also endeavoured to improve liquidity in the G-sec market. A slew of measures were taken to encourage capital inflows amid a widening of the CAD and foreign exchange market pressures. Risks to the financial system from global and internal spillovers were carefully monitored and appropriate measures were taken to mitigate them. Going forward, reforms of financial benchmarks are planned.

V.1 In the face of increased capital flows following uncertainties from the possible timeline for commencement of the US QE tapering risk since end-May 2013, several measures undertaken by the government and the Reserve Bank successfully restored stability to the currency markets. Efforts were also made by the Reserve Bank for developing other financial markets so as to enhance monetary policy transmission, furthering product innovations in the markets and creating an investor friendly climate to attract stable capital flows.

V.2 In order to ensure the robustness and credibility of the financial system and to minimise the risks therein, a continuous monitoring and review framework needs to be in place. Financial benchmarks provide a quick and convenient way to monitor the system and have a significant bearing on the stability of the financial system in view of the huge volume of financial contracts referenced to or valued through such benchmarks. To ensure their credibility, the Reserve Bank constituted a Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar) to analyse the financial benchmarks in the Indian context (Box V.1).

Box V.1
Reforms in Financial Benchmarks

Financial benchmarks are mainly used for pricing, settlement and valuation of financial contracts. Recent global developments with regard to manipulation of several key global benchmarks, *viz.* London Inter-bank Offered Rate (LIBOR), Euro Inter-bank Offered Rate (EURIBOR), Tokyo Inter-bank Offered Rate (TIBOR) and the London 4 PM FX fixing, *etc.*, have raised serious concerns about the reliability of the financial benchmarks. Several international standard setting bodies, national regulators, central banks and self-regulatory bodies have announced comprehensive measures and governing principles for reforming financial benchmarks. Notables among them are the Wheatley review of LIBOR (September 2012), the European Securities Market Authority-European Banking Authority's Principles for Benchmark Setting Processes in the European Union (June 2013) and International Organisation of Securities Commission (IOSCO)'s report on Principles for Financial Benchmarks (July 2013).

Building on the cross-country experience, the Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar) constituted by the Reserve Bank undertook an in-depth analysis of the existing benchmark setting methodology and governance framework of major Indian rupee interest rate and foreign exchange benchmarks. It identified the major benchmarks based on their extent of usage and relevance and found the existing system to be generally satisfactory. It recommended several measures for strengthening the benchmark quality and setting methodology and governance framework for benchmark administrators, calculation agents and submitters.

Major recommendations relating to benchmark quality and setting methodology include:

i) Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Foreign Exchange

(Contd...)

Dealers' Association of India (FEDAI) to administer the Rupee interest rate and foreign exchange benchmarks respectively, with primary responsibility for the entire setting process.

ii) Benchmark calculations may be based on observable transactions, wherever available, as the first layer of inputs subject to an appropriate threshold. Executable bids and offers, subject to appropriate threshold and polled submissions, may be used as the second and third layer of inputs respectively in terms of hierarchy of inputs.

iii) Overnight Mumbai Inter-bank Bid Rate (MIBID) – Mumbai Inter-bank Offered Rate (MIBOR) setting may be shifted from the existing polling-based method to volume weighted average (VWA) of trades executed between 9-10 am on the Negotiated Dealing System-Call (NDS-CALL).

iv) FIMMDA to coordinate the transition of legacy contracts referenced to the National Stock Exchange (NSE) MIBID-MIBOR through multilateral and bilateral amendment agreements, as appropriate.

v) Construction of the government security (G-sec) yield curve to be based on the VWA of trades executed over a longer time window in place of the last traded yields.

vi) In the absence of the required trading volume in state development loans (SDLs), the spread discovered in the last two SDL auctions, subject to appropriate qualifying criteria, may be used in place of the existing fixed 25 bps spread.

vii) The RBI reference rate may be based on VWA of actual transactions executed during a sufficiently longer time window in place of the existing polling method.

viii) The unused benchmarks may be phased out by the respective administrators.

Major recommendations relating to the governance framework include:

i) Administrators may formulate a comprehensive code of conduct for submitters specifying the hierarchy of data inputs for submission, pre-submission validation and post-submission review of inputs, *etc.*, and may oversee compliance by submitters.

ii) To overcome possible conflicts of interest with the benchmark setting process arising out of the current governance structure, FIMMDA and FEDAI may create an independent structure, either jointly or separately, for administration of the benchmarks.

iii) Calculation agents may appoint personnel with appropriate level of seniority and clear accountability to be responsible for calculating the benchmark; establish robust pre- and post-calculation controls; institute appropriate confidentiality protocols with respect to information received by or produced by them; subject calculation function to periodic internal and external audit and submit periodic confirmation to the administrator.

iv) Benchmark submitters may have an internal board approved policy for governance of the submission process; establish an effective conflicts of interest policy and whistle blowing policy; appoint clearly accountable personnel responsible for submissions; institute a maker-checker system to ensure integrity of submissions; subject the submission process to periodic internal audits and external audits where appropriate and submit periodic confirmation to the administrator.

The committee recommended suitable amendments to the RBI Act to empower the Reserve Bank to determine policy with regard to benchmarks used in money, G-sec, credit and foreign exchange markets in India and to issue binding directions to all agencies involved in benchmark setting.

The Reserve Bank has since advised FIMMDA and FEDAI to take necessary steps to implement the recommendations of the committee. Guidelines specifying the measures to be implemented by banks and primary dealers (PDs) acting as benchmark submitters for strengthening their governance frameworks have been issued. Benchmark submission activities of banks and PDs including their governance framework for submission are being brought under the Reserve Bank's on-site and off-site supervision.

GOVERNMENT SECURITIES MARKET

V.3 The Reserve Bank has taken various measures to develop government securities (G-secs) and interest rate derivatives (IRDs) markets through initiatives like introducing inflation indexed bonds, cash settled 10-year interest rate futures (IRF) and trading of separately traded registered interest and principal of securities (STRIPS) on NDS-Order Matching (NDS-OM); consolidating securities through buyback and switches; gradual upward revision of the investment limit for foreign institutional investors (FIIs) in

G-secs; reducing the held to maturity portfolio to 24 per cent of net demand and time liabilities; and in principal approval to the Clearing Corporation of India Limited (CCIL) for introducing an electronic swap execution facility with central counterparty for interest rate swap trades.

V.4 The limit for investment in G-secs available to FIIs/qualified foreign investors (QFIs)/foreign portfolio investors (FPIs) has been enhanced by US$ 5 billion by correspondingly reducing the amount available to long term investors from US$ 10 billion to US$ 5 billion within the overall limit of US$ 30 billion. The incremental investment limit should be invested in G-secs with a minimum residual maturity of 3 years.

FOREIGN EXCHANGE MARKET

V.5 In order to address the issues of widening current account deficit (CAD) and curbing the volatility in the domestic forex market emanating from sudden outflows, the Reserve Bank and the Government of India initiated a number of measures during the year which broadly aimed at reducing the import of gold; encouraging portfolio investments, particularly in the debt segment; rationalising external commercial borrowings (ECBs); moderating outflows through overseas direct investments (ODIs) by residents; and curbing the speculative intent of market players. With return of stability in the Rupee-Dollar exchange rate, restrictions with respect to remittances under ODIs and by individuals were largely withdrawn.

Current account

Curbs on gold import to dampen CAD

V.6 To stem the pressure on CAD from the growing gold import bill, a slew of measures were taken to moderate the demand for gold for domestic use. These *inter alia* included: (i) increase in customs duty on gold imports, (ii) prohibition of import of gold in the form of coins and medallions, and (iii) direction to all nominated banks and other entities to ensure that at least 20 per cent of every lot of gold import was exclusively made available for exports. With these measures, gold imports were brought significantly under control during 2013-14.

Centralised export data processing and monitoring system initiated

V.7 A comprehensive export data processing and monitoring system was put in place from March 1, 2014 for effective monitoring, easier tracking and reconciliation of export transactions. To capture all export transactions, this centralised automated export transaction system was developed with a single master database for all exports. Shipping data with customs' authorities will form the base for all subsequent export follow-up processes. These data will be shared with the stakeholders involved to monitor both receipt of export documents and repatriation of export proceeds using banking channels.

Other rationalisation measures

V.8 A comprehensive set of new regulations issued to boost merchant trade included: (i) rationalisation of time limit for completion of a transaction cycle within 9 months, without any outlay of foreign exchange beyond 4 months, (ii) short-term credit (suppliers or buyers) for merchant trade transactions be made available to the extent not backed by advance remittances for the export leg, including the discounting of the export-leg letter of credit. Third party payment was enabled for export/import of goods/software transactions subject to a firm irrevocable purchase order/ tripartite agreement else requiring documentary evidence indicating the circumstances leading to third party payments.

Outward remittances

V.9 With effect from May 19, 2014 a limited liability partnership (LLP), registered under the Limited Liability Partnership Act, 2008 (6 of 2009), was notified as an 'Indian party' for undertaking ODI.

V.10 The limit on financial commitments by an Indian party for making ODIs was reduced from 400 per cent of their net worth (as on the date of the last audited balance sheet) to 100 per cent under the automatic route with effect from August 2013 which was subsequently restored in July 2014 with stability returning to the foreign exchange market, with an additional condition that any financial commitment exceeding US$ 1 billion in a financial year would require prior approval of the Reserve Bank.

V.11 In August 2014, the prescribed limit for remittances under the liberalised remittance scheme (LRS) for any permitted capital and current account transaction or a combination of both were reduced from US$ 200,000 to US$ 75,000 per financial year. The LRS window, however, was expanded by permitting resident individuals to make ODIs to set up/acquire joint ventures (JVs)/wholly owned subsidiaries (WOS) abroad within the limit prescribed under LRS. With stability returning to the foreign exchange market, the eligible limit was enhanced to US$ 125,000 in June 2014 without end-use restrictions except for prohibited transactions such as margin trading.

V.12 With a view to facilitating travel requirements of residents travelling abroad and non-residents visiting India, the value of Indian currency for all travelers, except citizens of Pakistan and Bangladesh was fixed at ₹25,000.

Inward remittances

Foreign direct investment (FDI)

V.13 As part of the liberalisation measures, in September 2013 the Reserve Bank allowed non-residents (other than portfolio investors) to acquire shares on the stock exchange under the FDI scheme in a listed Indian company complying with the Securities Exchange Board of India's (SEBI) substantial acquisition of shares and takeover regulations.

V.14 Unlisted companies in India were allowed to raise capital abroad without the requirement of prior or subsequent listing in India. The scheme is initially for a period of 2 years, subject to conditionality and review thereafter. The optionality clause was permitted in equity shares and compulsorily and mandatorily convertible preference shares/ debentures to be issued to a person resident outside India under the FDI scheme without any assured return subject to certain conditions.

V.15 To enhance the effectiveness of the FDI policy and provide clarity on ownership and control, guidelines were issued on downstream investments in Indian companies including those by an Indian company that is not owned and/or controlled by resident entities. To make foreign investments in government and corporate debt more investor friendly, existing limits were rationalised to remove maturity restrictions and lock in period stipulations.

V.16 A new investor class, FPIs subsuming the existing regulatory framework for FIIs and QFIs with streamlined know your customer (KYC) procedures was introduced. In April 2013 investment limits in treasury bills (T-bills) was capped at US$ 5.5 billion. In June 2013 the limit for long term investors was increased by US$ 5 billion to US$ 30 billion so that the investment limits curtailed at the shorter end are available for longer maturities. The limit for long term investors was further increased in January 2014 to US$ 10 billion within the overall limit of US$ 30 billion. In July 2014, the sub-limit of US$ 10 billion has been modified as mentioned in paragraph V.4 above.

V.17 In order to further encourage longer term flows, in April 2014 all eligible foreign investors, including FPIs were permitted to make investments in dated G-secs having residual maturity of one year and above. Existing investments in T-bills and dated G-secs with less than one year residual maturity were allowed to be tapered off on maturity/ sale.

V.18 General permission was granted to Indian companies to issue non-convertible/redeemable preference shares or debentures to non-resident shareholders including the depositories that act as trustees for the American depositary receipt (ADR)/ global depositary receipt (GDR) holders, by way of distribution as bonus from its general reserves. This scheme of arrangement must be approved by an Indian court under the provisions of the Companies Act, subject to no objections from the income tax authorities. On subsequent listing of such instruments, registered FPIs were allowed to invest on a repatriation basis in such instruments, within the overall limit of US$ 51 billion earmarked for corporate debt.

V.19 To widen the avenues for FDI investments, LLPs were allowed FDI under the government approval route in sectors where 100 per cent FDI is allowed without any FDI linked performance related criteria.

Swap facility to enhance banks' overseas borrowing

V.20 With a view to augmenting capital inflows and providing additional avenues of overseas funds, overseas borrowing limits for authorised dealer (AD) category-I banks was raised to 100 per cent of their unimpaired Tier I capital as at the close of the previous quarter or US$ 10 million, whichever is higher, against the prevailing limit of 50 per cent. AD banks were also allowed to borrow from international/multilateral financial institutions for a limited period between September 11, 2013 and November 30, 2013 with the option of entering into a swap transaction with the Reserve Bank. The swaps were available at a concessional rate of a 100 basis points below the market rate for all fresh borrowings with a minimum tenor of one year and a maximum tenor of 3 years.

Liberalisation in inward remittance schemes

V.21 The scope of the Rupee drawing arrangement (RDA), one of the official channels for receiving inward remittances, has been further expanded. Additional activities permitted include (a) direct payment of bills to the utility service providers and tax authorities in India and (b) equated monthly installment (EMI) payments in India to banks and non-banking financial companies (NBFCs) for repayment of loans. Further, the limit on trade transactions permitted under the scheme was also increased from ₹200,000 to ₹500,000 per transaction.

V.22 To facilitate receipt of remittances directly into the bank account of the beneficiary even if held with a bank other than the recipient bank, remittances through the Money Transfer Service Scheme (MTSS) or RDA were allowed to be transferred to the beneficiary bank account through electronic mode such as the National Electronic Fund Transfer (NEFT) and the Immediate Payment Service (IMPS) provided the account is compliant with KYC guidelines. This facility will aid in expanding the network and also reduce cash transactions to some extent.

External commercial borrowings (ECBs)

V.23 With a view to strengthening foreign capital inflows in the infrastructure sectors: (a) the definition of the infrastructure sector was expanded for the purpose of availing ECBs; (b) NBFCs - asset finance companies were permitted to avail of ECBs under the automatic/approval routes to finance the import of infrastructure equipment for leasing to infrastructure sectors; and (c) the ECB limit for NBFCs – infrastructure finance companies was raised from 50 per cent to 75 per cent of their owned funds, including the outstanding ECBs under the automatic route, and beyond 75 per cent of their owned funds under the approval route and their hedging requirement for currency risk was reduced from 100 per cent to 75 per cent of exposure.

V.24 The benefits under the US$ 10 billion scheme, which allows borrowers who are consistent forex earners to raise ECB to refinance Rupee loans taken from domestic banks, was extended to companies which have established JVs/WOS/have acquired assets overseas.

V.25 Permission for credit enhancement by eligible non-resident entities (multilateral/regional financial institutions, government owned development financial institutions and direct/ indirect foreign equity holder(s)), that was earlier available exclusively for the infrastructure sector was extended to all borrowers eligible to raise ECB under the automatic route.

V.26 Eligible domestic subsidiaries of foreign companies were permitted to avail ECB with minimum average maturity of 7 years for general corporate purposes from their foreign equity holder companies subject to certain conditions.

Pilot float of Rupee bonds

V.27 As a pilot measure, the International Finance Corporation was permitted to float Rupee denominated bonds in overseas markets for an amount of ₹620 billion. These bonds were linked to the Indian rupee, but had to be subscribed to and settled in a foreign currency. This was the first approval granted by Reserve Bank for such bond issuance. All issuances received strong interests from global investors.

DERIVATIVES MARKET

Introduction of cash settled IRFs on 10-year G-secs

V.28 The working group on enhancing liquidity in the G-sec and IRD markets examined IRF markets in detail and recommended introducing cash settled 10-year IRFs subject to appropriate regulations like restricted participation, entity-based open position limit and price band. Directions on cash settled IRFs on 10-year G-sec were issued on December 5, 2013. In consultation with market participants and SEBI, two variants: (a) coupon bearing G-secs as underlying, that is, single bond IRF on 10-year G-secs, and (b) coupon bearing notional 10-year G-secs with the settlement price based on a basket of securities as underlying have been permitted for cash settled futures on 10-year G-secs. Exchanges have been permitted to launch contracts on any or both of the variants. All three authorised exchanges (NSE, the Bombay Stock Exchange and the Multi Commodity Exchange) introduced cash settled IRF on 10-year G-secs in January 2014.

V.29 The market is still in the nascent stage as many of the market participants are yet to put in place appropriate systems and procedures. It is, however, expected that as the market develops all regulated entities will start taking active positions in the IRF market for the better management of interest rate risks.

Restrictions on currency derivative trading to curb volatility

V.30 In the face of exchange market pressures, trading volumes in the domestic exchange traded currency derivatives rose reflecting the volatile conditions since the end of May 2013. To restore some order in the market, SEBI, in consultation with the Reserve Bank of India, imposed restrictions in the currency derivatives market *viz*., increase in the initial and extreme loss margins and reduction in the open position limits of clients and non-bank trading members. AD category-I banks were not allowed to carry out any proprietary trading in currency futures/exchange traded currency options markets, except on behalf of their clients.

Measures to provide flexibility to market participants to hedge exchange risk

V.31 As market conditions stabilised in the foreign exchange markets beginning Q3 of 2013-14, in order to provide operational flexibility with respect to current and capital account transactions, exporters (importers) were allowed to cancel and rebook forward contracts to the extent of 50 per cent (25 per cent) of the contracts booked in a financial year for hedging their contracted export (import) exposures. Subsequently, all forward contracts with respect to all current account transactions as well as capital account transactions with a residual maturity of one year or less were allowed to be freely cancelled and rebooked. Forward contracts booked by FIIs/QFIs/other portfolio investors are allowed to be rolled over on or before maturity, and once cancelled are allowed to be rebooked up to the extent of 10 per cent of the value of the contracts cancelled.

V.32 The requirement that all forward contracts booked under this facility (by both exporters and importers) be on a fully deliverable basis has also been relaxed. Contracts booked up to 75 per cent of the respective eligibility limits are allowed to be cancelled with the exporter/importer entitled to the loss or gain as the case may be. However, contracts booked in excess of 75 per cent of the eligible limit will be on a deliverable basis and cannot be cancelled, implying that in the event of cancellation, the exporter/importer shall have to bear the loss but will not be entitled to receive the gain.

Liberalisation in the foreign exchange derivatives market

V.33 FPIs are now permitted to access the exchange traded currency derivative (ETCD) market up to a threshold level and conditional access beyond it. Residents' access to ETCD has also been rationalised. Policy measures have been initiated to bring about some convergence in the over-the-counter (OTC) and the exchange traded markets. AD category-I banks are also permitted to take proprietary position in the ETCD market. Due to volatile market conditions, the banks were earlier temporarily prohibited from doing so. Banks can now also off-set their OTC positions in the futures market and vice-versa.

V.34 Restrictions imposed in December 2011 on foreign exchange markets have also been lifted almost entirely. The facility of rebooking of cancelled contracts has been restored. While compulsory delivery under the past performance route has also been done away with, the limits for exporters have been restored completely and the same for the importers have been kept at 50 per cent of the limit assessed.

V.35 Following the recommendations of the Technical Committee on Services/Facilities for Exporters (Chairman: Shri G. Padmanabhan) regarding rationalisation of the documentation process, AD category-I banks were allowed to obtain an annual certificate from statutory auditors while offering hedging products under the contracted exposure route to their customers. This measure is expected to ease the burden of documentation in the process of hedging exchange risks.