V REGULATION OF FINANCIAL MARKETS AND FOREIGN EXCHANGE MANAGEMENT

During 2014-15, the Reserve Bank undertook several measures to improve the financial markets. The efforts were targeted at increasing participation, simplifying procedures and making the markets deeper, efficient, accessible and stable. Developing the money market with appropriate instruments and adequate participation assumed central importance. Further, refining and rationalising foreign exchange regulations should contribute to the widening and deepening of the foreign exchange market. In the derivatives markets, the measures taken during 2014-15 were aimed at simplifying the documentation requirements and increasing participation in both over-the-counter and exchange traded currency derivatives.

V.1 Broadening and deepening financial markets and putting in place an appropriate architecture for regulating them have been an on-going engagement of the Reserve Bank. During 2014-15, guided by the five-pillar approach set out in the Second Quarter Review of Monetary Policy of 2013-14 to drive its developmental and regulatory policies, the Reserve Bank undertook several measures to improve liquidity, activity and resilience of various segments of the financial market spectrum, especially in the context of a volatile and uncertain international environment, so that these markets perform efficiently their intermediation role in financing India's growth. The efforts were targeted at increasing participation, simplifying procedures and making the markets deeper, efficient, accessible and stable.

V.2 In the money market, the endeavour was to further develop term/repo markets. In the government securities (G-secs) market, the objective, as in the past, was to promote liquidity and broad based participation, including by foreign investors and resident individuals. In the foreign exchange market, emphasis was placed on the liberalisation of transactions, both current and capital and inward and outward. In the derivatives segment, the objective was to develop participation through simplification of procedures. Three departments of the Reserve Bank are primarily entrusted with the roles of developing and regulating of financial markets, financial market operations and foreign exchange management.

FINANCIAL MARKETS REGULATION DEPARTMENT (FMRD)

V.3 FMRD was set up on November 3, 2014 with a mandate to regulate, develop and oversee financial markets in an integrated manner. The primary activities of the department include regulation and development of the money, G-secs, foreign exchange and related derivatives markets. The department is also responsible for the implementation of the recommendations of the Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar), strengthening of the financial market infrastructure and market surveillance. A Market Intelligence Cell is proposed to be set up as part of FMRD. Going forward, the department will focus on (i) making market access norms easier for all participants; (ii) expanding the menu of products and participants across all segments; (iii) strengthening market infrastructure in line with global standards; and (iv) leveraging the market analytics and surveillance mechanism for policy inputs.

Agenda 2014-15: Implementation Status

V.4 During 2014-15, FMRD undertook measures targeted at increasing participation, simplifying procedures and making the markets more efficient. The Technical Advisory Committee (TAC) on Money, Forex and G-secs Markets (Chairman: Harun R. Khan) was reconstituted in April 2015 with representation from various stakeholders to advise the Reserve Bank in this endeavour.

V.5 With the objective of implementing the recommendations of Committee on Financial Benchmarks, a new company, Financial Benchmarks India Pvt Ltd (FBIL), jointly promoted by the Fixed Income Money Market and Derivatives Association of India (FIMMDA), the Foreign Exchange Dealers' Association of India (FEDAI) and the Indian Banks' Association (IBA), has commenced operations in February 2015. As a first step, FBIL overnight Mumbai interbank offer rate (FBIL-Overnight MIBOR) was launched on July 22, 2015.

V.6 An appropriate public dissemination system was to be instituted at the Clearing Corporation of India Ltd. (CCIL) for disclosing the price and volume information on major interbank over-the-counter (OTC) foreign exchange derivatives. CCIL has, accordingly, started disseminating data on USD-INR forwards and USD-INR currency options with effect from April 13, 2015. The data disseminated are on an aggregated basis and contain tenor-wise traded rate/implied volatility in terms of open, high, low, last, weighted average rate (WAR), volumes and number of trades (Box V.1).

V.7 As planned, limits for short sale have been increased and undertaking short sales in the OTC market has been permitted. Re-repo of G-secs

Box V.1
G20 Commitments and Reforms in the OTC Derivatives Market in India

In response to the global financial crisis of 2007, the G20 initiated reforms to strengthen the regulation and oversight of the financial system, and tasked the Financial Stability Board (FSB) with coordination of the reforms. The reforms include improving transparency and enhancing the resilience of OTC derivatives markets. An implementation group for OTC derivatives (Chairman: Shri R. Gandhi), constituted on the direction of the sub-committee of the Financial Stability and Development Council (FSDC) has set out a roadmap for reforms.

Standardisation

- Following the standardisation of inter-bank trades in credit default swaps (CDS) and the rupee overnight index swap (OIS) based on overnight MIBOR, interest rate swaps (IRS) referenced to other benchmarks will be standardised in phases.
- Standardisation of foreign exchange derivatives will be addressed at the end of 2015 since they are generally 'plain vanilla' and market liquidity is low in currency swaps, IRS in foreign currency (FCY) and interest rate options.

Exchange or electronic platform trading

- As the market develops for forex options, currency swaps (CS), FCY-IRS and interest rate options in FCY and CDS, the possibility of introducing a trading platform will be examined.

Reporting to trade repositories (TRs)

- As in the case of all OTC forex and interest rate derivatives, client transactions in rupee IRS/ forward rate agreement (FRA) and CDS, FCY interest rate options will be brought under the reporting framework but as and when its liquidity picks up.
- Thus, India has become fully compliant with the G20 commitment on reporting of OTC derivatives transactions to TRs.

Central clearing

- More than 80 per cent of IRS trades are being centrally cleared on a non-guaranteed basis without a regulatory mandate. In principle approval has been given to CCIL to provide central counterparty (CCP) based clearing for IRS trades which will be made operational shortly.
- In the case of forex derivatives, CCP's clearing of forex forwards has been mandated. CCP clearing for forex options, CS, IRS and interest rate options in FCY and CDS in which liquidity remains low will be reviewed by end-2015.

Margin requirements

- Detailed modalities for OTC derivatives, including CDS will be prescribed taking into account the recommendation of the Basel Working Group on margin requirements and other international developments.

Capital requirements for non-centrally cleared OTC derivatives

- Rules on capital requirements for banks' exposures to CCPs have been made effective from January 1, 2014, reducing the capital requirements for centrally cleared products. In addition, credit valuation adjustment (CVA) capital charge for non-centrally cleared derivatives has also been made effective.

acquired under reverse repo has also been permitted. Facilitating participation of foreign portfolio investors (FPIs) in G-secs was one of the key mandates for the year. In this direction, FPIs were permitted to acquire G-secs directly from any counterparty in the secondary market, obviating the requirement of a broker. Settlement of all FPI transactions in G-secs has been permitted on T+2 basis. FPIs were allowed to reinvest coupons, received on their investments in G-secs, outside the existing limit and also permitted to hedge the currency risk of the coupon receipts on debt securities falling due during the following 12 months.

V.8 With the objective of introducing new products and expanding markets, 6-year and 13-year cash settled interest rate futures (IRFs) on Government of India (GoI) securities with residual maturity of 4-8 years and 11-15 years, respectively, were permitted on exchanges. A Working Group (Chairman: Prof. P.G. Apte) has been constituted for introduction of interest rate options.

V.9 To make documentation in forex markets less onerous, the certification required from the hedging entity's statutory auditors has been replaced with an undertaking from the designated officials of the entity, both in the OTC and the exchange traded currency derivatives (ETCD) markets. The eligibility limits for hedging for importers, based on past performance, have been brought at par with exporters, both in the OTC and ETCD markets. The permissible position limits on the exchanges, without the requirement of establishing underlying exposure, have been enhanced to US$ 15 million for USD-INR and US$ 5 million for all other permitted currency pairs put together.

V.10 Towards achieving the objective of providing overseas entities greater access to onshore hedging markets, external commercial borrowings (ECBs) lenders in rupees have been permitted to enter into swap transactions with their overseas bank which shall, in turn, enter into a back-to-back swap transaction with any authorised dealers (AD) category-I bank in India. In order to improve transparency and broad base participation in interest rate swaps (IRS), an anonymous electronic trading platform for IRS contracts referenced to overnight MIBOR benchmark was launched on August 3, 2015 with the CCIL's guaranteed settlement.

V.11 In respect of a few areas identified for implementation, while action has been initiated, full implementation is yet to be achieved. With regard to upgradation of the negotiated dealing system order-matching (NDS-OM) platform, necessary approvals were given to CCIL. While the architecture, messaging structure and technology infrastructure have been finalised for the purpose, software development is at an advanced stage.

V.12 Examining the feasibility of international settlements for Indian sovereign debt securities was another planned activity. There has been continuous engagement with the GoI and the major international central security depositories (ICSD), Euroclear and Clearstream, in this regard. A feasible mechanism addressing all concerns is likely to become operational during 2015-16.

Agenda for 2015-16

V.13 The regime for fixing limits for FPI investment in debt securities has undergone changes over the years. The Reserve Bank, in consultation with the GoI, intends to put in place a structured process for fixing these limits along with a framework for periodic reviews. Encouraging retail participation in G-secs continues to engage the Reserve Bank's attention. To enable seamless movement of securities from the subsidiary general ledger (SGL) form to the demat form and *vice versa,* it was announced to provide demat account holders a functionality to put through trades on NDS-OM. An implementation group with representatives from all stakeholders has been set up to roll out the measures by December 2015.

V.14 A deep and liquid corporate bond market has been a shared policy goal of the GoI and financial regulators. Introduction of an electronic platform for facilitating repo in corporate bonds will be considered for implementation. In order to impart liquidity to the options segment in the OTC forex market and attract greater all-round participation, final guidelines allowing exporters and importers to write covered options against their contracted exposures are expected to be issued shortly. Based on the recommendations of the Working Group on interest rate options, the final guidelines will be issued. A framework for assessment of benchmark submission practices by market participants will also be put in place in 2015-16.

FINANCIAL MARKETS OPERATIONS DEPARTMENT (FMOD)

V.15 As part of organisational restructuring, FMOD was created from the erstwhile Financial Markets Department (FMD) on November 3, 2014 by hiving off the surveillance function. With this, FMOD has primarily become an operational department responsible for conducting financial market operations efficiently. The role of FMOD is to facilitate vibrant, efficient and stable financial markets to support a rapidly growing real economy.

Agenda 2014-15: Implementation Status

V.16 FMOD is primarily entrusted with the task of conducting market operations in consonance with the policies of the Reserve Bank. Thus, as in the previous years, maintaining orderly conditions in the forex market through its operations in both spot and forward segments was high on the agenda for 2014-15. Efforts were also directed at maintaining appropriate levels of liquidity in the financial system through liquidity management operations, which include the liquidity adjustment facility (LAF) (fixed/variable rate repo/reverse repo of various tenors) and overnight marginal standing facility (MSF), other standing facilities and open market operations (OMOs) with a view to ensuring better alignment between money market rates and the policy rate for more efficient transmission of monetary policy signals. Regular analyses and research on developments in financial markets and market operations were also carried out.

V.17 During 2014-15, exchange rate of the rupee exhibited stability, unlike in the previous year when it witnessed intense volatility during July-August 2013 on account of taper tantrums. For better liquidity management, the LAF was revised in September 2014 which entailed more frequent 14-day term repo auctions besides use of variable rate repo/reverse repo auctions of various tenors for fine tuning. These steps helped in reducing volatility in the money market and ensuring closer alignment of the money market rates with the policy rate.

Agenda for 2015-16

V.18 The department aims to continue with its endeavour to carry out liquidity management operations effectively, conduct foreign exchange operations, including interventions, in an effective manner and carry out policy oriented research on financial markets. The department also intends to undertake technological up-gradation to facilitate smoother and more flexible liquidity management operations.

FOREIGN EXCHANGE DEPARTMENT (FED)

V.19 With increasing globalisation, and evolving business practices and models, effective integration of the needs of both residents and non-residents is necessary while meeting the basic objectives of the Foreign Exchange Management Act (FEMA), 1999. Since India is likely to remain a capital deficit country in the near to medium term, the regulatory regime needs to provide a framework which is simple, comprehensive and principle based so as to reduce the regulatory cost and improve the ease of doing business. This has to be implemented within the overarching principle of calibrated progress towards capital account liberalisation within the constraints imposed by macro-prudential stability. Within the Reserve Bank, FED acts as the nodal department for this purpose.

Agenda 2014-15: Implementation Status

V.20 With normalcy returning to the external sector, the Reserve Bank rolled back many of the emergency steps taken in 2013-14 and focussed on ensuring robust and stable capital flows to finance the current account deficit and supplement savings in financing the investment needs of the economy. In 2014-15, efforts were directed at further simplifying the foreign investment regime and making it more user-friendly both for domestic firms and foreign investors. A review of the existing framework of the ECBs was also envisaged.

Easing of FDI and FPI Regimes

V.21 On a review of the policy on eligible instruments for foreign direct investment (FDI) and FPI, partly paid equity shares and warrants issued by an Indian company were allowed to be considered as eligible instruments for the purpose of FDI and FPI schemes. To provide greater freedom and flexibility in the FDI framework, the issue and transfer of shares, including compulsorily convertible preference shares/debentures, with or without optionality clauses (without any assured return), was allowed to be carried out at a price worked out as per the guidelines issued by the Securities and Exchange Board of India (SEBI) in case of listed companies and any internationally accepted pricing methodology in case of unlisted companies on an arm's length basis. Further, Indian companies were permitted to issue equity shares against any funds payable by them, remittances of which did not require prior permission of the government or the Reserve Bank under FEMA, 1999 or any rules/regulations framed or directions issued thereunder.

V.22 AD category-I banks were permitted to allow pledge of equity shares of an Indian company held by non-resident investor/s in accordance with the FDI policy in favour of non-banking financial companies (NBFCs) to secure credit facilities extended to the resident investee company. Following the changes announced by the Government in the FDI policy, regulations were amended to enable foreign investments: (a) up to 49 per cent in the defence sector under the government approval route; and (b) up to 100 per cent in railway infrastructure and manufacturing of medical devices under the automatic route. In addition, FDI in the insurance sector was increased to 49 per cent from the earlier level of 26 per cent.

V.23 A new depository receipts scheme, 2014 was notified by the Reserve Bank on January 22, 2015, under which a person is eligible to issue or transfer eligible securities to a foreign depository for the purpose of converting the securities into depository receipts.

Review of Framework for ECBs

V.24 The scope of ECB was expanded and recognised non-resident lenders were allowed to extend loans in Indian rupees to eligible resident borrowers. The facility, besides providing greater flexibility for structuring of ECB arrangements, shifts the currency risk from borrowers to lenders. For better structuring of the draw-down of ECB proceeds and their subsequent utilisation for permitted end uses, eligible ECB borrowers were allowed to park ECB proceeds in term deposits with AD Category-I banks in India for a maximum period of six months, pending utilisation. The set of eligible securities for raising ECBs was made more broad-based to include movable assets and financial securities in addition to immovable assets.

Simplification of Non-trade Outward Remittances and Travel-related Transactions

V.25 Policies relating to overseas direct investment (ODI) were liberalised with a view to providing flexibility to residents for availing fund based or non-fund based facilities for overseas joint ventures (JVs), wholly owned subsidiaries (WOS) and step down subsidiaries (SDS). This, *inter alia*, included permitting pledging of shares of its overseas SDS and creating a charge on domestic/ foreign assets.

V.26 In view of the resumption of buoyant capital inflows in the recent period and as part of macro-prudential management, the limit under the liberalised remittance scheme (LRS) was enhanced to US$ 2,50,000 per individual per financial year from the existing limit of US$ 1,25,000. Further, to ensure ease of transactions, all the facilities for release of exchange/ remittances for current account transactions available to resident individuals under Schedule III of the Foreign Exchange Management (Current Account Transactions) Rules, 2000, as amended from time to time, were subsumed under this limit.

V.27 To mitigate the hardships faced by people travelling to Nepal and Bhutan, individuals were permitted to carry higher value denomination notes up to a value of ₹25,000. Earlier, individuals travelling to these two countries were allowed to carry Indian currency without any limit in denominations of only up to ₹100.

Export Data Processing and Monitoring System (EDMPS)

V.28 An EDPMS was put in place in March 2014 to bring about efficiency and ease in data reporting as also enabling more effective monitoring of export transactions. EDPMS has a single master database for all export transactions and is shared by all the stake-holders involved (Reserve Bank of India, customs and banks). EDPMS effectively addressed the long standing issue of unmatched export transactions reported by customs but not detected in the banking channel.

International Financial Services Centre (IFSC)

V.29 Regulations were framed in March 2015 to enable functioning of IFSCs under which a financial institution or a branch of a financial institution will be treated as a person resident outside India and its transactions with a person resident in India will be treated as those between a non-resident and a resident and subject to the provisions of FEMA, 1999.

Rupee Denominated Overseas Bonds

V.30 A few international institutions were permitted since 2013 to issue rupee bonds in overseas markets, which elicited a positive response. In the monetary policy statement of April 2015, the Reserve Bank, in consultation with the GoI, decided to permit Indian corporates eligible to raise ECBs to issue rupee denominated bonds overseas. The draft framework on overseas issuance of rupee linked bonds by multilateral financial institutions and eligible borrowers was placed in the public domain and the policy in this regard is likely to be finalised soon.

Agenda for 2015-16

V.31 Considering the progress that the country has made in foreign exchange management and to facilitate the ease of doing business, there is a need for aligning the regulations issued under FEMA, 1999 with evolving business models and practices. Accordingly, the Reserve Bank proposes to (i) complete the task of rationalising and simplifying the notifications issued under FEMA, which commenced last year; (ii) issue master regulations covering all instructions on a subject in a more user friendly format; and (iii) rationalise the returns submitted to it in order to reduce the regulatory load on users of foreign exchange. The task of simplifying the ECB guidelines is an ongoing process and the Reserve Bank will also take into account the recommendations of the Committee to Review the Framework of Access to Domestic and Overseas Capital Markets (Phase II, Part II: Foreign Currency Borrowing, Report III; Chairman: Shri M.S. Sahoo). Encouraged by the stabilisation of EDPMS, the Reserve Bank will initiate work on installing an import data processing and monitoring system (IDPMS) in coordination with the government agencies.