Final Strike Order
19-8-03

IX DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

9.1 Adequate liquidity and orderly financial conditions facilitated the progress of reforms in the money, government securities and foreign exchange markets during 2002-03. In order to promote balanced development of the various segments of the money market, and to preserve its integrity and transparency, prudential limits on exposure of banks and primary dealers to call/notice money market were applied. This was accompanied by the infusion of vibrancy into the repo, commercial paper (CP), certificates of deposit (CD) and derivatives segments by easing entry conditions and providing flexibility in issuance. The deepening of the government securities market was carried forward with stricter regulation and surveillance. In the foreign exchange market, the prime objective has been to manage volatility, while there is no fixed target for the exchange rate which is determined by market forces. Liberalisation in current and capital account transactions was continued apace with a view to augment activity in the foreign exchange market, consistent with the growing openness of the economy, and to prepare market participants for greater sensitivity to volume-driven market movements. Priority was accorded during the year to modernising the technological infrastructure for markets in the form of automated screen-based trading under the Negotiated Dealing System (NDS) and risk minimising mechanism for efficient clearing and settlement under the Clearing Corporation of India Limited (CCIL).

MONEY MARKET

9.2 The basic objective of money market reforms continues to be the development of a proper short-term rupee yield curve with sufficient liquidity in all segments. The Reserve Bank has been following a four-fold strategy. First, with a view to transforming the call/notice money market into a pure inter-bank market, a phased exit of non-banks from the call/notice money market was started in May 2001. As the implementation of Stage I did not cause any strain in the call/notice money market and in view of the encouraging progress in NDS/CCIL, the process of moving towards a pure inter-bank call money market was accelerated with the implementation of the Stage II in June 2003. Secondly, prudential limits were assigned on call exposure during 2002-03. The objective is to ensure that banks use the call/notice money market to finance only temporary mismatches. Thirdly, with the liquidity adjustment facility (LAF) emerging as a primary instrument for modulating day-to-day liquidity conditions and providing a corridor for market play, the sector-specific standing liquidity support to the banks and primary dealers was rationalised. Fourthly, measures (discussed below) were taken to make other money market instruments freely accessible to non-bank participants. These measures were intended to improve depth, efficiency and transparency in money market operations.

Call/Notice Money Market

9.3 Large exposures to call/notice money borrowings, which are uncollateralised by nature, carry potential danger of systemic instability arising out of defaults. It also impedes the development of other segments of the money market and constrains the Reserve Bank's ability to influence short-term interest rates.

9.4 In the call/notice money segment, the thrust of reforms was to establish limits on exposure of banks and primary dealers in order to facilitate balanced development of various segments of the money market. The limit on maximum daily call/notice money borrowings at two per cent of aggregate deposits at the end of March of the previous financial year, that had been placed on Urban Co-operative Banks (UCBs) was extended to State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) on April 29, 2002. Furthermore, prudential limits on borrowing and lending in call/notice money market were stipulated for scheduled commercial banks (SCBs) with a view to preserving the integrity of the financial system and facilitating the development of the repo market. A two-fold strategy was adopted in order to ensure that these banks do not face any disruption in their asset-liability management (ALM). Borrowers and lenders were allowed to unwind their positions by October 4, 2002. Second, the application of caps on banks in the call/notice money market was undertaken in two stages, commencing from the fortnights beginning October 5, 2002 and December 14, 2002, respectively. Any bank facing mismatches was allowed to approach the

Reserve Bank for temporary access to the call/notice money market in excess of the stipulated limit. An increased access over stipulated norms was also permitted for a longer period for banks with fully functional and satisfactory ALM systems.

9.5 Effective December 14, 2002, scheduled commercial banks were allowed to lend up to 25 per cent of their owned funds, on a fortnightly average basis, and up to 50 per cent of such funds on any day during a fortnight. Similarly, they were allowed to borrow up to 100 per cent of their owned funds or two per cent of aggregate deposits, whichever is higher, on a fortnightly average basis and up to 125 per cent of their owned funds on any day during a fortnight. Primary dealers (PDs) were allowed to lend up to 25 per cent of their net owned funds (NOF) on average basis during a reporting fortnight from October 5, 2002. A two-stage call/notice money borrowing restriction on primary dealers of up to 200 per cent and up to 100 per cent, respectively, of their NOF as at the end-March of the preceding financial year would become effective, contingent upon greater deepening of the repo market.

9.6 In view of the encouraging results from the functioning of NDS and CCIL and to facilitate further deepening of repo/term money market, the process of moving towards a pure inter-bank call/notice money market was accelerated. Accordingly, Stage II of the transition was made effective from the fortnight beginning June 14, 2003. Non-bank participants were allowed to lend, on an average in a reporting fortnight, only up to 75 per cent of their average daily lending in the call/notice money market during 2000-01 (Table 9.1). The Reserve Bank may consider providing temporary permission to lend higher amounts in the call/notice money market for a specific period on a case-by-case basis.

9.7 It was made mandatory for all NDS members to report all their call/notice money market deals on NDS from the fortnight beginning May 3, 2003. This will help to improve transparency and strengthen efficiency in the market. Deals done outside NDS have to be reported within 15 minutes on NDS, irrespective of the size of the deal or whether the counterparty is a member of the NDS or not. Full compliance with the reporting requirement to NDS will be reviewed in September 2003. In case there is repeated non-reporting of deals by an NDS member, those non-reported deals may be considered invalid from a future date.

Certificates of Deposit

9.8 In order to impart transparency and flexibility to secondary market transactions, banks and financial institutions (FIs) were required to issue CDs in dematerialised form from June 30, 2002 without prejudice to the Depositories Act, 1996. Existing CDs in physical form had to be converted into demat form by October 2002. Earlier, the Fixed Income Money Market and Derivatives Association of India (FIMMDA) issued standardised procedures, documentation and operational guidelines on June 20, 2002 for issue of CDs in both physical and dematerialised forms. In order to increase the investor base, the minimum size of issues of CDs by banks and FIs was reduced to Rs.1 lakh in June 2002. Furthermore, with a view to providing more flexibility in pricing of CDs and giving

Table 9.1 : Time Table for Pure Inter-bank Call/Notice Money Market

Stages	Time Table announced	Progress Achieved so far
1	2	3
Stage I	It was announced in April 2001, effective May 5, 2001, non-bank institutions (*i.e.*, financial institutions, mutual funds and insurance companies) would be allowed to lend, on an average in a reporting fortnight, up to 85 per cent of their average daily lendings in the call/notice money market during 2000-01.	Implemented
	Permission to corporates to route their call transactions through primary dealers was available up to June 30, 2001.	Implemented
Stage II	It was announced in April 2002, the limit of non-bank lendings in the call/notice money market would be scaled down to 75 per cent of their average daily lendings in the call/notice money market during 2000-01, the effective date of which would be announced when NDS/CCIL becomes fully operational and widely accessed.	Implemented with effect from fortnight beginning June 14, 2003.
Stage III	It was announced in April 2001 that effective 3 months after Stage II, access of non-banks to the call/notice money market would be 40 per cent of their average daily lendings in the call/notice money market during 2000-01.	Not yet implemented.
Stage IV	It was announced in April 2001 that effective 3 months after Stage III, access of non-banks to the call/notice money market would be 10 per cent of their average daily lendings in the call/notice money market during 2000-01.	Not yet implemented.

additional choice to both investors and issuers, CDs were permitted to be issued as coupon-bearing instruments. Banks were allowed to issue CDs on a floating rate basis provided the methodology of computing the floating rate was objective, transparent and market-based.

Commercial Paper

9.9 Banks and FIs have the flexibility to provide credit enhancement for a CP issue by way of standby assistance/credit, backstop facility based on their commercial judgement, subject to prudential norms. In order to provide further flexibility to both issuers and investors in the CP market, non-bank entities, including corporates,were allowed to provide unconditional and irrevocable guarantee for credit enhancement for CP issue to enable flexibility to both issuers and investors. The issuer should fulfil the eligibility criteria prescribed for issuance of CP and the guarantor has to have a credit rating of at least one notch higher than that of the issuer from an approved credit rating agency. The offer document for CPs should disclose the net worth of the guarantor company, the names of the companies to which the guarantor has issued similar guarantees, the extent of the guarantees offered by the guarantor company, and the conditions under which the guarantee will be invoked. Banks have been allowed to invest in CPs guaranteed by non-bank entities, provided their exposure remains within the regulatory ceiling for unsecured exposures.

Derivatives

9.10 In pursuance of the recommendations of the Working Group on Rupee Derivatives (Chairman : Shri Jaspal Bindra), banks and primary dealers were permitted to undertake transactions in exchange traded interest rate derivatives in June 2003. Trading in futures contracts in notional 10-year Government of India bonds, notional 91-day Treasury Bills and 10-year zero coupon bonds commenced at the National Stock Exchange on June 24, 2003. In the first phase, only interest rate futures have been introduced and banks were allowed to hedge interest rate risk inherent in the government securities portfolio. Primary dealers were allowed to take hedging as well as trading positions. Banks can seek membership of stock exchanges for the purpose of transacting in proprietary positions. Extension of hedging to other items of the balance sheet, participation of regulated entities in interest rate derivatives with non-linear pay-offs as well as allowing banks to hold trading positions are slated for the next phase. The Reserve Bank is also actively considering harmonising the regulatory, legal and prudential treatment of OTC and exchange traded interest rate derivatives.

Collateralised Borrowing and Lending Obligation

9.11 Collateralised Borrowing and Lending Obligation (CBLO) was operationalised as a money market instrument through the Clearing Corporation of India Ltd. (CCIL) on January 20, 2003. The CBLO has original maturity between one day and up to one year. The regulatory provisions and accounting treatment for CBLO are the same as those applicable to other money market instruments. In order to develop CBLO as a money market instrument, it has been exempted from CRR subject to banks maintaining minimum CRR of three per cent. As on July 31, 2003, 52 members were admitted in CCIL's CBLO segment. The total turnover in CBLO during January 20, 2003 – July 31, 2003 stood at Rs.7,925 crore amounting to a daily average turnover of Rs.74 crore. The active participants include select co-operative banks and an insurance company. In the recent period, select public sector banks and a mutual fund have also become active in this segment.

Repo Market

9.12 The successful and non-disruptive transition of the call/notice money market into a pure inter-bank market is contingent on the development of the repo market so as to provide a stable collateralised funding alternative. The eligibility requirement of maintaining an SGL account with the Reserve Bank for participation in the repo market, however, excluded a large number of potential users of repos.

9.13 The eligibility to participate in the repo market was expanded with effect from March 3, 2003 to include non-SGL account holders like non-banking financial companies, mutual funds, housing finance companies and insurance companies. These entities were permitted to access the repo market through their "gilt accounts" maintained with the custodians. Since they do not maintain current and SGL accounts with the Reserve Bank, necessary precautions were built in to ensure "Delivery *versus* Payment" (DvP) and transparency while restricting the repos to government securities only. Repos between a custodian and its own clients as well as between clients of the same custodian are not permitted as DvP cannot be ensured for these transactions.

Box IX.1

Repo Accounting

Ready forward or Repurchase Agreements (Repo) are contracts whereby the seller of securities agrees to buy the securities at a pre-specified date and price. Repo contracts are a popular way to raise resources for the entities having sufficient stock of securities. Typically, as repo transactions are collateralised in nature, the rates are lower than the clean lending rates of equivalent tenors. Although any security can be sold as collateral under a repo transaction, only Government of India dated securities, Treasury Bills and State Government bonds are the eligible underlying instruments for undertaking repo transactions in India.

Although repo transactions are in the nature of buy and sell of securities, they essentially enable borrowing and lending of cash. Despite being a money market instrument, the legal nature of the transaction (*i.e.*, buy and sell) has to be reflected in the investment accounts of both the buyer and the seller since the buyer of securities gets clear and absolute title over the securities acquired through repo. This leads to complications in accounting of repo transactions. In view of the possibility of influencing the investment portfolio through repo transactions, participants were previously allowed to conduct repo transactions only in securities held in their 'held for trading' portfolio. Furthermore, market participants followed different norms with respect to accounting for repo transactions. With the increasing use of repos in the wake of limits on non-bank participation in inter-bank call/notice money markets, a uniform accounting as well as documentation policy is a pre-requisite for the development of the repo market.

The Reserve Bank, in consultation with Fixed Income Money Markets and Derivatives Association of India (FIMMDA) issued comprehensive guidelines for uniform accounting of repo/reverse repo transactions on March 24, 2003. The salient features of the repo accounting guidelines are:

- The legal character of repo under the current law, *viz.*, as outright purchase and outright sale transactions is kept intact.
- The first leg of the repo should be contracted at prevailing market rates. Accrued interest received/paid in a repo/reverse repo transaction and the clean price (*i.e.*, total cash consideration *less* accrued interest) should be accounted for separately and distinctly.
- Securities will exit and enter the investment account of the seller at the book value.
- The buyer of securities will mark to market the securities acquired under reverse repo transactions as per the investment classification of the security.
- While the buyer will book the coupon during the period of the repo, the coupon will not accrue to the seller during the period of the repo.
- Participants may consider entering into bilateral Master Repo Agreement as per the documentation finalised by FIMMDA.

9.14 Several other measures were taken to widen and deepen the repo market and to give funding access to the non-bank entities who are being gradually phased out from the call market. Reporting of all transactions on the NDS and their settlement through CCIL was made compulsory to ensure transparency. A Master Repo Agreement was finalised for use of market participants. Permitting rollover of repos is under active consideration. In order to strengthen the institutional infrastructure, uniform accounting norms for repo and reverse repo transactions were prescribed to the market participants on March 24, 2003 (Box IX.1).

GOVERNMENT SECURITIES MARKET

9.15 Since the early 1990s, the Reserve Bank has been engaged in the deepening and widening of the primary and secondary segments of the government securities market in order to obviate the need for monetisation of fiscal deficits, as part of reforms in monetary-fiscal coordination. Significant steps taken by the Reserve Bank in the recent period include elongation of maturity, development of new benchmark government securities by consolidating new issuances in key maturities, enhancing fungibility and liquidity by reissuances of existing loans, promoting retailing of government securities, introduction of floating rate bonds, announcement of a core calendar and enhanced transparency of the Central Government's borrowing programme.

Diversification of instruments

9.16 In July 2002, there was an issuance of Floating Rate Bonds, which is an effective instrument for hedging interest rate risk in the context of the elongation of the maturity profile of Government debt. For the first time, on July 17, 2002 a 10-year bond was issued with put and call option exercisable on or after 5 years from the date of issue. The issuance of two 30-year Government bonds in August and October 2002 provided additional flexibility to market participants.

9.17 Operational and prudential guidelines on separate trading for registered interest and principal

of securities (STRIPS) are being formulated. Dates for consolidation of coupon strips (March 25/September 25 and May 30/November 30) would be aligned with coupon payment dates in future issuances. The coupon payment dates of 6.01% GS 2028, issued on August 7, 2003, were aligned to March 25/September 25. Primary Dealers (PDs) which meet certain laid down financial criteria would be authorised to undertake stripping and reconstitution of securities. The Reserve Bank's Public Debt Office (PDO) would act as a registry for stripped bonds.

9.18 Measures were introduced on May 20, 2002 to accelerate the process of holding of securities in the dematerialised mode and to reduce the scope for trading in government securities in physical form which leads to possible irregularities through non-delivery. They included compulsory holding of government securities in demat form by all regulated entities, limiting the number of gilt accounts or dematerialised accounts to be maintained by such entities to one and total prohibition on transactions in physical form with any broker entity. In connection with demating of securities through constituent secondary general ledger (CSGL) and to eliminate possibility of "excess" securities being created, specific action points were drawn up for a system of more frequent and effective reconciliation of Government loans.

Negotiated Dealing System

9.19 The Negotiated Dealing System (NDS) has stabilised since its inception on February 15, 2002. Almost all market participants have joined NDS and Subsidiary General Ledger (SGL) transactions at the Public Debt Office (PDO), Mumbai are now on electronic mode through NDS. Similarly, bids in LAF, Treasury Bills and Central Government dated securities auctions are being received electronically through NDS, which has resulted in reducing auction bid processing time. The advancement of bid submission time in Treasury Bills and Central Government auctions from 2.30 pm to 12.30 pm and electronic bidding has facilitated the announcement of the auction results within market hours. To provide wider access to the data on the government securities market, information on trades captured by the NDS is being disseminated through the Reserve Bank's website since October 25, 2002 on near real time basis. In the next phase of the NDS, it will be integrated with the securities accounts, servicing of debt and primary issuance with countrywide access through the Indian financial network (INFINET).

Clearing Corporation of India Limited

9.20 The Clearing Corporation of India (CCIL) commenced operations with transactions in government securities as well as Rupee/US dollar foreign exchange spot and forward deals since November 12, 2002. Effective April 1, 2003 all transactions in government securities in the Public Debt Office (PDO), Mumbai are now being settled through CCIL which has resulted in significantly reduced funding requirement for every member and mitigation of liquidity risk. An independent assessment of the CCIL's risk management system was conducted by an expert from the European Central Bank. The overall assessment was that the CCIL's system is good and its management competent. Suggestions for further improvements include: (i) reconsideration of the legal status of CCIL as a credit institution to obtain better protection; (ii) conducting stress tests of CCIL's risk management under extreme catastrophic scenarios; (iii) development of a clear legal framework for finality of multilateral netting; and (iv) introduction of real time gross settlement system (RTGS) at an early date.

Trading on Stock Exchanges

9.21 Buying and selling of government securities through the stock exchanges (National Stock Exchange (NSE), Stock Exchange Mumbai (BSE) and Over the Counter Exchange of India (OTCEI) was allowed with effect from January 16, 2003 on an anonymous screen-based order-driven basis to facilitate countrywide access and wider participation in the government securities markets. This measure was aimed at reducing time and cost in trade execution by matching orders on a strict price and time priority, and enhancing the operational and informational efficiency of the market as well as its transparency, depth and liquidity. The volumes are, however, still meagre.

Regulatory Oversight

9.22 In the wake of certain irregularities in government securities transactions by some of the DCCBs and UCBs in government securities transactions, monitoring the developments in the government securities market has become critical from the point of view of systemic stability. The measures initiated include:

- recommending supersession of the boards of the co-operative banks and filing of criminal complaints where losses have been incurred by banks;

- imposition of penalty in cases of major violations and issuance of show-cause notices in cases of minor transgressions;
- introduction of quarterly audit certificates on investment transactions in government securities of DCCBs/UCBs;
- compulsory dematerialised holdings of securities for all regulated entities; single dematerialised account together with a designated funds account to ensure availability of clear funds and sufficient securities before putting through the transactions; and,
- prohibition of all transactions in physical form with any broker.

Primary Dealers

9.23 The primary dealer (PD) system has been in operation for the last eight years. At the end of 2002-03, there were 18 primary dealers in the government securities market. During 2002-03, the PDs absorbed 63 per cent of auctioned primary issues of government securities and 65 per cent of Treasury Bill auctions as against 65 per cent and 83 per cent, respectively, during the preceding year, reflecting a more aggressive interest by other investors. While call money borrowings remained a steady source of finance for their gilt investments, the average daily utilisation of liquidity support by the PDs was well below the levels in 2001-02. This reflected the ample liquidity available in the system during the year. With the development of the repo market and measures taken to facilitate repo transactions, it is expected that the repo market will provide a major source of funds for PDs' operations.

9.24 Primary dealers are required to maintain minimum capital of 15 per cent of aggregate risk weighted assets, covering credit risk and market risk. At the end of March 2003, the Capital to Risk Weighted Assets Ratio (CRAR) of the PD system was significantly higher than the prescribed minimum capital requirement (Table 9.2). The market risk capital is maintained at higher of the estimates of standardised model and the Value-at-Risk (VaR) method. In January 2002, PDs were advised to follow a prudent dividend distribution policy so as to build up sufficient reserves even in excess of regulatory requirements which can act as a cushion against any adverse interest rate movements in the future. The financial strength of the PDs has been monitored at regular intervals.

Table 9.2 : Select Indicators of the Primary Dealers

(Amount in Rupees crore)

Item	End March 2003@	End March 2002	End March 2001
1	2	3	4
Number of PDs	18	18	15
Total Capital (NOF)	5,048	4,380	3,184
Total assets	19,931	17,225	14,772
Of which: Government Securities	14,585	11,961	10,401
Government Securities as percentage of total assets	73.2	69.4	70.4
PD system turnover (Outright)	7,32,143	6,52,127	3,16,915
Market turnover (Outright)	27,55,482	24,23,933	11,44,291
PD turnover to Outright Market Turnover (per cent)	26.6	26.9	27.7
Liquidity Support limits	3,000 (Normal)	4,000 (Normal)	6,000
	1500 (Backstop)	2,000 (Backstop)	
CRAR (per cent)	30.90	38.40	40.90

@ Unaudited in respect of one PD.
NOF : Net Owned Funds

9.25 Keeping in view the growing systemic importance of PDs, they were brought under the purview of the Board for Financial Supervision (BFS) in 2002-03. Besides off-site supervision through prescribed periodic returns, on-site inspection of each PD is also conducted.

9.26 With a view to enlarging the funding avenues for their operations, PDs were allowed to avail of FCNR(B) loans from banks within an overall limit of 25 per cent of their NOF to supplement their funding sources, subject to the foreign exchange risk on such loans being hedged at all times at least to the extent of 50 per cent of exposure.

9.27 Operational guidelines were issued to enable PDs to undertake Portfolio Management Services (PMS) for entities other than those regulated by the Reserve Bank. The undertaking of PMS activity is subject to prior approval of the Reserve Bank and obtaining of certificate of registration from the Securities and Exchange Board of India (SEBI), besides compliance with operational guidelines.

FOREIGN EXCHANGE MARKET

9.28 Reforms in the foreign exchange market were carried forward to deepen various segments of the market and impart sophistication to its functioning. Market participants were allowed greater flexibility of operations in both spot and forward segments,

especially in managing risks. Alongside the introduction of new instruments, significant liberalisation was effected in international current and capital transactions. These efforts are intended to prepare the market for equilibrating significantly higher volumes, and for improving the process of price discovery, supported by the ongoing modernisation of the technological infrastructure. The development of the foreign exchange market in India has been facilitated by the stance of exchange rate policy – underlying demand and supply conditions are allowed to determine exchange rate movements in an orderly manner.

9.29 Authorised Dealers (ADs) were allowed to hedge their exchange risk without limit while undertaking foreign currency-rupee swaps with residents in India with long-term exposures in foreign currency or rupee. Limits continue to exist for swap transactions which allow customers to assume a foreign exchange liability. Moreover, ADs were advised against offering of swaps involving leveraged structures.

9.30 The cap on booking of forward contracts by ADs on behalf of exporters and importers on the basis of the last three years' average performance was raised to US $ 100 million (subject to the facility not exceeding 25 per cent of the eligible limit). Corporates with genuine exposures were allowed to approach the Reserve Bank for booking forward contracts beyond this cap. ADs were permitted to rebook cancelled forward contracts in respect of all foreign exchange exposures falling due within one year. This facility is only available to customers who submit details of exposure and unhedged portion thereof.

9.31 Banks with a minimum CRAR of 9 per cent were allowed to offer foreign currency rupee options on a back-to-back basis from July 7, 2003. ADs with adequate internal control, risk monitoring/ management systems, mark to market mechanism and fulfilling certain other stipulated criteria were allowed to run an option book after obtaining one time approval from the Reserve Bank. Writing of options by customers is not permitted.

9.32 Foreign banks operating in India were allowed to hedge their Tier I capital in Indian books without any restriction on timing of the hedge transaction. To enlarge the scope of forward contracts, ADs were permitted to offer forward cover for inflows under foreign direct investment and for foreign exchange exposures denominated in foreign currency but settled in Indian rupees; they were also allowed to offer cross currency forward cover for FCNR(B) deposits.

9.33 In conformity with global anti-money laundering regulations, the Money Transfer Services Scheme was modified. Only licensed overseas entities with a good credit rating and well established Anti-Money Laundering Systems can act as principals. The Indian agent should be an AD, Full Fledged Money Changer, or registered NBFC. A collateral equivalent to three days' drawings or US $ 50,000 (whichever is higher) has to be maintained by the overseas principal with a designated bank in India in the name of the Indian agent. Amount in excess of US $ 50,000 can be furnished by the principal in the form of bank guarantee. A cap of US $ 2,500 has been placed on individual transactions under the scheme while the number of remittances that can be received by a single individual is restricted to 12 during a year. Amounts exceeding Rs.50,000 must be paid by means of cheque/demand draft/postal order or credited directly to the beneficiary's account.

Exchange and Payments Reforms

9.34 Contemporaneous with the progressive broadening and deepening of the foreign exchange market since the mid-1990s, significant progress has been made in liberalising external current and capital transactions. During 2002-03, significant relaxations were allowed for overseas investments and remittances abroad by banks, corporates and resident individuals. Domestic entities were allowed to retain considerable proportions of their earnings abroad to meet future foreign exchange requirements. Policy initiatives to improve the inflows of foreign direct investment, foreign portfolio investment, non-resident deposits and external commercial borrowings were built upon.

(a) Facilities for Exporters and Importers

9.35 A number of measures were taken to improve exchange arrangements to facilitate foreign trade. Merchant exporters/traders and manufacturer exporters of stipulated goods were allowed to realise export proceeds within an extended period of 365 days subject to certain conditions till September 2003. Units in special economic zones (SEZs) were freed from time limits for such realisations. Other facilities for units in SEZs include permission to undertake job work abroad, receive payment in form of precious metals for export of jewellery, netting off of export receivables against import payments, and capitalisation of import payments.

9.36 Status Holder exporters may credit up to 100 per cent of their eligible receipts of foreign exchange

in their Exchange Earners' Foreign Currency (EEFC) accounts. Exporters were also allowed to use the balance in their EEFC accounts for repayment of packing credit advances to the extent exports have actually taken place, and to extend trade related loans/ advances to overseas importers out of their EEFC balances. Hiring of warehouses abroad by exporters was simplified and it can be permitted by ADs without the need to seek the approval of the Reserve Bank. Exporters of sea food and other perishable food products were allowed to avail of rejection risk insurance cover from an insurer outside India.

9.37 The value limit for which submission of documentary evidence for imports is obligatory was enhanced to US $ 25,000 from US $ 5,000. Furthermore, in respect of companies listed on the stock exchanges with net worth not less than Rs.100 crore, public sector companies, Government of India departmental undertakings, and autonomous scientific or academic institutions audited by the Comptroller and Auditor General (CAG), banks may accept exchange control copy of bill of entry or a certificate from the Chief Executive Officer (CEO) or Auditor of the company in respect of receipt of goods imported, *in lieu* of bill of entry (if the value of goods imported is less than US $ 100,000). With a view to simplifying the procedure for import, the limit for advance remittance without bank guarantee for all current account payments was revised upwards to US $ 100,000 or its equivalent, from the earlier limit of US $ 25,000.

9.38 Authorised Dealers were empowered to approve proposals, within specified parameters, for buyers' credit and suppliers' credit not exceeding US $ 20 million per import, and to open standby letters of credit on behalf of their importer constituents for import of goods permissible under the EXIM policy.

(b) Facilities for Residents

9.39 Norms on release of foreign exchange were liberalised and the maximum permissible amounts were raised for purposes such as medical treatment abroad, private visits abroad, use of payment cards abroad, procurement of books and other items through Internet. With a view to enabling residents to avail of foreign exchange for medical treatment without any irritants and loss of time, release of foreign exchange up to an amount of US $ 50,000 or its equivalent was allowed, without any estimate from a hospital/doctor. This limit was enhanced to US $ 100,000, with effect from July 17, 2003. Release of foreign exchange up to US $ 10,000 to residents was permitted without prior permission of the Reserve Bank for private visits to any country (except Nepal and Bhutan, where Indian rupees can be used). Remittances by residents up to US $ 500 or its equivalent were allowed for transactions permissible under EXIM policy on the basis of mere declaration. International Credit Card (ICC)/ATM Card/Debit Card holders were allowed to use their cards while on holidays outside India to meet their expenses subject only to the credit card limit (as opposed to the limit for private travel), as also for purchase of item of import and when in India, for making payment in foreign exchange for purchase of books and other items through Internet. Furthermore, residents maintaining a foreign currency account with an AD in India or a bank abroad, are free to obtain ICCs issued by overseas banks and other reputed agencies. The restrictions on use of international credit card for purchase of prohibited items continues.

9.40 Resident individuals were permitted to open Resident Foreign Currency (Domestic) [RFC(D)] Accounts with a bank in India and deposit foreign exchange earnings repatriated to India through banking channel out of export of goods and/or services, royalty or honorarium. They were also allowed to open/credit the RFC(D) account with amounts (a) saved from outside India; (b) received as honorarium during the trip outside India; (c) received as gift from persons on visit to India; and (d) received from a person on a visit to India for services rendered in India. These accounts are not interest bearing and there is no ceiling on the balances that can be built up in these accounts. The balances held in these accounts can be used for any purpose for which foreign exchange can be bought from a bank in India. Residents were also allowed to remit foreign exchange for purchase of foreign securities under the employees stock option (ESOP) scheme without limit.

(c) Facilities for Overseas Investment

9.41 The norms for overseas investment were relaxed for banks, corporates and individuals. Listed Indian companies and mutual funds were permitted to invest in companies listed on a recognised stock exchange abroad but with shareholding of at least 10 per cent in an Indian company listed on a recognised stock exchange in India, provided such investment does not exceed 25 per cent of the company's net worth. Resident individuals were also permitted to invest in these companies without any monetary limit. Mutual funds, which were hitherto permitted to invest in ADRs/GDRs of the Indian

companies and rated debt instruments within an overall cap of US $ 500 million, were permitted to invest in equity of overseas companies, subject to the overall cap of US $ 1 billion.

9.42 Banks were accorded greater flexibility in funds management. Earlier, they were allowed to invest up to 50 per cent (as against the existing ceiling of 25 per cent) of their unimpaired Tier 1 capital or US $ 25 million in overseas money market instruments and/or debt instruments. They are now free to undertake investments in overseas money market instruments and/or debt instruments subject to the limits approved by their board of directors. Investment norms for undeployed FCNR(B) funds were also liberalised. ADs were allowed to invest these funds in long-term fixed income securities in overseas markets, subject to rating requirements.

9.43 Companies with a proven track record were allowed to make investment in a foreign entity abroad engaged in any *bona fide* business, without prior approval of the Reserve Bank, by purchasing foreign exchange in the market up to 100 per cent of their net worth (not exceeding US $ 100 million).

9.44 In order to encourage Indian companies to list ADRs/GDRs on overseas exchanges, resident shareholders of Indian companies were permitted to receive the sale proceeds of conversion of shares to ADRs/GDRs in foreign currency. The sale proceeds can also be credited to their EEFC/RFC(D) accounts or to their rupee accounts. Indian companies were also allowed to retain ADR and GDR proceeds abroad for any period to meet their future foreign exchange requirements. In case of ADR/GDR proceeds pending utilisation/repatriation, they may be invested in certain categories of deposits and monetary instruments abroad. Indian companies were permitted to sponsor issues of ADRs/GDRs with an overseas depository against the shares held by its shareholders.

9.45 In order to facilitate increased floating stock of shares of large Indian companies with capital base of Rs.1,000 crore or more, the threshold limit for investments by FIIs/NRIs under the portfolio investment scheme was enhanced from the existing two per cent to 0.5 per cent below the limit up to which non-resident investments are permitted in such companies. Indian companies were allowed to remit the redemption proceeds of the non-convertible debentures (NCDs)/partial convertible debentures (PCDs) issued by them to non-resident Indians (NRIs)/ overseas corporate bodies (OCBs).

9.46 An 'automatic route' for prepayment of external commercial borrowings was introduced during the year. The norms for prepayment of External Commercial Borrowings (ECBs) were simplified by allowing prepayment without any limit out of balances held in EEFC account as well as out of local resources/market purchases. Corporates raising ECBs were allowed to retain the funds abroad, subject to some stipulations.

9.47 Corporates who have set up overseas offices were allowed to acquire immovable property of their staff abroad for business as well as for residential purposes with prior permission from the Reserve Bank.

(d) Facilities for Non Resident Indians (NRIs) and Persons of Indian Origin (PIOs)

9.48 With a view to further liberalising the exchange control regulations and providing additional facilities to NRIs/PIOs, more powers were delegated to ADs. Initially they were allowed to remit specified amount out of NRO account of non-residents for purposes like education (US $ 30,000), medical treatment (US $ 100,000) and sale proceeds of immovable property (US $ 100,000). There was further delegation of power to banks to remit up to US $ 1 million in a calendar year out of balances held in NRO accounts, subject to payment of taxes/submission of undertaking.

9.49 Furthermore, the lock-in period for repatriation of sale proceeds of immovable property was removed and the NRIs were permitted to credit their current income to their NRE accounts for easy repatriability. They were also provided freedom to repatriate excess money remitted towards purchase of shares, surplus money on account of non-allotment/cancellation of flats/plots/bookings and redemption proceeds of non-convertible debentures (NCDs)/partially convertible debentures (PCDs) (that were issued under FERA). ADs in India were allowed to issue international credit cards to NRIs and PIOs and they were also permitted the settlement of charges on usage of such cards through funds in Non-Resident (Ordinary) Rupee Account. The current income like rent, dividend, pension, interest, *etc.*, of NRIs was allowed to be credited to their Non-Resident (External) Rupee Accounts.

(e) Foreign Exchange Clearing

9.50 An important element in the infrastructure for the efficient functioning of the foreign exchange

market is the clearing and settlement of inter-bank dollar-rupee transactions. The CCIL offers a multilateral netting mechanism for inter-bank spot and forward dollar-rupee transactions. As a Central Counter Party (CCP) guaranteeing trade settlement, the CCIL interposes as a buyer to each seller and as a seller to each buyer in a defined trade through a process called novation thereby giving rise to two contracts from the single original contract between the two parties. Live operations for clearing and settlement of spot and forward dollar-rupee transactions commenced on November 12, 2002. While the US dollar leg of transactions is settled through CCIL's account with its settlement agent in the US, the rupee leg is settled through the member banks' current accounts maintained with the Reserve Bank. During the period November 12, 2002 to March 31, 2003, 91 settlements have taken place covering 2,01,614 settled transactions amounting to over US $ 137 billion. During April-July, 2003, 75 settlement constituting 2,02,206 settled transactions amounting to over US $ 141 billion have taken place. The CCIL has lines of credit amounting to US $ 275 million from a foreign bank and Rs.700 crore from seven Indian banks to take care of any unforeseen contingency. This new facility for clearing and settling dollar-rupee transactions in India is likely to provide substantial cost and time benefits to banks.

Outlook

9.51 The Reserve Bank has pursued a process of consultation with market participants in its endeavour to deepen and widen the financial markets so as to enhance allocative efficiency, preserve financial stability and improve the transmission of monetary policy. The objective is to ensure balanced development of various segments of the financial market as also to preserve integrity and transparency of market operations. The operationalisation of the CCIL, NDS and CFMS combined with the advanced stage of implementation of centralised PDO and the RTGS system would contribute to efficient functioning of the markets. Simultaneously, efforts are underway to reduce market overlap and to develop segments which cater exclusively to specific classes of instruments and participants. This will enhance efficiency and contain risk in a systemic sense.

9.52 The progress of money market reforms so far has been satisfactory and without undue strains on market conditions. The transformation of the call/notice money market into a pure inter-bank market is progressing and the accessibility of non-banks would be further reduced before being eventually phased out. The implementation of borrowing restrictions on primary dealers in call/notice money market is contingent on further developments in the repo market. A wider array of hedging instruments have been made available to the market as banks and PDs have been permitted to undertake exchange traded futures and foreign currency-rupee OTC options with suitable safeguards.

9.53 In the government securities market, various measures are being undertaken to widen the base of repo transactions by extending coverage to CSGL account holders, and to allow rollover of repo contracts using the same securities between the same counter-parties. Allowing sale of securities purchased under repo, widening of the repo market to all entities including corporates and extending the eligibility to all debt instruments including rated corporate bonds are some of the measures under active consideration. Furthermore, a "when issued" market for government securities would help efficient price discovery in the primary auctions. Widening of the instrument base through introduction of inflation indexed bonds and STRIPS in the government securities market is in progress. Measures to further develop the retail market for government securities using PDs and banks are being considered. The scheme of trading of government securities on stock exchanges through order-matching screen-based trading has been introduced and ways of enhancing investor interest are being examined. The implementation of the next phase of the PDO-NDS project involving integration with security settlement system and primary markets operations, automation and inter-connectivity of PDOs, electronic maintenance of record of ownership will represent a step forward in improving the government securities market.

9.54 With regard to the foreign exchange market, the Reserve Bank will continue to follow the approach of preparing the market for transacting rising volumes of international transactions. A key priority is to avoid disruptive shifts in volatility and market sentiment. Accordingly, the Reserve Bank will continue its stance of watchfulness, caution and flexibility by closely monitoring the developments in the markets at home and abroad, with appropriate monetary, regulatory and other measures as considered necessary from time to time.