V FINANCIAL MARKETS AND FOREIGN EXCHANGE MANAGEMENT

During 2016-17, the Reserve Bank undertook a number of measures for developing various segments of the financial markets. In the money market, the Reserve Bank undertook proactive liquidity management operations, with a view to aligning money market rates with the policy rate for better transmission of monetary policy. Orderly conditions were maintained in the spot, forward and futures segments of the forex market, alongside further liberalisation of the capital account and rationalisation of the reporting requirements to promote ease of doing business.

V.1 The Reserve Bank has been developing financial markets in tune with the evolving needs of a growing economy. During the year, the Bank provided more operational flexibility to market participants and conducted market operations to align money market rates with the stance of monetary policy. Interventions in the forex market were also carried out in pursuance of the stated objective of maintaining orderly conditions. In an endeavour to facilitate external trade and payments, and promote ease of doing business, many existing rules on foreign investment in India and external commercial borrowings (ECBs) were rationalised and reporting was simplified.

FINANCIAL MARKETS REGULATION DEPARTMENT (FMRD)

V.2 The mandate of the FMRD is to regulate and develop money, government securities (G-sec), foreign exchange and related derivatives markets. The department undertook a number of measures during 2016-17, aimed at easing norms for market participants, improving accessibility, increasing the number of financial products, strengthening market infrastructure apart from harnessing market analytics and pursuing richer surveillance for policy formulation.

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V.3 Final directions on introduction of money market futures and interest rate options were issued in October and December, 2016 respectively, with the objective of developing the interest rate market. These directions are intended to enhance flexibility and product development in line with market requirements. Exchanges as well as over-the-counter (OTC) participants are free to propose any product that meets the broad requirements set in these directions.

V.4 The report of the Working Group on development of the corporate bond market in India (Chairman: Shri H R Khan) was submitted in August 2016. The department has taken concerted efforts to implement the various recommendations of the Group.

V.5 In line with these recommendations, foreign portfolio investment (FPI) was permitted in unlisted corporate debt securities and securitised debt instruments in November 2016 up to ₹350 billion within the extant investment limits for corporate bonds. Further, with a view to easing access to the G-sec market, foreign portfolio investors were allowed from December 2016 to trade G-sec in the secondary market directly on the negotiated dealing system-order matching (NDS-OM), without involving brokers.

V.6 Repo directions were further liberalised during the year with the objective of deepening the market and widening the participation base. Effective September 06, 2016, listed companies were allowed to borrow or lend in the repo market without the minimum seven-day restriction. Gilt account holders (GAHs) were permitted to enter into a repo transaction with their custodians or with another GAH. Further, in August 2016, brokers undertaking market-making activities in corporate bonds were permitted access to corporate bond repo market to meet their liquidity requirement.

V.7 In order to stimulate retail participation in the G-sec market, an implementation group with representation from all stakeholders was constituted to recommend specific measures to enable seamless movement of securities from the Subsidiary General Ledger (SGL) form to demat form and *vice versa* and to provide demat account holders a functionality to put through trades on NDS-OM. Accordingly, demat account holders of National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL) were permitted from August 2016 to put through trades in G-sec on the NDS-OM platform through their respective Depository Participant (DP) bank which should also be an SGL account holder and a direct member of NDS-OM and the Clearing Corporation of India Limited (CCIL).

V.8 Existing directions on commercial paper (CP) were reviewed with a view to broadening access to it, strengthening disclosure requirements by issuers, and reviewing the role of issuing and paying agents while putting in place an information dissemination mechanism, and revised draft directions were placed on the Bank's website for public comments. The final directions were issued on August 10, 2017.

V.9 Draft directions on the introduction of tri-party repo were placed on the Bank's website in April 2017 for public comments, with the objective of enabling market participants to use the underlying collateral more efficiently and to facilitate the development of term repo market. Taking into account the feedback received from the market, final directions were issued on August 10, 2017.

V.10 With a view to providing operational flexibility to multinational entities and their Indian subsidiaries exposed to currency risk, the non-resident centralised or regional treasury of such entities was permitted in March 2017 to enter into foreign exchange derivative contracts with authorised dealer (AD) banks in India to hedge the exposure of their Indian subsidiaries by entering into tri-partite agreement involving the Indian subsidiary, its non-resident parent or treasury and the AD bank.

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V.11 Initiatives currently under consideration include a framework for authorisation of trading platform for OTC markets under the Reserve Bank's ambit, introduction of a comprehensive code of fair practices for debt market in line with global standards and framing of guidelines on financial markets in the International Financial Service Centre (IFSC), *viz.,* Gujarat International Finance Tec-City (GIFT).

V.12 Draft guidelines for simplified hedging facility for residents and non-residents were released in April 2017 for comments and feedback from the stakeholders. Under the proposed facility, documentary evidence of forex exposure would not be required for booking derivative contracts and net gains on the derivative positions would be passed on to the customer on delivery. To begin with, entities with forex exposure of up to US$ 30 million would be permitted under the facility.

V.13 In fulfilment of the G20 mandate for shifting OTC derivatives on to exchanges or electronic trading platforms, a framework for authorisation of such platforms would be put in place. The implementation of the legal entity identifier (LEI) regime for financial market entities would begin during the year.

FINANCIAL MARKETS OPERATIONS DEPARTMENT (FMOD)

V.14 FMOD is entrusted with the responsibility of conducting liquidity management operations for maintaining appropriate level of liquidity in the financial system for monetary transmission. It also works towards ensuring that orderly conditions are maintained in the forex market through operations in the spot, forward and futures segments.

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Money Markets and Liquidity Management

V.15 The department continued its efforts to maintain an appropriate level of liquidity in the financial system through liquidity management operations, using fixed and variable rate repo and reverse repo under the liquidity adjustment facility (LAF), the marginal standing facility (MSF) and outright open market operations (OMOs), with a view to aligning money market rates with the policy rate for more efficient transmission of monetary policy signals. In line with the change in the monetary policy stance from a deficit to a position close to neutrality, as enunciated in the monetary policy statement of April 05, 2016, the department conducted nine OMO purchase auctions during April-October 2016, injecting liquidity amounting to ₹1.1 trillion into the banking system. The Government of India's decision on November 8, 2016 to withdraw ₹500 and ₹1000 notes resulted in a huge influx of deposits into the banking system. This led to exceptional surplus liquidity conditions in the banking system, which was managed by imposing an incremental cash reserve ratio of 100 per cent, with effect from the fortnight beginning November 26, 2016, on the increase in net demand and time liabilities (NDTL) between September 16, 2016 and November 11, 2016. This was a temporary measure and was withdrawn from the next fortnight, *i.e.*, the fortnight beginning December 10, 2016. The liquidity surplus was also managed through (1) issuance of cash management bills (CMBs) under the market stabilisation scheme (MSS), which touched a peak outstanding level at ₹5,966 billion during the first half of January 2017; and (2) undertaking multi-tenor variable rate reverse repos. The liquidity absorbed by the Reserve Bank (including through MSS) during this period touched a high of ₹7,956 billion on January 04, 2017.

V.16 The department also introduced measures to facilitate the development of the term money market that included security substitution, market-based valuation of collateral securities in LAF operations and re-repo of collateral received by market participants under term reverse repo with the Reserve Bank.

Foreign Exchange Market

V.17 Orderly conditions were maintained in the forex market during the year through operations in the spot, forward and futures segments. The Reserve Bank's foreign exchange market operations, aimed at containing excessive volatility and maintaining orderly conditions in the forex market, resulted in net purchase of foreign currency amounting to US$ 12.3 billion during 2016-17 (US$ 10.2 billion in 2015-16) and US$ 8.9 billion during April-June 2017. Outstanding net forward purchases, which stood at US$ 10.8 billion as at end-March 2017, increased to US$ 17.1 billion at end-June 2017. India's foreign exchange reserves increased to US$ 386.54 billion as at end-June 2017 from US$ 360.18 billion as at end-March 2016.

V.18 During 2016-17, there was smooth unwinding of concessional foreign exchange swaps undertaken by market participants with the Reserve Bank in 2013. These concessional swaps were executed against foreign currency non-resident (bank) [FCNR(B)] deposits maturing from September 2016 onwards. Some of the outflows also pertained to concessional swaps against overseas foreign currency borrowings (OFCBs) of banks. The Reserve Bank's forward forex assets were consciously matched with the FCNR(B) and OFCB liabilities. This helped avoid a sharp fall in the foreign exchange reserves and also neutralised the impact on liquidity which was also managed by appropriately timed OMO purchase operations.

V.19 The department also carried out a number of research studies on market movements and behaviour over the year which helped in shaping the policy and operational framework.

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V.20 The department aims to carry out liquidity management operations effectively in line with the stance of monetary policy by absorbing excess liquidity and maintaining system liquidity at the desired level over the year. The department will continue to closely monitor evolving liquidity conditions and the impact of the narrowing of the corridor (with effect from April 06, 2017) on money markets and will modulate market operations to ensure alignment of the weighted average call rate (WACR) with the policy rate. The expansion of currency in circulation will drain most of the surplus liquidity associated with demonetisation. The residual surplus liquidity, coupled with evolving liquidity inflows and outflows from other sources, will be managed by a judicious mix of the following: (i) variable rate repo and reverse repo auctions with a preference for longer tenors; (ii) operations under the MSS using CMBs, Treasury Bills and dated securities; and (iii) OMO sales and purchases to manage durable liquidity and move the system liquidity to a neutral level, if required.

V.21 The department will continue to conduct foreign exchange intervention operations in an effective manner to curb undue volatility in the exchange rate.

V.22 The department also proposes to continue policy-oriented research on financial markets.

FOREIGN EXCHANGE DEPARTMENT (FED)

V.23 The FED aims at facilitating external trade and payments while enhancing ease of doing business. The department leveraged on information technology for effective monitoring of trade transactions. In pursuance of greater capital account convertibility, the extant rules and regulations under the Foreign Exchange Management Act (FEMA), 1999 were rationalised further during 2016-17. Alongside, the reporting to the Reserve Bank was also simplified. Further, ADs were delegated with greater operational flexibility in the areas of trade and ECBs.

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Rationalisation of Regulations

V.24 As per FEMA, regulations on capital account transactions are notified in consultation with the central government. In the past two years, the Reserve Bank has rationalised a number of regulations in sync with evolving business practices and models relating to, *inter alia*, export and import of currency; acquisition of immovable property outside India by persons resident in India; realisation, repatriation and surrender of foreign exchange; foreign currency accounts by a person resident in India; possession and retention of foreign currency; insurance; remittance of assets; manner of receipt and payment; establishment in India of a branch office or a liaison office or a project office or any other place of business; and export of goods and services. The regulations on acquisition and transfer of immovable property in India by a person resident outside India, borrowing and lending between residents and non-residents, and inward and outward investments are being finalised in consultation with the central government.

Import Data Processing and Monitoring System

V.25 A Working Group on Import Data Processing and Monitoring System (IDPMS) was constituted towards effective monitoring of import payments and, based on its recommendations, a centralised system in the form of IDPMS went live on October 10, 2016 to facilitate efficient data processing for payment of import transactions and its effective monitoring. The IDPMS provides end-to-end monitoring of import transactions from shipment to final payment, thereby doing away with current monitoring on a stand-alone basis by the custom authorities, AD banks and the Reserve Bank.

Startups

V.26 Considering that startups have the potential to play a significant role in economic growth and job creation, their access to foreign funds was eased. Startup companies were permitted to raise funds by issuing convertible notes to persons resident outside India for an amount of ₹2.5 million or more in a single tranche. Further, foreign venture capital investors (FVCIs) were permitted to invest in (a) startups, irrespective of the sector in which the startup operated and (b) in any category-I alternative investment fund. Startups were also allowed to raise ECB up to US$ 3 million or equivalent per financial year either in rupees or any convertible foreign currency or a combination of both.

Easing of Foreign Investment Regime

V.27 The policy on foreign investment was oriented towards greater capital account convertibility and facilitating flow of capital. A comprehensive regulation was issued on receipt of foreign investment by e-commerce entities which clearly defined an e-commerce entity as also inventory based and market place models of e-commerce. Under the regulations, while foreign investment is permitted up to 100 per cent under automatic route for market place model, foreign investment is prohibited in inventory-based model of e-commerce.

V.28 Foreign investment in pension funds was enabled under the automatic route up to 49 per cent. The ownership and control of the Indian pension fund should, however, remain at all times in the hands of resident Indian entities.

V.29 Foreign investment up to 100 per cent was permitted under the automatic route in 'other financial services', *viz.*, activities regulated by a financial sector regulator, subject to certain conditions including minimum capitalisation norms.

V.30 A wholly owned subsidiary in India, set up by a non-resident entity (in a sector where 100 per cent foreign investment was allowed in the automatic route with no FDI-linked conditionalities), was permitted to issue FDI-compliant instruments to the said non-resident entity against pre-incorporation/ pre-operative expenses incurred. The instruments were permitted to be issued up to a limit of five per cent of its capital or US$ 0.5 million whichever was less, subject to certain conditions.

V.31 Persons resident outside India were permitted to invest in the equity of asset reconstruction companies (ARCs) up to 100 per cent under the automatic route. FIIs/ FPIs were permitted to invest up to 100 per cent in security receipts (SRs) issued by ARCs.

Liberalising External Commercial Borrowings

V.32 With a view to developing the market for Rupee-denominated bonds overseas as also for providing an additional avenue to Indian banks to raise capital/long term funds, Indian banks were permitted, within the limit set for foreign investment in corporate bonds, to issue (i) perpetual debt instruments (PDI) qualifying for inclusion as additional tier 1 capital, and debt capital instruments qualifying for inclusion as tier 2 capital, by way of Rupee-denominated bonds overseas; and (ii) long term Rupee-denominated bonds overseas for financing infrastructure and affordable housing. Further, to provide a fillip to Indian entities issuing Rupee-denominated bonds abroad, multilateral and regional financial institutions in which India is a member country have been permitted to invest in Rupee-denominated bonds. Certain conditions, pertaining to maturity period, all-in-cost ceiling and recognised investors were added to Rupee-denominated bonds in order to harmonize the instrument with ECBs.

V.33 To simplify procedures relating to ECBs, powers have been delegated to designated AD category-I banks to deal with extension of matured but unpaid ECB, provided that (i) no additional cost is incurred; (ii) lender's consent is available; and (iii) reporting requirements are fulfilled. Further, powers were delegated to AD category-I banks to approve cases of conversion of matured but unpaid ECB into equity, subject to certain conditions.

BRICS Seminar

V.34 A BRICS seminar on 'Investment Flows: Challenges, Opportunities and Road Ahead' was organised on October 13, 2016 in Mumbai in collaboration with the Ministry of Finance and the Securities and Exchange Board of India. Panel discussions in the seminar deliberated on topics such as loan and equity capital and investment flows in BRICS, portfolio investment and capital flows from low tax jurisdictions. The department conducted a number of 'Forex for You' programmes across the country to spread awareness and clarify issues on FEMA for AD banks and the general public.

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V.35 Changing trends in global trade and investment flows require calibrated responses, both from Indian companies and regulators, necessitating rapid evolution of regulations. During 2017-18, the Reserve Bank proposes to put in place, in due consultation with the central government, regulations pertaining to export in services and succession planning through Indian trusts and cross border mergers and acquisitions.

V.36 On-line payment gateway service provider (OPGSP) guidelines will be reviewed to facilitate e-commerce business and simplify the steps involved in physical fund transfer.

V.37 The Reserve Bank will continuously review current regulations to sync with dynamic market conditions. Towards containing the costs of regulatory compliance, merger of certain forms, *viz.*, advance remittance form (ARF) and foreign currency gross provisional return (FC-GPR), is proposed to be completed apart from introducing a Master form online encompassing all FDI reporting.