V DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

The financial markets functioned smoothly during 2009-10 reflecting the stabilising operations of the Reserve Bank in various segments of the markets as also the sound regulatory framework put in place prior to the global crisis. During the year, with stronger recovery in growth and normal market conditions, market development regained policy emphasis. Regulatory measures initiated were aimed at deepening and strengthening the markets, offering new products, improving transparency and enhancing liquidity. In the money market, a reporting platform for CDs and CPs was introduced with a view to promoting transparency; repo transactions in corporate bonds were allowed to promote liquidity in the corporate bond market and guidelines for accounting of repo/ reverse repo transactions were revised to reflect their true economic sense and enhance transparency. In the government securities markets, measures were undertaken to improve the efficiency of the auction procedure. With a view to further deepening the government securities market, the ready forward facility was extended to unlisted companies which have been issued special securities by the government. The initiatives in the foreign exchange market included rolling back of certain measures taken in response to the global crisis and continuation of the gradual liberalisation of the capital account.

V.1 The global financial crisis widely demonstrated the fault lines in different regulatory structures of countries, whether in the form of multiple regulators with either overlapping jurisdictions or clear separation of roles, or in the form of inadequate coordination mechanism among regulators to ensure systemic stability. The Indian financial system was relatively unscathed by the crisis as its exposure to the stressed/ troubled assets was low and more importantly, India has been following a calibrated approach towards financial sector reforms. Financial stability has been explicitly recognised as a key objective of the Reserve Bank. All the deposit taking entities have been clearly covered under regulatory ambits, while the OTC derivative market is also well regulated, unlike in most other countries. During 2009-10, while the global economic conditions stabilised, India along with several other emerging market economies led the global economic recovery. Reflective of these conditions, Indian financial markets remained stable, which in turn helped in managing the recovery.

MONEY MARKET

V.2 The money market is an important segment of the financial market because it not only reflects the impact of liquidity mismatch in the system but also operates as the first leg in transmitting monetary policy changes to the other parts of the financial system. During 2008-09, against the backdrop of global financial crisis, the policy efforts were primarily aimed at ensuring smooth functioning of this market in an environment of global liquidity squeeze. The sustained availability of ample liquidity helped in containing stress levels in this market segments. With recovery in growth and stabilisation of markets in 2009-10, certain regulatory measures were taken aimed at deepening markets, improving transparency and promoting liquidity.

Reporting Platform for Certificates of Deposit (CDs) and Commercial Papers (CPs)

V.3 In order to promote transparency in the secondary market for CDs and CPs, the Reserve Bank has introduced a reporting platform, similar to corporate bonds platform being operated by FIMMDA, for all secondary market transactions in CDs and CPs. The reporting platform, operationalised by FIMMDA with effect from July 01, 2010, captures and disseminates secondary market transactions in CDs and CPs. The Reserve Bank has mandated all its regulated entities to report their OTC trades in CDs and CPs on the FIMMDA reporting platform. Other regulators *viz*., SEBI and IRDA have since advised their regulated entities to report all trades in CDs/CPs on this platform.

Repo in Corporate Bonds

V.4 As a measure aimed at development of the corporate bond market, the Reserve Bank permitted repo in corporate bonds from March 1, 2010. All repo trades in corporate bonds have to be reported to the FIMMDA reporting platform for real-time dissemination of price/yield information to the market participants. The repo trades in corporate bonds shall settle through the mechanism available in the case of OTC trades in corporate bonds, *i.e*., D*v*P-I based settlement through the NSCCL and ICCL. Only listed corporate debt securities which are rated 'AA' or above are eligible securities for repo transactions. SCBs, PDs, NBFCs, AIFIs and other regulated entities are eligible to undertake repo transactions in corporate debt securities. The repo transactions in corporate debt securities would be accounted as borrowing/lending transactions. The participants entering into repo in corporate bonds are required to sign the Global Master Repo Agreement (GMRA) as finalised by the FIMMDA.

Revised Guidelines for Accounting of Repo / Reverse Repo Transactions

V.5 The accounting guidelines on repo/reverse repo transactions issued on March 24, 2003 captured the character of repo/reverse repo transaction as outright sale and outright purchase as per the market convention prevailing then. The Reserve Bank of India (Amendment) Act, 2006 defines 'repo' and 'reverse repo' as instruments for borrowing (lending) funds by selling (purchasing) securities with an agreement to repurchase (resell) the securities on a mutually agreed future date at an agreed price, which includes interest for the funds borrowed (lent). Accordingly, to bring repo/reverse repo transactions onto the balance sheet to reflect their true economic sense and enhance transparency, the accounting guidelines have been reviewed and the revised guidelines came into effect from April 1, 2010. The revised guidelines specify, *inter alia*, that the movement of securities should be accounted for in the books of the counterparties by showing the same as contra entries for the sake of greater transparency.

Regulation of Non-Convertible Debentures (NCDs) of Maturity up to One Year

V.6 In order to address the regulatory gap that existed in the case of issuance of NCDs of maturity up to one year through private placement, the Reserve Bank has issued Directions in terms of section 45W of the RBI (Amendment) Act, 2006 on June 23, 2010. The Directions provide for regulation of the issuance of NCDs of maturity up to one year, which are money market instruments. The Directions are applicable to both secured as well as unsecured NCDs. As per the Directions, NCDs cannot be issued for maturity less than 90 days and cannot have call/put options that are exercisable within 90 days from the date of issue. Issuers of the NCDs need to appoint a Debenture Trustee and all issuances are to be reported to the Reserve Bank. The eligibility criteria, rating requirements, *etc.*, for these NCDs have been prescribed broadly in line with the extant guidelines on issuance of CPs.

GOVERNMENT SECURITIES MARKET

V.7 The government securities market is regarded as the backbone of fixed income securities markets as it provides the benchmark yield and imparts liquidity to the financial system. From the perspective of the Government, a deep and liquid government securities market facilitates its borrowings from the market at a reasonable cost without incurring rollover risk. For a central bank, a developed government securities market allows greater use of indirect or market based instruments of monetary policy, such as open market operations and repo. Recognising the need for a well developed government securities market, the Reserve Bank, over the years has initiated a series of measures in the government securities market, which include, *inter alia*, market-based price discovery, widening of investor base, introduction of new instruments, establishment of primary dealers and electronic trading and settlement infrastructure.

V.8 During 2008-09, against the backdrop of global financial crisis and the consequent fiscal stimulus package initiated by the government, the market borrowing by the government dominated the activities of the markets. During 2009-10, the borrowing requirements of the government remained high as the fiscal policy stance remained supportive of the recovery. The initiatives regarding development of government securities market during the year were aimed at upgrading the systems, harnessing the developments in technology, ensuring greater transparency, smoothening operating procedures and deepening the market.

Auctions of Government Securities

V.9 The Negotiated Dealing System-Auction platform (NDS-Auction) version 2.0 with capability of handling treasury bill auction was upgraded to conduct the auction of dated securities effective May 13, 2009. In order to improve the efficiency of the auction procedure, the Reserve Bank, in consultation with the Government of India (GoI), has made changes in the manner in which bids are submitted in the auctions of the GoI dated securities and treasury bills, in line with the recommendations of the Working Group on Auction Process of GoI Securities (Chairman: H.R. Khan). These measures include early announcement of the results of the auction and submission of non-competitive bids in electronic form.

Extension of Ready Forward Facility

V.10 Ready forward facility has been permitted by the Reserve Bank in dated securities, treasury bills and state development loans (SDLs) to persons or entities maintaining either a Subsidiary General Ledger (SGL) account or Constituent Subsidiary General Ledger (CSGL) account. With a view to further deepening the government securities market, in addition to the existing categories of eligible entities, unlisted companies, which have been issued special securities by the Government of India and maintain gilt accounts with SCBs, have been permitted to enter into ready forward facility.

Introduction of STRIPS in Government Securities

V.11 The guidelines relating to Separate Trading of Registered Interest and Principal of Securities (STRIPS) in government securities became effective from April 1, 2010. The STRIPS in government securities would ensure availability of sovereign zero coupon bonds, which would lead to the development of a market determined zero coupon yield curve (ZCYC), provide institutional investors with an additional instrument for their asset-liability management, and be attractive to retail/non-institutional investors as they have zero reinvestment risk.

Non-Competitive Bidding for SDLs

V.12 The scheme of non-competitive bidding for state government securities was introduced from the auction held on August 25, 2009. Under this scheme, 10 per cent of the notified amount is reserved for the non-competitive bidders (as against 5 per cent in respect of central government dated securities).

Penalty for SGL Bouncing

V.13 The penalty for subsidiary general ledger (SGL) bouncing has been revised effective July 14, 2010 in the light of the provisions of section 27 and sub-section (3) of section 30 of Government

Securities Act 2006. In terms of the earlier guidelines, if the SGL transfer form bounced three times in a half year, for want of either funds or the securities, the account holder was liable to be debarred from using SGL account facility for a period of six months. After restoration of the facility, if the SGL transfer form bounced again, such account holder was liable to be debarred from using SGL facility. Under the revised guidelines, graded monetary penalties (subject to a maximum penalty of ₹ 5 lakh per instance) are charged for the first nine instances in a financial year while the tenth default would lead to debarment from under taking short sales for the remaining part of the financial year. The permission to undertake short sales shall be restored in the next financial year subject to certain requirements in terms of improved internal controls, *etc*.

FOREIGN EXCHANGE MARKET

V.14 India experienced a resumption of net capital inflows during 2009-10, as witnessed in other emerging market economies (EMEs), driven by the easy liquidity conditions in the global system, low interest rates prevailing in advanced economies and robust growth prospects of the domestic economy. Large and persistent capital flows can potentially jeopardise financial stability as surge in capital inflows in excess of domestic absorptive capacity, could give rise to liquidity overhang, exert upward pressures on exchange rate and overheat asset prices. Further, volatile capital flows are often procyclical, which complicate macroeconomic management. FDI and NRI deposits have been stable components of capital flows in India, while FIIs, ECB, trade credit and banking capital (excluding NRI deposits) remain volatile. Thus, management of capital flows, during episodes of both surges and sudden stops, has been a key challenge for the Reserve Bank.

Current Account

V.15 The Reserve Bank had to continue some of the measures taken during the global crisis to enhance availability of foreign exchange liquidity to avoid disruptions to trade and growth in the initial months of 2009-10. Subsequently however, with stabilisation of global financial markets, easy domestic liquidity and improvement in the trade credit conditions, some of these measures were either scaled down or rolled back. The facility of enhanced export credit refinance limit (from 15 per cent to 50 per cent) provided to the commercial banks by the Reserve Bank was rolled back to the pre-crisis level of 15 per cent on October 27, 2009. The special rupee refinance facility to EXIM Bank was discontinued with effect from April 1, 2010. Further, the swap facility to EXIM Bank has been reduced from USD 1 billion to USD 525 million (the outstanding level as on January 25, 2010), which will be available only up to September 30, 2010. The period of realisation and repatriation to India of the amount representing the full export value of goods or software, which was enhanced from 6 months to 12 months from the date of export initially up to June 2009, however, has been further extended up to March 31, 2011.

V.16 To facilitate transactions and settlements among the Asian Clearing Union (ACU) countries, participants in the ACU have been given the option to settle their transactions either in ACU dollar or in ACU euro, effective January 1, 2009.

Capital Account

V.17 The Reserve Bank pursues a policy of active capital account management in the absence of full capital account convertibility. ECB, as a policy instrument, has been flexibly used during periods of both high capital inflows and sudden reversals. During the global crisis period, ECB norms were liberalised by expanding the list of eligible borrowers, easing all-in-cost ceilings, and allowing relaxations in end-use stipulations. A facility of buyback of FCCBs was made available to the Indian corporates to benefit from asset price corrections in global markets. This facility, initially available up to June 30, 2010, has been extended up to June 30, 2011, under the approval route. Following the improvement in the credit market conditions and narrowing of credit spreads in the international markets, the relaxation allowed in the all-in-cost ceilings under the approval route for ECB was withdrawn, with effect from January 1, 2010.

V.18 ECB policies were further liberalised to facilitate flow of more external funds to the infrastructure sector to augment the growth potential of the economy. A separate category of NBFCs, *viz*. Infrastructure Finance Companies (IFCs) was introduced for accessing ECB for on-lending to the infrastructure sector. The facility of credit enhancement of raising debt through capital market instruments by entities in the infrastructure sector as also IFCs has been put in place. SEZ developers have been allowed to avail ECB for developing infrastructure facilities within the zones under the approval route. The definition of the infrastructure sector has been expanded by including farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat, as announced in the Union Budget 2010-11. Corporates engaged in development of integrated township have been permitted to avail of ECB, under the approval route, up to December 31, 2010. Take-out financing has been permitted through ECB under approval route to enhance availability of credit to the infrastructure sector.

V.19 The conversion price norms for FCCBs were relaxed by the government in February 2010, to enable Indian companies to renegotiate the conversion prices, which are substantially in premium even to the current market prices. These measures would facilitate higher conversion ratio and avoid the situation of redemption of bonds, for which many issuers have not provided adequate liquidity. The revision in pricing is, however, subject to approval by the Reserve Bank.

V.20 The process of capital account liberalisation continued in the areas of foreign direct investment, portfolio investment, and overseas investment by Indian corporates, besides further development of forex market. The policy of removal of procedural impediments and anomalies in external transactions was strengthened to make the liberalisation process more meaningful. The guidelines for issue of Indian Depository Receipts (IDRs) have been operationalised since July 2009, thereby enabling foreign companies to mobilise funds directly from the Indian capital market. Now residents can make investments in foreign securities without any limits and going through currency conversion in India. Foreign Institutional Investors (FIIs) registered with the SEBI and the Non-Resident Indians (NRIs) are also allowed to invest, purchase, hold and transfer IDRs.

V.21 FIIs have been permitted to offer domestic government securities as collateral to the recognised stock exchanges in India, in addition to cash and AAA-rated foreign sovereign securities, for their transactions in the cash segment of the market. However, cross-margining of government securities (placed as margins by the FIIs for their transactions in the cash segment of the market) is not allowed between the cash and the derivative segments of the market. The pricing guidelines in respect of issue of shares including preferential allotment and transfer of equity instruments from a resident to a non-resident and *vice versa* have been revised.

V.22 To simplify the procedure, an on-line reporting system for Overseas Direct Investment (ODI) by the Indian parties has been operationalised in a phased manner, with effect from March, 2010. The new system would enable on-line generation of the Unique Identification Number (UIN), acknowledgment of remittance/s and filing of the Annual Performance Reports (APRs) and easy accessibility of data at the AD level for reference purposes.

CORPORATE BOND MARKET

V.23 The absence of an active corporate bond market has generally been perceived as a major hindrance to long term funding of infrastructure projects. In the Indian case, bank finance, coupled with equity markets and external borrowings have been the preferred funding sources for raising of resources, as compared to the corporate debt market. Public financial institutions and financial intermediaries have been dominant issuers in the corporate debt market although in the recent past, following the lack of access to overseas markets, non-financial sector entities have also been raising funds in this market. Recognising the importance of this market segment and following the recommendations of the High Level Expert Committee on Corporate Bonds and Securitisation (Chairman: Dr. R.H. Patil), a number of steps have been taken in the recent years to address issues related to the primary issuance and smoothen the secondary market trading process for corporate bonds. The efforts to deepen and strengthen this market segment continued in 2009-10.

Settlement of OTC Trades in Corporate Bonds

V.24 In order to facilitate D*v*P based settlement for OTC trades in corporate bonds, the National Securities Clearing Corporation Limited (NSCCL) and the Indian Clearing Corporation Limited (ICCL) have been permitted to open transitory pooling accounts with the Reserve Bank of India, Mumbai. The buyers of the securities can transfer funds from their bank accounts to this account under RTGS to settle OTC trades in corporate bonds on a D*v*P-I (*i.e.,* on a trade-by-trade) basis. The clearing house thereafter transfers the securities from the seller's account to the buyer's account and effects the release of funds from the transitory account to the seller's account. Accordingly, all Reserve Bank regulated entities have been mandated to clear and settle their OTC trades in corporate bonds through the NSCCL or ICCL under the above arrangement, with effect from December 1, 2009.

DERIVATIVES MARKET

V.25 In the pre-global crisis period, derivatives were viewed as important instruments of price discovery, portfolio diversification and risk hedging. However, given the role of the derivative products in the recent global financial crisis, such products are internationally being viewed as a potential source of risk to systemic stability. In India, even before the onset of the global crisis, the approach to introduction of derivative products had been cautious. In terms of the RBI (Amendment) Act, 2006, the Reserve Bank is empowered to regulate, *inter alia*, the money market, the government securities market, the credit market, the foreign exchange market and the related derivatives. In respect of OTC derivatives, only those derivatives where one party to the transaction is regulated by the Reserve Bank, have legal validity. In respect of products traded on the exchanges, procedures for trade execution and settlement fall within the regulatory purview of SEBI. Thus, unlike many countries, India has established procedures for regulation of OTC derivatives.

V.26 Even though this cautious approach has demonstrated its merits during the period of global financial crisis, the need to introduce products through which the market participants can diversify and hedge their risks is acknowledged by the Reserve Bank. The regulatory efforts to widen and deepen these markets were therefore, continued by the Reserve Bank during 2009-10.

Interest Rate Futures

V.27 The Interest Rate Futures contract on 10-year notional coupon bearing GoI security was introduced on August 31, 2009. Going ahead, and based on the market feedback and the recommendations of the Technical Advisory Committee (TAC) on the Money, Foreign Exchange and Government Securities Markets, the Bank has proposed to introduce interest rate futures on 5-year and 2-year notional coupon bearing securities and 91-day treasury bills. The RBI-SEBI Standing Technical Committee shall finalise the product design and operational modalities for introduction of these products on the exchanges.

Credit Default Swaps (CDS)

V.28 Credit Derivative as a product remains one of the important risk management tools, enabling the investors to transfer/hedge their credit risk. This ability to hive off credit risk encourages investors to hold bonds, thus enhancing the liquidity in the markets.

V.29 In 2007, the Reserve Bank had issued draft guidelines for introduction of credit default swaps (CDS) in India. However, the issuance of final guidelines was kept in abeyance, in view of the role of credit derivatives in the recent financial crisis. It was considered appropriate to proceed with caution, reflecting the lessons from the financial crisis in this regard. In the Second Quarter Review of monetary policy 2009-10, it was proposed to introduce plain vanilla OTC single-name CDS for corporate bonds for resident entities, subject to appropriate safeguards, taking inputs from the international work already conducted/underway in the area of credit derivatives. To begin with, it was proposed that all CDS trades would be required to be reported to a centralised trade reporting platform and in due course they would be brought on a centralised clearing platform. An internal working group was set up to formulate operational guidelines for introduction of CDS, in line with the announcement made in the Review. The draft report of the group has since been placed on the Bank's website on August 04, 2010 for public comments.

Exchange Traded Currency Derivatives

V.30 The currency futures are operational in USD-INR since August 2008. Three more currency pairs, *viz.* Euro-INR, Japanese Yen-INR and Pound Sterling-INR were introduced in the currency futures market during 2009-10 to provide more avenues to hedge the currency exposure of Indian residents. Users can now choose an appropriate currency pair to hedge their exposures directly, without crossing with other currencies. In the interest of financial stability, participation in the currency futures markets is, however, restricted to residents and the issue of wider participation will be examined at a later stage.

V.31 In order to expand the existing menu of exchange traded hedging tools, recognised stock exchanges have since been permitted to introduce plain vanilla currency options on spot US Dollar / Rupee exchange rate for residents.

Reporting of OTC Derivative Transactions

V.32 The issues of transparency and the need for information repositories for transactions in OTC derivatives have assumed sharper focus in the post-global crisis scenario. In India, centralised reporting of OTC trades in interest rate derivatives [interest rate swap (IRS)/forward rate agreements (FRAs)] commenced in August 2007 on the reporting platform of Clearing Corporation of India Limited (CCIL). To capture the trade data pertaining to all OTC derivative transactions for regulation, surveillance and transparency purposes, it is necessary to extend the existing reporting arrangement in respect of IRS to all other OTC derivatives including forex derivatives. Accordingly, the Reserve Bank has set up a Working Group consisting of members of the Reserve Bank, the CCIL and market participants to work out the modalities for an efficient, single point reporting mechanism for all OTC interest rate and forex derivative transactions.

V.33 During 2009-10 the Reserve Bank facilitated the process of recovery by initiating appropriate measures aimed at reducing stress in the financial markets, and smooth conduct of transactions in the financial system. Consistent with the market development goal, several regulatory measures were taken during the year, aimed at enhancing the contribution of the financial system to economic growth, while containing vulnerability to instability. The cautious and gradual approach would continue, driven by the primary goal of ensuring a financial market condition that meets the needs of the real economy.