V FINANCIAL MARKETS AND FOREIGN EXCHANGE MANAGEMENT

During 2015-16, the Reserve Bank undertook measures aimed at broadening participation – both domestic and foreign, widening the range of products and bolstering the financial market infrastructure. Initiatives in the money market included proactive liquidity management, providing market participants more flexibility, reducing volatility and improving transmission of monetary policy signals. The regulatory regime for the foreign exchange market was further streamlined in terms of rules for transactions and reporting requirements.

V.1 The Reserve Bank has, over time, guided and nurtured the evolution of financial markets in India in tune with the needs of a growing economy, but making them more accessible and globally integrated has been a recent focus. Efforts have also been directed at improving ease of doing business by way of rationalising existing regulations on an on-going basis and simplifying documentation requirements. At the same time, steps have also been taken to render the financial markets more resilient to external as well as internal shocks.

FINANCIAL MARKETS REGULATION DEPARTMENT (FMRD)

V.2 FMRD is primarily responsible for regulating and developing money, government securities (g-secs), foreign exchange and related derivatives markets. The department took concerted steps to fulfil its mandate of easing market norms for all participants, improving accessibility, increasing the number of financial products, strengthening market infrastructure as also employing market analytics and surveillance mechanism for policy inputs.

Agenda 2015-16: Implementation Status

V.3 Towards developing a more predictable investment regime, a medium-term framework (MTF) was announced in October 2015 for a phased increase in foreign portfolio investment limits for central government securities and state development loans. Based on the recommendations of the Implementation Group on Encouraging Greater Retail Participation in G-Secs (Chairperson: Smt. Rekha Warriar), the Clearing Corporation of India Ltd. (CCIL) was advised to enable participation of demat account holders in negotiated dealing system order-matching (NDS-OM).

V.4 A Working Group (Chairman: Harun R. Khan), set up under the aegis of the Financial Stability and Development Council Sub-committee (FSDC-SC) considered several measures for strengthening participation, improving market infrastructure and easing the issuance process for corporate bonds. Unlisted securities and securitised debt instruments will shortly be added to the basket of corporate debt for foreign portfolio investor (FPI) investments.

V.5 Guidelines on the introduction of cross-currency futures and options on exchanges were issued on December 10, 2015. Covered options against underlying currency exposures have been allowed. Comments were sought from market participants on the recommendations of the Working Group on Introduction of Interest Rate Options (Chairman: Professor P.G. Apte).

V.6 With a view to further liberalising existing hedging facilities and harmonising the OTC and exchange traded markets, the limits for all resident individuals, firms and companies to book foreign exchange forwards and foreign currency-Indian rupee (FCY-INR) options contracts on the basis of declaration have been increased from US$ 250,000 to US$ 1,000,000. Indian residents having long term foreign currency (FCY) borrowings were permitted to enter into FCY-INR swaps with multilateral or international financial institutions (MFIs/IFIs), in which the Government of India is a shareholding member provided such swaps were undertaken by the MFI/IFI concerned on a back-to-back basis with an authorised dealer (AD) Category-I bank in India.

V.7 Existing guidelines on various financial instruments were comprehensively reviewed with a view to rationalising participation. In the when-issued (WI) market, scheduled commercial banks were allowed to take short positions whereas all eligible entities were permitted to take long positions. Primary dealers (PDs) were allowed to participate in exchange traded currency futures market. For a more broad based participation in OTC derivatives, regulated entities other than banks and PDs such as mutual funds and insurance companies have been enabled to trade in such derivatives on electronic platforms with guaranteed settlements by the CCIL.

V.8 In a move to a more informed policy making process, a standing group on OTC derivatives reforms was constituted under the Technical Advisory Committee on Financial Markets.

V.9 The Financial Benchmarks India Pvt. Ltd. (FBIL) took over the administration of the benchmark for the overnight inter-bank rate based on the actual traded rates on July 22, 2015, replacing the existing ‘FIMMDA-NSE Overnight MIBID/MIBOR’ by ‘FBIL-Overnight MIBOR’. FBIL started publishing the polled term Mumbai interbank offer rate (MIBOR) for three tenors, *viz.,* 14-day, one month and three months from September 23, 2015. In continuation of these efforts, it started publishing the FBIL FC-Rupee Options Volatility Matrix rates from May 05, 2016. FBIL proposes to take over the administration of foreign exchange benchmarks and other Indian rupee (INR) interest rate benchmarks over a period of time in consultation with the stakeholders. The CCIL trade repository expanded the public dissemination of data on a gross basis in pursuit of enhanced transparency. In addition to data on interbank OTC trades on interest rate swaps/forward rate agreements, credit default swaps (CDS) and USD/INR forwards and options, CCIL has also started disseminating data on short term USD/INR interbank near maturity swaps, *i.e.,* Cash-Tom, Tom-Spot and Cash-Spot from December 28, 2015.

Agenda for 2016-17

V.10 Initiatives currently under consideration include changes in e-Kuber to facilitate seamless transfer of g-secs between demat accounts and subsidiary general ledger/gilt accounts and operationalising electronic platforms for repo in corporate bonds in coordination with the Securities and Exchange Board of India (SEBI). Public feedback on the draft framework to comprehensively review documentation requirements in the OTC foreign exchange market has been received and is being examined for implementation. Guidelines on commercial paper (CP), CDS and Separate Trading of Registered Interest and Principal of Securities (STRIPS) will be reviewed to bolster trading activity in these products. Guidelines on currency options relating to suitability and appropriateness will be revisited to make them less restrictive. Taking into account the feedback received from the market, final guidelines on introduction of interest rate options will be issued. In order to further develop the rupee futures market, money market futures will be introduced.

V.11 In fulfilment of the G20 mandate for shifting OTC derivatives on to exchanges or electronic trading platforms, where appropriate, a framework for authorisation of such platforms will be put in place. The legal entity identifier (LEI) uniquely identifies parties to financial transactions globally, the need for which was felt in the aftermath of the global financial crisis. The implementation of the LEI regime for financial market entities will begin during the year. The scope of dissemination of OTC forex derivative transactions by the CCIL Trade Repository will be expanded.

V.12 Market surveillance will be strengthened through use of technology. Data analytics will be leveraged to enhance surveillance capabilities across market segments. Towards leveraging the benefits of Fin Tech, the adoption of various innovations in strengthening market infrastructure will be explored by engaging with industry participants and other central banks.

V.13 Exposure of Indian entities to commodity price risks has been accentuated by the growing integration of the Indian economy with the rest of the world and increasing volumes of cross border trade. An expert group will be set up to review the existing framework for hedging of commodity price risks by Indian entities in the overseas markets with the objective of addressing the gaps in terms of commodities covered, permitted products and users.

FINANCIAL MARKETS OPERATIONS DEPARTMENT (FMOD)

V.14 FMOD is responsible for conducting financial markets operations in consonance with the policy stance of the Reserve Bank for supporting monetary policy transmission.

Agenda 2015-16: Implementation Status

Money Markets and Liquidity Management

V.15 Efforts at maintaining appropriate level of liquidity in the financial system continued through liquidity management operations, using the fixed/variable rate repo/reverse repo under liquidity adjustment facility (LAF), the overnight marginal standing facility (MSF), other standing facilities 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. Towards promoting the term money segment while keeping in view evolving liquidity conditions, a 56-day variable rate repo was conducted in January 2016. As part of the technological up-gradation for smoothening liquidity operations, straight through processing (STP) was introduced for fixed rate repo and reverse repo, and MSF on August 03, 2015, enabling eligible participants to receive credit/debit immediately on placement of bids/offers. More flexibility was imparted to LAF/MSF windows with the extension of timing from November 30, 2015.

V.16 With the second and the fourth Saturdays every month being public holidays for banks under Section 25 of the Negotiable Instruments Act, 1881, it was decided to keep open all money market segments on the working Saturdays from September 01, 2015. Towards aligning liquidity operations with the payment system, reverse repo and MSF are being conducted from February 19, 2016 on all Mumbai holidays when the real time gross settlement (RTGS) system is in operation.

RBI Reference Rate

V.17 The Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar) constituted by the Reserve Bank to study various issues relating to financial benchmarks in India recommended that the derivation of the USD/INR RBI reference rate should be based on actual market transactions so as to ensure that it appropriately represents the prevailing spot rate. Accordingly, from May 02, 2016, the Reserve Bank reference rate is being computed on the basis of the volume weighted average of the actual market transactions that have taken place during a randomly selected 15-minute window between 11.30 a.m. and 12.30 p.m. every weekday (excluding Saturdays, Sundays and bank holidays in Mumbai). The other three reference rates, *viz.,* EUR/INR, GBP/INR and JPY/INR will continue to be computed by crossing the USD/INR reference rate with the ruling EUR/USD, GBP/USD and USD/JPY rates.

Foreign Exchange Market

V.18 Orderly conditions were maintained in the forex market during the year through operations in the spot, forward and futures segments. As an additional instrument to address the volatility in the foreign exchange market, intervention in the exchange traded currency derivatives (ETCD) segment commenced in September 2015. Over the last few months, it has proved to be a useful supplementary tool.

Agenda for 2016-17

V.19 The department aims to carry out liquidity management operations effectively as per the revised framework, which entails, *inter alia,* lowering the average *ex-ante* liquidity deficit in the system to a position closer to neutrality by supplying durable liquidity over the year. It will continue to conduct foreign exchange operations, including interventions, in an effective manner. The department will be watchful of market conditions to ensure smooth unwinding of concessional foreign exchange swaps against foreign currency non resident (bank) account [FCNR(B)] deposits maturing from September 2016 onwards.

V.20 The department also intends to introduce measures which are likely to facilitate development of the term money market such as introducing substitution of securities in the LAF window for a specified tenor of repo transactions and accepting collateral based on market value of securities for the LAF/MSF windows. It has taken up a number of research studies on market movements/behaviour over the year which has helped in shaping the policy and operational framework. The department proposes to continue policy oriented research on financial markets.

FOREIGN EXCHANGE DEPARTMENT (FED)

V.21 The mandate of the FED is to promote the orderly development and maintenance of the foreign exchange market in India and to facilitate external trade and payments. Accordingly, the measures undertaken during 2015-16 aimed at promoting ease of doing business, focusing particularly on dealing with increasing complexities of international transactions and also reducing the regulatory costs by rationalising, reviewing and revising regulations and returns.

Agenda 2015-16: Implementation Status

V.22 The guidelines on external commercial borrowings (ECBs) were rationalised and liberalised during 2015-16 in tune with macroeconomic developments and the experience gained in administering ECBs over the years. The overarching principles of the revised framework for ECBs are: (i) fewer restrictions on end-uses, higher all-in-cost ceiling for long term FCY borrowings as the extended term makes repayments more sustainable and minimises rollover risks for a borrower; (ii) a more liberal approach for INR denominated ECBs where the currency risk is borne by the lender; (iii) expansion of the list of eligible overseas lenders to include long term lenders like sovereign wealth funds and pension funds; and (iv) alignment of the list of infrastructure entities eligible for ECBs with the harmonised list of the Government of India.

V.23 To provide greater flexibility in structuring of trade credit arrangements for imports, resident importers were allowed to raise trade credits in INR allowing the transfer of currency risk to overseas lenders. To facilitate rupee denominated borrowings/bonds from abroad, a framework for such issuance has been put in place with defined parameters such as eligible borrowers, recognised investors, maturity, amount and end-uses (Box V.1).

V.24 After the operationalisation of the export data processing and monitoring system (EDPMS), leading to improved monitoring of export transactions, an analogous information technology based system for monitoring import transactions [import data processing and monitoring system (IDPMS)], is being operationalised.

V.25 The Foreign Exchange Management Act (FEMA), 1999 enacted with 25 original notifications has since undergone over 300 amendments. In this context, the task of rationalising FEMA notifications (which are subordinate legislations) was undertaken. So far 15 original notifications and 95 amendments thereof have been rationalised and consolidated into 13 notifications with 'R' series. In addition, 17 Master Directions covering foreign exchange transactions have been issued

Box V.1
Masala Bonds

Foreign currency denominated funding through debt – including external commercial borrowings (ECBs), trade credits and bonds – accounts for about one-fifth of the total corporate funding in India (IMF, 2016). Corporates are thus exposed to exchange rate risks, if insufficiently hedged. This makes a case for raising foreign debt (both contractual and marketable) in Indian rupees.

Issuers from a few countries have floated offshore local currency bonds in recent years. However, such issuances have not grown significantly, except in China. Efforts by Chinese authorities to internationalise the Chinese yuan (CNY), a large offshore Renminbi deposit base and gradual CNY appreciation during 2010-14 led to a surge in issuances of offshore CNY bonds. However, CNY depreciation, default by some Chinese entities and improved access to local markets have dampened investor appetite recently. In 2015, offshore CNY bond issuances slumped to USD equivalent 17 billion after hitting a record USD equivalent 33 billion in 2014 with no new issuances in the first two months of 2016. Mexico, Brazil and Philippines have also seen some amount of offshore local currency bond issuances. In summary, offshore domestic currency bonds still form a very small portion of issuances from emerging market countries.

In India, while rupee denominated contractual borrowings from abroad were permitted in September 2011, in September 2015 the Reserve Bank also allowed Indian entities to issue rupee denominated bonds overseas. Prior to this general permission by the Reserve Bank, international financial institutions like the Asian Development Bank and the International Finance Corporation (IFC) had already obtained permission from the Reserve Bank to issue rupee denominated bonds overseas. IFC, which named its rupee denominated bonds as 'Masala Bonds', has been successful in issuing such bonds on multiple occasions with maturity as long as 15 years. A robust macroeconomic scenario in India and a relatively stable currency view could attract investors to rupee bonds issued overseas by Indian corporates. Foreign investors already involved in the Indian domestic currency space could also be interested in the overseas rupee product. Rupee bonds overseas offer ease of access compared to the process of direct investments in India (registration as a foreign portfolio investor (FPI) and involvement of domestic custodians and brokers and local settlement systems). With restrictions primarily in the form of minimum maturity and no restrictions on cost and end-uses virtually opened up, the window for rupee denominated bonds overseas is expected to become a meeting ground for fund seeking Indian corporates and return seeking foreign investors. The window which witnessed initial activities in the form of private placements of bonds overseas, has gathered steam with diverse offshore investors now getting interested in rupee denominated paper of Indian companies. Total agreements for such papers till the first week of August 2016 by Indian companies were to the tune of ₹60 billion. The borrowings would help in discovery of benchmark rates. Further, addressing of issues like: (i) tax adjusted returns to investors and comparative costs for borrowers and (ii) liquidity in the secondary market for overseas bonds, will render the route even more attractive.

Reference:

International Monetary Fund (IMF), 2016 Country Report No. 16/76 – India, March.

which cover different classes of transactions permitted as per the rules and regulations framed under FEMA. The Master Directions are updated simultaneously whenever there is a change in rules/regulations or there is a change in policy.

Easing of Foreign Investment Regime

V.26 During the year, regulations pertaining to the employee stock options (ESOP) scheme were reframed in sync with the SEBI regulations (for listed companies) and the Ministry of Corporate Affairs' regulations (for unlisted companies). Furthermore, the National Pension System (NPS) was made an eligible investment option for non-resident Indians (NRIs).

V.27 Following the revisions in the foreign direct investment (FDI) policy announced by the Government, the regulations have been amended as: (i) wherever sectoral limits/caps on foreign investment are in place, such limits/caps are required to be reckoned in a composite manner aggregating both FDI and FPI and the 'total foreign investment' in an Indian company is to be taken as the sum total of direct and indirect foreign investments; (ii) foreign investment in limited liability partnership (LLP) is permitted under the automatic route for sectors where 100 per cent FDI is allowed without attendant FDI-linked performance conditionality; (iii) foreign investment up to 100 per cent under the automatic route is permitted in the plantation sector which now includes tea, coffee, rubber, cardamom, palm oil tree and olive oil tree plantations; (iv) the definition of 'real estate business' has been modified and rent income on lease of a property, not amounting to transfer, will not be considered as 'real estate business'; (v) manufacturing has been given a precise definition wherein foreign investment up to 100 per cent under the automatic route is permitted; (vi) entities engaged in single brand retail trading through brick and mortar stores are permitted to undertake retail trading through e-commerce; and (vii) foreign investment in the insurance sector under the automatic route has been increased to 49 per cent from 26 per cent.

Startups

V.28 Pursuant to the Monetary Policy Statement of February 02, 2016, several steps have been initiated to facilitate the ease of doing business and contribute to an ecosystem that is conducive to the growth of startups. Accordingly, a dedicated mailbox was set up to provide assistance and guidance to the startup sector. Further, online submission of form A2 for outward remittances has been enabled. Certain transactions related to startups have been clarified/notified as under: (i) issue of shares without cash payment through sweat equity is permitted, provided that the scheme has been drawn either in terms of regulations issued by the SEBI or the government; (ii) issue of shares against legitimate payment owed by the investee company, remittance of which does not require permission under FEMA, is permitted subject to adherence to the FDI policy; (iii) having an escrow arrangement or paying the consideration on a deferred basis for an amount up to 25 per cent of the total consideration for a period not exceeding 18 months in respect of transfer of shares between a resident and a non-resident and (iv) a startup having an overseas subsidiary has been permitted to open an FCY account with a bank outside India for the purpose of crediting to it foreign exchange earnings out of exports/sales made by the said startup and/or the receivables, arising out of exports/sales, of its overseas subsidiary. Furthermore, payments in foreign exchange arising out of its own or its subsidiaries' sales/exports, have been allowed as a permissible credit to an Indian startup's exchange earners' foreign currency (EEFC) account. In addition, the following proposals are under consideration, in consultation with the Government of India: (i) permitting startups to access rupee loans under the ECB framework with relaxations in respect of eligible lender, end-use and cost of borrowing, *etc.*; (ii) issuance of innovative FDI instruments like convertible notes by startups; (iii) streamlining of overseas investment operations for startups; and (iv) simplifying the process for dealing with delayed reporting of FDI related transactions by building a penalty structure into the regulation itself.

Setting up a Liaison Office, Branch Office or Project Office in India

V.29 In order to improve the ease of doing business in India, the Reserve Bank has liberalised the approval process for setting up liaison/branch/project office in India by delegating most of the authorities to AD banks except for applications received from citizens of/companies registered or incorporated in Pakistan. Furthermore, applications received from citizens of/companies registered in Bangladesh, Sri Lanka, Afghanistan, Iran, China, Hong Kong or Macau for opening offices in Jammu and Kashmir, the Northeast region, and Andaman and Nicobar Islands would require the prior approval of the Reserve Bank.

Non-Resident Deposits and Foreign Currency Accounts of Residents

V.30 Transfers between non-resident ordinary rupee (NRO) accounts have been permitted. Further, NRIs and persons of Indian origin (PIOs) have been permitted to open NRO accounts jointly with other NRIs/PIOs. While permitting remittances outside the country from the balances held in NRO accounts maintained by NRIs and PIOs, ADs are now required to obtain a declaration that the remittances represent the account holder's legitimate receivables in India and do not represent any borrowing from any other person or transfer from any other NRO account. Non-residents having a business interest in India are permitted to open a repatriable special non-resident rupee (SNRR) account with balances commensurate with business operations. An Indian company receiving foreign investment under the FDI route has been permitted to open and maintain an FCY account with an AD in India provided it has impending FCY expenditure. The account needs to be closed immediately after the requirements are completed or within six months from the date of opening of such account, whichever is earlier.

Black Money Act

V.31 Pursuant to the enactment of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act on May 26, 2015, the Reserve Bank has put in place a process for regularising assets declared under the Act which are being held in contravention of FEMA or the rules and regulations framed thereunder.

Trade Transactions and Settlement

V.32 Use of Nostro accounts of commercial banks of the Asian Clearing Union (ACU) member countries, *i.e.*, the ACU dollar and ACU euro accounts, has been allowed for settling payments for both exports and imports of goods and services among the ACU countries.

V.33 Guidelines were issued to banks for settling export/import transactions where the invoicing is in a freely convertible currency and the settlement takes place in the currency of the beneficiary, which though convertible, does not have a direct exchange rate.

V.34 To ease operational difficulties faced by importers of rough, cut and polished diamonds, AD banks have been delegated the powers to permit clean credit for an additional period of up to 180 days over and above the 180 days prescribed period, subject to certain conditions.

Rationalisation of Returns

V.35 Towards rationalisation of returns and liberalisation of procedures, the physical filing of three FDI related returns, *viz.*, advance remittance form (ARF), form foreign currency gross provisional return (FC-GPR) and form foreign currency transfer of shares (FC-TRS) has been replaced with online filing on the Government's e-Biz portal. Reporting by AD banks to the Reserve Bank under the Diamond Dollar Account scheme has been dispensed with. Filing of returns showing details of trade related loans and advances by exporters to overseas importers from their EEFC accounts has also been dispensed with. The submission of documents by full-fledged money changers (FFMC)/AD Category-II while opening additional branches has been relaxed while the single/bulk filing of the SOFTEX form for certification has been made available to all software exporters.

Compounding of Contraventions under FEMA, 1999

V.36 With a view to imparting transparency and providing greater disclosure, the compounding orders passed on or after June 01, 2016 are being put on the Reserve Bank website. For the general public's information, the guidance note on the methodology used for calculating the amount imposed under the compounding process has been hosted on the Reserve Bank website.

Agenda for 2016-17

V.37 To further facilitate trade, payments and investments, the department will: (i) complete the task of rationalising and simplifying notifications issued under FEMA; (ii) rationalise returns to reduce the regulatory burden on users of foreign exchange; (iii) operationalise IDPMS for monitoring of import transactions and (iv) put in place a simplified revised framework for dealing with delayed reporting of FDI transactions. Furthermore, proposals with respect to startups as mentioned above (para V.28) will be implemented in consultation with the government.