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FINANCIAL MARKETS AND FOREIGN EXCHANGE MANAGEMENT

During 2017-18, the Reserve Bank made concerted efforts to strengthen various segments of the financial markets. The Reserve Bank used a variety of instruments to absorb the persisting surplus liquidity in the system for ensuring better alignment of money market rates with the policy rate in order to achieve efficient transmission of monetary policy signals. The Reserve Bank operated in both over-the-counter (OTC) and exchange traded currency derivatives (ETCD) segments to maintain orderly conditions in the forex market. Further rationalisation of regulations while maintaining a mechanism for effective monitoring of foreign exchange transactions was carried out during the year for facilitating cross-border flow of funds.

V.1 The Reserve Bank has always strived to develop the financial markets for meeting the evolving financing needs of a fast growing economy. It issued many directions/circulars during 2017-18 for enhancing the operational flexibility of the market participants. Further, it employed a multitude of liquidity management tools for managing the persistent surplus liquidity condition in the financial system. It also intervened in both OTC and ETCD segments of the forex market for managing excessive volatility. Regulations were rationalised during the year, particularly in respect of foreign investment, cross-border mergers and acquisitions, external commercial borrowings (ECBs), acquisition and transfer of immovable property in India while maintaining a robust reporting structure for monitoring these transactions, with a view to facilitating seamless cross-border flow of funds.

FINANCIAL MARKETS REGULATION DEPARTMENT (FMRD)

V.2 FMRD is tasked with the responsibility for development, regulation and surveillance of money, government securities (G-secs), foreign exchange and related derivatives markets. The department initiated a number of measures during 2017-18, aimed at broadening

participation in financial markets, both domestic and foreign; easing access and transaction norms for participants, widening the range of products, improving financial market infrastructure and maintaining market integrity.

Agenda 2017-18: Implementation Status

V.3 In order to encourage Indian rupee (INR) invoicing of trade transactions while also encouraging non-residents to hedge INR risks onshore, non-resident centralised treasuries of multinational companies were permitted in March 2017 to hedge the INR risk on transactions of their Indian subsidiaries. In October 2017, the scope of this facility was broadened by permitting non-resident importers and exporters (NRIE) entering into INR invoiced trade transactions with residents to hedge their INR exposures through their centralised treasury/group entities.

V.4 The operational complexity of currency hedging activity was also sought to be resolved through a new simplified hedging facility, introduced in November 2017, under which both residents and non-residents could hedge exchange rate risk on any current and capital account transaction with any of the products permissible under the Foreign Exchange Management Act (FEMA), 1999. Further, the

requirement to provide documentary evidence for establishing the exposure was removed. Furthermore, entities could freely resort to dynamic hedging, following the removal of most restrictions on cancellation and rebooking of hedge contracts.

V.5 In February 2018, persons resident in India and foreign portfolio investors (FPIs) were permitted to take positions (long or short), without having to establish existence of underlying exposure, upto a single limit of US\$ 100 million equivalent across all currency pairs involving INR, put together, and combined across all exchanges. Earlier this limit was US\$ 15 million per exchange for position in US\$-INR and US\$ 5 million equivalent per exchange for position in EUR (*i.e.*, euro)-INR, GBP (*i.e.*, Great Britain pound)-INR and JPY (*i.e.*, Japanese yen)-INR pairs, all put together.

V.6 The Reserve Bank allowed FPIs on November 16, 2017 to settle OTC G-sec transactions either on a T+1 or T+2 basis. This measure would enable easing of market pressure on days of short squeeze.

V.7 With a view to improving liquidity in the G-sec market and to address short squeeze, notional short sales were permitted in November 2017, allowing market participants not to compulsorily borrow securities in repo market. In exceptional situations of market stress, entities undertaking notional short sale are permitted to deliver securities from their own held to maturity (HTM)/available for sale (AFS)/held for trading (HFT) portfolios.

V.8 To facilitate further development of Interest Rate Futures (IRF) market, a separate limit of ₹50 billion for FPIs to take long position in IRF was introduced in March 2018. The existing

limits prescribed for investment by FPIs in G-sec (currently ₹2,860 billion) will be exclusively available for investment in G-sec.

V.9 The Financial Benchmarks India Private Limited (FBIL), an independent financial benchmark administrator, introduced five new benchmarks, *viz.*, Treasury Bill (T-Bill) rates, Certificates Deposit (CD) curve, Market Repo Overnight Rate (MROR), Mumbai Inter-bank Forward Offer Rate (MIFOR) and Mumbai Inter-bank Overnight Indexed Swaps (MIOIS) rates during the year, with the approval of the Reserve Bank. As advised by the Reserve Bank, FBIL has started publication of both central government securities and state development loans (SDL) valuation benchmarks with effect from March 31, 2018.

V.10 Draft comprehensive repo directions were issued in March 2018 for simplifying, harmonising and streamlining the existing repo guidelines. After receiving comments from the market participants and other stakeholders, final guidelines will be issued in this regard.

V.11 Rupee interest rate options (IROs) were introduced in December 2016. Initially, only plain vanilla IROs were allowed but, in June 2018, directions on rupee interest rate options were reviewed resulting in the introduction of rupee interest rate swaptions.

V.12 Draft guidelines on the framework of electronic trading platform for financial instruments, regulated by the Reserve Bank, were issued in October 2017 for public comments/suggestions. The objective of this framework is to improve transparency, reduce transaction time and cost, facilitate efficient audit trails, improve risk controls and enhance market monitoring in the financial markets regulated by the Reserve

Bank. Market participants have submitted their views and comments, which are being examined by the Reserve Bank. Based on the evaluation of the feedback, final guidelines will be issued.

V.13 To enhance participation in the G-Sec market, it is proposed to widen the eligible participants' base and relax the position limits in the short sale and 'when issued' segment of the G-Sec market, as announced in the statement on developmental and regulatory policies of June 06, 2018.

V.14 The regulatory regime for FPIs' debt investments was reviewed during the year to provide FPIs greater latitude in managing their portfolios in terms of increased investment limits, eligible instruments, tenor and duration management, etc. The limits for FPI investment in debts have been linked to the outstanding stock - 5.5 per cent for central government securities, 2 per cent for SDLs and 9 per cent for corporate bonds for 2018-19. Investment in corporate bonds has been rationalised by discontinuing its various sub-categories and prescribing a single limit for FPI investment in all types of corporate bonds. The cap on aggregate FPI investments in any central government security has been revised upward from 20 per cent to 30 per cent of the outstanding stock of that security. The minimum residual maturity requirement of three years for investment in debt has been withdrawn, subject to certain conditions. Other macro-prudential measures put in place include: concentration limits for FPI investment as a percentage of overall investment limit in each debt category, short-term investment limits, and single as well as group investor-wise limit in corporate bonds.

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V.15 The department would endeavour to develop derivatives markets in order to promote better risk management by banks and other market players. It would take steps aimed at rationalising access to foreign currency hedging instruments and simplifying such procedures. Ensuring the integrity of the financial markets and eradication of market abuse continue to be high on the agenda of the department. In line with the global best practices, the department plans to frame regulations on market abuse for the markets regulated by the Reserve Bank, as announced in the statement on developmental and regulatory policies of June 06, 2018.

FINANCIAL MARKETS OPERATIONS DEPARTMENT (FMOD)

V.16 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.

Agenda 2017-18: Implementation Status

Money Market and Liquidity Management

V.17 Surplus liquidity conditions in the banking system, which resulted from the withdrawal of Specified Banknotes (SBNs) in November 2016, continued during the year. The department pursued with its efforts to absorb the surplus liquidity with a view to aligning money market rates with the policy rate for more efficient transmission of monetary policy signals. Various liquidity management tools were used such as fixed/variable rate reverse repos under the

liquidity adjustment facility (LAF) and outright open market operations (OMOs) to mop up the surplus liquidity. Further, T-Bills issued under the market stabilisation scheme (MSS) in April-May 2017, which matured in March 2018, served as an additional tool for managing the surfeit of liquidity.

V.18 The extent of surplus liquidity due to SBNs came down by March 2018 on account of the usual year-end fund requirement of banks, including tax payments. This was managed by multi-tenor variable rate repo operations to the tune of ₹1.7 trillion in addition to the regular 14-day variable rate repo operations.

V.19 During the year, the department also adopted new tools to handle situations of excess liquidity. A securities borrowing and lending arrangement (SBLA) scheme was put in place to be used in exceptional circumstances, in case the Bank runs short of securities (to be used as collateral) for absorbing excess system liquidity. Under the SBLA scheme, the Reserve Bank can borrow securities from large institutions to conduct reverse repo operations. With the recent amendment to the RBI Act, 1934 *vide* Finance Bill, 2018, the standing deposit facility (SDF) has been made available for adoption. The SDF would be an unlimited, uncollateralised deposit facility, which once operationalised, would enable the Reserve Bank to absorb unlimited liquidity without any constraint of securities.

V.20 The margin system for LAF/MSF (*i.e.*, marginal standing facility) did not differentiate between the securities on the basis of duration as similar margin requirement was prescribed for securities regardless of their residual maturities. Therefore, it was decided to align margin requirements for LAF/MSF with residual maturities of the securities from August 01, 2018. The initial margin requirement for central

government securities (including T-Bills) would be in the range of 0.5 per cent to 4 per cent for five different buckets of residual maturity. The initial margin requirement in case of SDLs would be in the range of 2.5 per cent to 6.0 per cent for the same maturity buckets. Further, with a view to incentivising the state governments to obtain public rating for their issuances, it has also been decided that the margin requirement for rated SDLs shall be 1 per cent lower than that of unrated SDLs for the same maturity bucket.

Foreign Exchange Market

V.21 Orderly conditions were maintained in the forex market during the year through operations in the OTC and ETCD segments. The liquidity impact was also managed by appropriately timing the OMO operations.

V.22 A new FX Global Code has been formulated by the Bank for International Settlements (BIS) to strengthen the standards and practices in the global foreign exchange (FX) market. The code was launched on May 25, 2017 in London and is being implemented globally by the Global FX Committee (GFXC) in co-ordination with the Local FX Committee (LFXC) in each jurisdiction. The Reserve Bank is a founding member of the GFXC and in India, a LFXC has been set up in coordination with the Foreign Exchange Dealers' Association of India (FEDAI) to take forward the implementation of and adherence to the FX Global Code.

V.23 As announced in the sixth bi-monthly monetary policy statement for 2017-18, the computation and dissemination of the daily reference rate for spot US\$/INR and other major currencies against the INR, which was being done by the Reserve Bank, has been taken over by Financial Benchmarks India Private Limited.

V.24 The department has taken up a number of research studies on market movements/behaviour over the year, which have helped in shaping both policy and operational framework.

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V.25 The department aims to carry out liquidity management operations effectively in line with the stance of monetary policy, by absorbing excess liquidity and supplying durable/temporary liquidity over the year. The department will continue to closely monitor the evolving liquidity conditions and will modulate the operations to ensure alignment of the weighted average call rate with the policy rate. It will continue to conduct foreign exchange operations, including interventions, in an effective manner to curb undue volatility in the exchange rate. The department also proposes to continue policy-oriented research on financial markets.

FOREIGN EXCHANGE DEPARTMENT (FED)

V.26 FED strives to facilitate trade and payments while enhancing ease of doing business. New processes and technologies are adopted while continuing with the basic principles for effective monitoring of all cross-border transactions. In continuation of the mission to streamline the FEMA in alignment with current business and economic scenario, a few more regulations were rationalised during the year. In the process, there has been greater clarity and consolidation of the regulations.

Agenda 2017-18: Implementation Status

Easing of Foreign Investment Regime

V.27 A notification (No. FEMA 20(R)) dealing with Foreign Direct Investment (FDI), viz., Foreign Exchange Management (Transfer or issue of security by a person resident outside India)

Regulations, 2017 was issued on November 7, 2017, subsuming 2 original and 91 amendment notifications while keeping the instructions as principle-based as possible. The highlights of the notification (including subsequent revisions) are as follows:

- (i) While simplifying the instructions, the policy on foreign investment was oriented towards facilitating inflow of capital in a move to make the country a favoured destination for foreign investment.
- (ii) Foreign investment limits for scheduled air transport service/ domestic scheduled passenger airline and regional air transport service were increased from 49 per cent to 100 per cent with investment over 49 per cent requiring prior government approval. In addition, foreign investment up to 49 per cent has been permitted in M/s Air India Ltd., with the condition that substantial ownership and effective control of M/s Air India Ltd., shall continue to be vested in Indian nationals. Foreign investment limit in single brand product retail trading has been increased.
- (iii) Conversion of a company with foreign investment into a limited liability partnership and *vice versa* was permitted under the automatic route subject to certain conditions.
- (iv) FDI and FPI have been defined in line with the recommendations of the Committee on Rationalising the FDI/FII Definition (Chairman: Dr. Arvind Mayaram). In addition, the time period for issue of capital instruments has been brought down from 180 days to 60 days to align the same with the Companies Act, 2013.

- (v) A concept of late submission fee for reporting delays has been introduced.
- (vi) Transfer of shares from non-resident Indians (NRIs)/ overseas citizens of India (OCIs) to persons resident outside India was brought under the automatic route.
- (vii) In order to enable listed Indian companies to ensure compliance with various foreign investment limits, the Reserve Bank, in consultation with Securities and Exchange Board of India (SEBI), has put in place a new system for monitoring foreign investment limits. Necessary infrastructure and systems for operationalising the monitoring mechanism would be made available by depositories. Further, following its implementation, all authorised dealer (AD) banks would be required to provide the details of investment made by their respective NRI clients to depositories. Reporting to the Reserve Bank by FPIs on stock exchange transactions in the existing system, would continue.

Cross-Border Mergers and Acquisitions

V.28 With a view to promoting ease of doing business, a need was felt to lay down a clear and transparent framework for cross-border mergers, covering merger, amalgamation and arrangement between Indian companies and foreign companies. Accordingly, regulations have been laid down for granting in-principle approval to all cross-border merger proposals from the FEMA angle as well as other perspectives. The regulations also prescribe the transactions under FEMA, 1999, which need to be adhered to consequent to a cross-border merger.

Acquisition and Transfer of Immovable Property in India

V.29 The status of an NRI and an OCI has been redefined in the regulation on acquisition and transfer of immovable property. Joint acquisition of immovable property by the spouse of an NRI or an OCI has been permitted. A person being a citizen of Afghanistan, Bangladesh or Pakistan belonging to minority communities, viz., Hindus, Sikhs, Jains, Buddhists, Parsis and Christians, who is residing in India and has been granted a long term visa (LTV) by the government has been permitted to purchase only one residential immovable property in India as dwelling unit for self-occupation and only one immovable property for self-employment, subject to certain conditions. The other stipulations pertaining to acquisition, transfer of immovable properties, and repatriation of sales proceeds, have been modified appropriately.

Revision in Framework for External Commercial Borrowings (ECBs)

V.30 Rupee denominated bonds (RDBs) issued overseas by Indian entities were excluded from the FPI investment limit in corporate bonds.

Refinancing of ECBs

V.31 As per the statement on developmental and regulatory policies issued along with the fifth bi-monthly monetary policy for 2017-18, overseas branches/subsidiaries of Indian banks were permitted to refinance ECBs of highly rated (AAA) corporates as well as *Navratna* and *Maharatna* public sector undertakings, while keeping all other aspects of the ECB policy unchanged: (i) outstanding maturity of the original borrowing is not reduced; and (ii) all-in-cost of fresh ECB is lower than the existing ECB.

Partial refinance of the existing ECBs was also permitted, subject to the same conditions.

Discontinuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits

V.32 The practice of issuance of LoUs/ LoCs for trade credits for imports into India by AD category-I banks in favour of overseas supplier, bank or financial institution up to US\$ 20 million per import transaction for a maximum period up to one year in case of import of non-capital goods and a maximum period of three years for import of capital goods, was discontinued from March 13, 2018. However, letters of credit (LCs) and bank guarantees for trade credits for imports into India continue to be allowed, subject to the prescribed norms.

Rationalisation and Liberalisation of ECBs

V.33 Towards further rationalisation and liberalisation of the ECB guidelines, a uniform all-in-cost ceiling of 450 basis points (bps) over the benchmark rate was stipulated. The benchmark rate was defined as 6 month US\$ LIBOR (or applicable benchmark for respective currency) for track I and track II, and prevailing yield of the Government of India securities of corresponding maturity for track III (Rupee ECBs) and RDBs. The ECB liability to equity ratio for ECB raised from direct foreign equity holder under the automatic route was increased to 7:1 for the total of all ECBs raised by an entity for amounts exceeding US\$ 5 million or equivalent. The eligibility of raising ECBs was extended to housing finance companies, regulated by the National Housing Bank, port trusts constituted under the Major Port Trusts Act, 1963 or Indian Ports Act, 1908 and to companies engaged in the business of maintenance, repair and overhaul, and freight forwarding. The practice of having a separate

positive end-use list and a negative end-use list depending on the category of borrowers (tracks I, II and III) has been discontinued, and it has been decided to have only a negative list for all tracks.

Facilitating Outward Remittance Services by Non-bank Entities

V.34 With a view to facilitating the customers, the system of outward remittance services was further liberalised by extending the operating framework to non-bank entities, provided the remittances were routed through AD-category I banks and such banks should ensure compliance to KYC/AML (*i.e.*, Know your customer/Anti money laundering) standards prescribed by the Reserve Bank.

Data Collection on the Liberalised Remittance Scheme (LRS)

V.35 As per the extant practice, transactions under LRS are permitted by AD banks, based on the declaration made by the remitter. In order to improve monitoring as also to ensure compliance with the LRS limits, a system has been put in place for daily reporting by AD banks of transactions undertaken by individuals under the LRS, which would be accessible to all ADs to ensure verification.

Issuance of Electronic Bank Realisation Certificate (eBRC)

V.36 With a view to having uniformity and consistency of data to enable seamless flow of data as also to reduce documentation, AD category-I banks have been directed to update the Export Data Processing and Monitoring System (EDPMS) with data of export proceeds on 'as and when realised basis' and generate eBRC only from the data available in EDPMS. Integration of EDPMS with eBRC would make

export regularisation simpler and disbursement of duty drawback and incentive process online.

Export Declaration Form Waiver

V.37 Following amendments to the Foreign Trade Policy 2015-20 by the Directorate General of Foreign Trade (DGFT), the annual limit for grant of export declaration form (EDF) waiver to exporters for export items (excluding gems and jewellery, articles of gold and precious metals) on free of cost basis has been revised and reflected in the Master Direction. Such free of cost supplies would not be entitled to duty drawback or any other export incentive under any export promotion scheme. Further, export of goods not involving any foreign exchange transaction directly or indirectly will continue to require the waiver of EDF procedure from the Reserve Bank.

Delegation to Authorised Dealers (ADs)

V.38 The operational powers delegated to AD banks for ratification of delayed reporting of certain routine overseas direct investment (ODI) transactions were extended during the year.

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Rationalisation of Remaining Regulations

V.39 The department has so far rationalised and consolidated 18 original notifications and 193 amendments in consultation with the government. The rationalisation of notifications pertaining to regulations on foreign investments in India, and acquisition and transfer of immovable property in India by person resident outside India was the highlight of the year 2017-18. The remaining notifications pertaining to borrowing and lending between residents and non-residents as well as ODI are being finalised in consultation with the government.

Enhancing Ease of Doing Business by Leveraging Data for Better Policy Making

V.40 During 2017-18, the department has transitioned to a technology-based compilation with greater reliance on technology for collection of information. The availability and accessibility of almost near time data will enhance operational efficiency and overall functioning of the department.