IV DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

IV.1 During 2006-07, the institutional framework for financial markets was further strengthened in terms of instruments and processes to improve price discovery, while allowing greater flexibility to market participants to carry out their transactions. The broad policy objectives in the money market continued to be ensuring stability, minimising default risk and achieving a balanced development of its various segments. Policy initiatives in the Government securities market segment were guided by the need to ensure a smooth transition to a regime in which the Reserve Bank is prohibited from participating in the primary market for Central Government securities, (effective April 1, 2006). The Government Securities Act, 2006 was also passed by the Parliament during the year. The focus in the foreign exchange market was on further liberalising and simplifying the external payments regime for resident entities in pursuance of the recommendations of the Committee on Fuller Capital Account Convertibility (FCAC).

IV.2 This Chapter sets out the various regulatory and development measures initiated by the Reserve Bank during 2006-07 towards further widening and deepening of various segments of financial market under its jurisdiction, *viz*., the money market, the Government securities market and the foreign exchange market. In the money market, a screen-based negotiated quote-driven system for dealings in the call/notice and term money markets was operationalised. Recognising the need for a robust interest rate futures market as an effective instrument for management of interest rate risk, a Working Group has been set up to go into all the relevant issues and to suggest measures to facilitate the development of the interest rate futures market. In the Government securities market, the membership of the NDS-Order Matching (NDS-OM) platform was expanded to include insurance companies, mutual funds and provident funds. The 'when issued' market, which was initially introduced for 'reissued' Central Government dated securities, was later extended to newly issued securities. Short-selling in Central Government securities, which was initially allowed on an intra-day basis, was later extended to five days. In the foreign exchange market, the limit for remittances for individuals was increased from US $ 25,000 to US $ 1,00,000. For corporates, limits on remittances for overseas investments were further raised to facilitate overseas acquisitions. The guidelines for external commercial borrowings were liberalised by raising the prepayment limits. In view of the experience gained by market participants in using various hedging instruments such as forward foreign exchange contracts and options, and improvements in liquidity and accounting systems relating to these instruments, a Working Group on Currency Futures has been set up to study the international experience and suggest a suitable framework to operationalise the proposal.

IV.3 The Technical Advisory Committee (TAC) on Money, Foreign Exchange and Government Securities Markets, which was reconstituted in June 2006, continued to provide valuable guidance to the Reserve Bank on issues relating to the development and regulation of financial markets. Three meetings of the TAC have been held since its reconstitution.

MONEY MARKET

IV.4 The money market is the key link in the transmission of monetary policy impulses. Accordingly, a number of measures have been undertaken in recent years with a view to improving the functioning of various segments of the money market and enhancing the smooth flow of funds across instruments and participants. The broad policy objectives being pursued for the development of the money market are to ensure stability, minimise default risk and achieve a balanced development of various segments through introduction of new instruments, broadening of participants' base and strengthening of institutional infrastructure. The policy thrust given to the growth of the collateralised segment has improved options for liquidity management while reducing risks. Developments in institutional and technological infrastructure have also helped in improving transparency, facilitating price discovery process and providing avenues for better liquidity and risk management.

IV.5 In pursuance of the announcement made in the Annual Policy Statement (April 2006), a screen-based negotiated quote-driven system for dealings in the call/notice and term money markets (NDS-CALL) was operationalised with effect from September 18, 2006. Developed by the Clearing Corporation of India Ltd. (CCIL), the system has helped in improving the ease of transactions, while also bringing about greater transparency and efficient price discovery. Though banks are free to contract deals outside the NDS-CALL system, there is a growing preference for the NDS-CALL screen, which currently accounts for around 75 per cent of the total call money volumes.

Reporting Platform for Interest Rate Swaps

IV.6 The Reserve Bank issued comprehensive guidelines in respect of interest rate derivatives in April 2007, incorporating the broad regulatory framework for undertaking derivative transactions. In respect of over-the-counter (OTC) derivative transactions, it has become necessary to have a mechanism for transparent capturing and dissemination of trade information as well as an efficient post-trade processing infrastructure to address some of the attendant risks. To begin with, the CCIL is being advised to start a trade reporting platform for Rupee Interest Rate Swaps (IRS). This reporting module would be functional by August 31, 2007 and will thereafter be available to all market participants.

Interest Rate Derivatives

IV.7 An anonymous order driven system for trading in Interest Rate Derivatives (IRDs) was introduced on exchanges in 2003. Banks were allowed to hedge the risk in their underlying investment portfolio while primary dealers were also permitted as market-makers. Since then, the Government securities market has undergone numerous developmental measures, including the introduction of short selling and when issued markets. Recognising the need for a robust interest rate futures market as an effective instrument for management of interest rate risk and, in pursuance of the recommendation of the Reserve Bank's Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets, a Working Group on Interest Rate Futures (Chairman: Shri. V. K. Sharma) has been set up in August 2007 to go into all the relevant issues and to suggest measures to facilitate further development of interest rate futures market.

GOVERNMENT SECURITIES MARKET

IV.8 The provision of the Fiscal Responsibility and Budget Management Act, 2003 prohibiting the Reserve Bank from participating in the primary issuances of Government securities came into effect on April 1, 2006. Building upon the measures already put in place in 2005-06 to meet the requirements of the new environment, a number of initiatives were taken during 2006-07 with the objective of further deepening and widening the Government securities market. These measures included extending short selling in the Central Government securities to five-day basis, introduction of 'when issued' market, permitting diversification of primary dealer (PD) business and extension of the NDS-OM module to new participants such as qualified mutual funds, provident funds and pension funds.

NDS-Order Matching System

IV.9 In order to provide market participants of the Government securities with an advanced and efficient trading platform, and as recommended by the Working Group on Screen Based Trading in Government Securities (Chairman: Dr. R. H. Patil), the Negotiated Dealing System - Order Matching (NDS-OM) platform was operationalised on August 1, 2005. Initially, the system accommodated trading only in Central and State Government dated securities. The system was later upgraded to handle trading of Treasury Bills from July 31, 2006. Membership of the NDS-OM, which was initially only for the Reserve Bank regulated NDS members (banks and PDs), has been expanded to include insurance companies, mutual funds and select large provident funds. Apart from the direct access of NDS-OM members, indirect access to NDS-OM through the Constituents' Subsidiary General Ledger (CSGL) route has been extended to qualified entities maintaining gilt accounts with the NDS-OM members. 'Qualified' entities cover all entities that are required by law or by regulation to invest in Government securities such as deposit taking NBFCs, provident funds, pension funds, mutual funds, insurance companies, cooperative banks, regional rural banks and trusts. Furthermore, to encourage retail trading, a separate module on NDS-OM was operationalised to enable trading in odd lots (of sizes less than standard lot of Rs.5 crore).

When Issued Market

IV.10 The Internal Technical Group on Central Government Securities market recommended introduction of 'when issued' (WI) trading in Government securities in a phased manner. It was suggested that in the first phase, WI trading may be permitted in the reissued securities and, after about a year, the same could be extended to new securities as well. The guidelines on 'WI' trading in 'reissued' Central Government dated securities were prescribed

Table 4.1: When Issued Market – Open Position Limits

Category	Reissued Security	Newly Issued Security
1	2	3
Non-PDs	Long position, not exceeding five per cent of the notified amount	Long position, not exceeding five per cent of the notified amount.
PDs	Long or short position, not exceeding 10 per cent of the notified amount	Short position not exceeding six per cent and long position not exceeding 10 per cent of the notified amount.

in May 2006. The actual trading started from August 2006 after the necessary software modifications were carried out in the system. On a review, it was decided to permit 'WI' trading in newly issued securities and the guidelines to this effect were issued in November 2006. At present, the 'WI' trading can be undertaken in Central Government dated securities, both reissued and newly issued securities, on a selective basis. The 'WI' trading is permitted only on the NDS-OM to banks and PDs, subject to the open position limits (Table 4.1). The total traded volumes in 'WI' during the year 2006-07 aggregated Rs.1,320 crore (0.1 per cent of total trading in Government securities during 2006-07). During April-July 2007, total traded volume in 'WI' segment was Rs.270 crore.

Short Selling in Central Government Securities

IV.11 With a view to enabling the market participants to take a two-way view on interest rate expectations and to better manage their interest rate risk, the Internal Technical Group on Central Government Securities recommended the introduction of short selling in Central Government securities in a phased manner. In the first phase, banks/PDs were permitted intra-day short selling from February 28, 2006. Subsequently, on January 31, 2007, the participants were permitted to keep their short positions open up to five trading days including the day of trading. With a view to enabling participants to run short positions across settlement cycles, banks/ PDs have been permitted to use the securities acquired under a reverse repo (other than LAF) to meet the delivery obligation of the short sale transaction. The total reported short sale volume was about Rs.7,900 crore (0.4 per cent of total volume in Government securities) during 2006-07 and Rs.1,119 crore during April-July 2007.

Active Consolidation of Central Government Securities

IV.12 The Internal Technical Group on Central Government Securities recommended the active consolidation of Central Government securities to impart liquidity to the Government securities market. This would involve buying back of a large number of small sized illiquid Central Government securities from existing holders and issuing a smaller number of liquid securities in exchange. The resultant availability of more number of large sized securities, held across a wider base of market participants, is expected to improve the availability of floating stock and trading interest. A scheme of active consolidation was finalised and approved by the Central Government. Under this scheme, securities to be bought back were identified by the liaison group formed for the purpose. In the Union Budget 2007-08, the Central Government provided Rs.2,500 crore towards the premium payment under the scheme. The actual exercise of buying back of securities is expected to be conducted during 2007-08.

Primary Dealers

IV.13 During 2006-07, 17 primary dealers (PDs) were in operation. HDFC Bank Limited was granted approval to take up the PD business and it commenced operations with effect from April 2, 2007. Pursuant to issuance of guidelines for banks undertaking the PD business, nine banks took up PD business departmentally, hitherto carried on by their group entities. With the inclusion of HDFC Bank, the total number of PDs as on July 31, 2007 stood at 18, of which 10 are bank PDs and eight are stand-alone PDs.The following instructions/guidelines having a bearing on the operations of the PDs were issued during the year:

- The system of underwriting in primary auctions was restructured to entrust the PDs with the responsibility to underwrite the entire issue. Under the revised scheme, the PDs are required to meet underwriting commitment instead of the earlier requirements of bidding commitment and voluntary underwriting. The underwriting commitment is divided into two parts: (i) Minimum Underwriting Commitment (MUC); and (ii) Additional Competitive Underwriting (ACU). The PDs are paid underwriting commission which is determined by the success achieved in the ACU auction. During 2006-07, out of 33 primary auctions of dated Government securities, partial devolvement took place on three occasions.

- In order to broad-base the PD activity, the structure of the PD business was expanded to include scheduled commercial banks (excluding RRBs) fulfilling certain minimum eligibility criteria.
- In order to enable the PDs to withstand the vicissitudes of interest rate fluctuations, they were allowed to diversify into other businesses such as investment/trading in equity/equity derivatives/ equity-oriented mutual funds and certain fee-based activities, subject to prudential exposure limits. PD entities were prohibited from setting up subsidiaries. Existing PDs were required to restructure their operations accordingly.

Government Securities Act, 2006

IV.14 The Government Securities Act was passed by the Parliament on August 31, 2006 (see Box I.4). After notification of its effective date, the Act will replace the existing Public Debt Act, 1944. The Government Securities Act, 2006, among other things, recognises pledge and lien on Government securities and also allows stripping of Government securities. An internal Group has been formed to examine various aspects of implementation of the Separate Trading of Registered Interest and Principal of Securities (STRIPS). The software modifications required on the NDS are being worked out.

FOREIGN EXCHANGE MARKET

IV.15 During 2006-07, the Reserve Bank continued to pursue the objective of creating a more conducive environment for external transactions while according high priority to customer service. India's cautious approach towards opening of the capital account and viewing capital account liberalisation as a process contingent upon certain preconditions has held it in good stead. Given the changes that have taken place over the last two decades, the need was felt to revisit the subject and suggest a roadmap towards fuller capital account convertibility (FCAC) based on current realities. In consultation with the Government of India, the Reserve Bank appointed a Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore). The Committee made several recommendations for the development of financial markets in addition to addressing issues related to interaction of monetary policy and exchange rate management, regulation/supervision of banks and the timing and sequencing of capital account liberalisation measures (Box IV.1). The Committee, *inter alia*, noted that countries intending to move towards FCAC need to ensure that different financial market segments, besides being well-developed, in terms of physical infrastructure, skill and competency levels, are also well integrated. If different markets remain segmented, any policy shock to influence market behaviour would not get transmitted to the various segments, thus, leading to inefficiency of policy outcome. Moreover, segmentation impedes the development of a term structure of interest rates, which in turn, impedes the transmission of monetary policy.

IV.16 The Committee on FCAC also recommended that an Internal Task Force should be constituted to re-examine the extant regulations under the Foreign Exchange Management Act (FEMA) and make recommendations to remove the operational impediments in the path of liberalisation already in place. Accordingly, an Internal Task Force was constituted and it completed the assigned task in January 2007. The Task Force made recommendations on 169 issues encompassing all areas under foreign exchange management. Certain recommendations of the Task Force were implemented in the Annual Policy Statement for the year 2007-08 announced on April 24, 2007.

Facilities for Resident Individuals

IV.17 With a view to simplifying the procedures and providing greater flexibility in foreign exchange transactions, the ceiling for remittances for resident individual under the Liberalised Remittance Scheme for Resident Individuals was enhanced in two stages: from US $ 25,000 (per calendar year) to US $ 50,000 in December 2006 (per financial year) and further to US $ 1,00,000 (per financial year) in May 2007. Remittances towards gift and donation by a resident individual as well as investment in overseas companies has been subsumed under the scheme of US $ 1,00,000. The requirement of 10 per cent reciprocal shareholding in the listed Indian companies by such overseas companies has been dispensed with. Banks are not allowed to extend any credit facilities for remittances under the Scheme. Furthermore, remittances towards margins or margin calls to overseas exchanges/overseas counterparty are not allowed under the Scheme. The existing facility of release of exchange by authorised persons up to US $ 10,000 or its equivalent in one calendar year on a declaration basis for one or more private visits to any country (except Nepal and Bhutan) will continue to be available on a self-declaration basis, but on a

Box IV.1
Committee on Fuller Capital Account Convertibility

The Committee on Fuller Capital Account convertibility (Chairman: Shri S. S. Tarapore) submitted its Report in July 2006. The major recommendations were as follows:

Money Market

- Prudential regulations should be strengthened to encourage capital inflows.
- More players should be allowed to access the repo market.
- The CBLO and the repo markets should be allowed to cover corporate debt instruments.
- Skills should be upgraded to develop the inter-bank term money market.
- Prudential limits for commercial paper (CP) and certificates of deposit (CD) may be fixed.
- The market in interest rate futures should be activated and interest rate options should be allowed. Provision for netting of derivative transactions should be made, before opening up the swap market.
- Fixed Income Money Market and Derivatives Association (FIMMDA) be suitably empowered to act as a self-regulatory organisation to develop market ethics, trading standards and also undertake regulation of participants, besides disseminating information.

Government Securities Market

- The share of mark-to-market category should be progressively increased.
- Short-selling across settlement cycles with adequate safeguards should be permitted.
- Gilt funds should be exempted from the dividend distribution tax and income up to a limit from direct investment in gilts could be exempted from tax to stimulate retail investments in gilts.
- STRIPS in Government securities should be expeditiously introduced.
- Non-resident investors, especially longer term investors, could be permitted entry to expand investor base.
- Repo facility in Government securities should be widened by allowing all market players without any restrictions.
- The limit for FII investment in Government securities could be gradually raised to 10 per cent of gross issuance by the Centre and States by 2009-10. The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued.

Foreign Exchange Market

- The spot and forward markets should be liberalised and extended to all participants, removing the constraint on past performance/underlying exposures.
- Bank margins on foreign exchange transactions of smaller customers need to be reduced by separating foreign exchange business from lending transactions and introducing an electronic trading platform.
- The Reserve Bank's intervention in the foreign exchange market should be through the anonymous order matching system.
- To nurture interest rate parity in forward markets, more flexibility may be provided to banks to borrow and lend overseas both on short-term and long-term, depending upon the strength of their balance sheet.
- Currency futures may be introduced subject to risks being contained through proper trading mechanism, structure of contracts and regulatory environment.
- The existing guaranteed settlement platform of CCIL needs to be extended to the forwards market.
- The banking sector should be allowed to hedge currency swaps by buying and selling without any monetary limits.

Fiscal Consolidation

- The Central and the State Governments should graduate from the present system of computing the fiscal deficit to a measure of the public sector borrowing requirement (PSBR).
- The Office of Public Debt should be set up to function independently outside the Reserve Bank.

Strengthening of the Banking System

- All commercial banks should be subject to a single banking legislation.
- The minimum share of the Central Government/ Reserve Bank in the capital of the public sector banks should be reduced from 51 per cent (55 per cent for the State Bank of India) to 33 per cent. The proposed transfer of ownership of the State Bank of India from the Reserve Bank to the Central Government should be put on hold.
- Setting up of new private sector banks and conversion of non-banking finance companies into banks should be encouraged.
- Issues of corporate governance in banks needed early attention.

Monetary Policy

- The Reserve Bank should activate variable rate repo/reverse repo auctions/operations on a real time basis and also consider somewhat longer-term LAF facilities.
- To the extent the Reserve Bank assesses the excess liquidity to be more than transient, it should also use the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).
- The authorities may consider the imposition of an unremunerated reserve requirement on fresh FII inflows in extreme situations.
- The Reserve Bank and the Central Government should jointly set out the objectives of monetary policy for a specific period and this should be put in the public domain. A formal Monetary Policy Committee should be set up for strengthening the institutional framework.

External Sector

- A monitoring exchange rate band of +/- 5.0 per cent around the neutral real effective exchange rate (REER) may be considered and the REER should incorporate services to the extent possible.
- As an operative rule, if the current account deficit persists beyond three per cent of GDP, the exchange rate policy should be reviewed.

financial year (April-March) basis. Total outflows under the Scheme were US $ 42 million for the quarter ended March 2007, led by investments in equity and debt (Table 4.2).

IV.18 A uniform period of six months has been stipulated for surrender of received/unspent/unused foreign exchange from the date of receipt/purchase/ acquisition/date of return of the traveller, as the case may be.

IV.19 In April 2007, resident individuals were permitted to manage/hedge their foreign exchange exposures, including anticipated exposures by booking forward contracts without production of underlying documents up to an annual limit of US $ 1,00,000 which can be freely cancelled and rebooked.

IV. 20 In view of the experience gained by market participants in using various hedging instruments such as foreign exchange contracts and options and improvements in liquidity and accounting systems relating to such instruments, a Working Group on Currency Futures has been constituted to study the international experience and suggest a suitable framework to operationalise the proposal, in line with the current legal and regulatory framework

Facilities for Non-resident Indians and Persons of Indian Origin

IV.21 The requirement of issue of encashment certificate on security paper if the amount of foreign currency encashed exceeds Rs.15,000 in value has been dispensed with. Accordingly, AD category-I banks[1], when requested by the customer, can now issue encashment certificate, duly signed by authorised officials, on their letter head (with their logo printed on it), irrespective of the amount. In cases where the encashment certificate is not issued, unspent local currency held by non-resident visitors will not be allowed to be converted into foreign currency.

Table 4.2 : Remittances under the Liberalised Remittance Scheme for Resident Individuals

(US $ million)

Purpose	Dec-2006	End-Mar-2007
1	2	3
Deposit	1.0	3.2
Purchase of Immovable Property	1.8	4.6
Investment in Equity/ Debt	6.7	14.0
Gift	1.2	6.3
Donations	0.0	0.1
Others	2.7	13.7
Total	**13.3**	**41.9**

IV.22 Non-Resident Indians (NRIs) and Persons of Indian Origin (PIO) are permitted to remit up to US $ 1 million per financial year for any bonafide purpose out of the balances in their Non-Resident Ordinary (NRO) accounts. The balance in the NRO accounts could also include the sale proceeds of immovable property acquired by the non-resident out of her/his resources in India, or sale proceeds of property received by way of inheritance or gift. With a view to providing greater flexibility, the lock-in period of 10 years for remittance of sale proceeds of immovable property was dispensed with, effective November 2006.

IV.23 Taking into account the sizeable increase in non resident deposits in 2006-07 and reports of large growth in advances being granted against such deposits, and in order to avoid upward pressure on asset prices in sensitive sectors, banks were prohibited from granting fresh loans in excess of Rs.20 lakh against the NR(E)RA and FCNR(B) deposits, either to depositors or to third parties, effective January 31, 2007. The banks have also been advised not to undertake artificial slicing of the loan amount to circumvent the ceiling.

Facilities for Corporates

IV.24 In order to provide corporates with greater flexibility in their external transactions, following measures were taken:

(i) Effective May 2007, actual users of aviation turbine fuel (ATF) and domestic producers/users of aluminium, copper, lead, nickel and zinc have been permitted to hedge their price risk in international commodity exchanges, based on their domestic purchases/underlying economic exposures. In other cases, the authorised dealer banks could approach the Reserve Bank for necessary permissions.

(ii) AD category-I banks were permitted to allow re-imbursement of pre-incorporation expenses incurred in India up to five per cent of the

[1] Banks currently authorised to deal in foreign exchange (namely, scheduled commercial banks, State cooperative banks, and urban cooperative banks) are categorised as AD category-I banks. They are authorised to deal in all current and capital account transactions, according to the Reserve Bank's directions issued from time to time.

investment brought into India or US $ 1,00,000 whichever was higher, on the basis of certification from statutory auditors.

(iii) AD category-I banks were permitted (April 2007) to make remittances on account of donations by corporates for specified purposes subject to a limit of one per cent of the foreign exchange earnings of the corporate during the previous three financial years or US $ 5 million, whichever is less.

(iv) The limit for remittance for consultancy service procured from outside by Indian companies executing infrastructure projects was raised (April 2007) from US $ 1 million per project to US $ 10 million per project.

Facilities for Exporters and Importers

IV.25 The following liberalisation/simplification procedures were undertaken with regard to the facilities available to exporters/importers:

(i) All categories of foreign exchange earners were allowed to credit up to 100 per cent (50 per cent earlier) of their foreign exchange earnings to their Exchange Earner's Foreign Currency (EEFC) account, effective November 2006.

(ii) AD category-I banks were allowed (February 2007) to grant extension of time to realise export proceeds beyond the prescribed period of six months, irrespective of the invoice value of exports.

(iii) AD category-I banks were permitted (November 2006) to issue guarantee on behalf of their customers importing services up to US $ 1,00,000, subject to guidelines.

(iv) AD category-I banks were allowed (November 2006) to provide forward cover to hedge the economic (currency indexed) exposure of importers in respect of customs duty payable on imports.

(v) AD category-I banks were permitted to allow importers and exporters to book forward contracts on the basis of a declaration of an exposure and based on the past performance up to the average of the previous three financial years (April to March) actual import/export turnover or the previous year's actual import/export turnover, whichever is higher, subject to the specified conditions. Until December 2006, forward contracts booked in excess of 25 per cent of the eligible limit were to be on a deliverable basis and could not be cancelled. The limit of 25 per cent was increased to 50 per cent in December 2006 and to 75 per cent in April 2007.

(vi) AD category-I bank(s)/Exim Bank were allowed (January 2007) to permit exporters to open, maintain and operate one or more foreign currency account(s) in currency/currencies of their choice with inter-project transferability of funds in any currency or country. Earlier, project/service exporters were allowed to maintain a single foreign currency account for more than one project being executed in the same country; furthermore, the facility of temporary inter-project transfer of funds was available subject to approval from and reporting to the exporter's banker monitoring the project and with condition of re-transfer of the fund to the lending project as soon as possible.

(vii) In January 2007, project/service exporters were allowed to deploy their temporary cash surpluses, generated outside India, in specified instruments/products such as short-term paper abroad including Treasury Bills and deposits with branches/subsidiaries outside India of an AD category-I bank in India. Project/service exporters were earlier required to approach the Reserve Bank for overseas deployment of their temporary cash surpluses.

(viii) In order to increase the competitiveness of the Indian IT sector, the requirement of repatriation of 30 per cent of the contract value in respect of on-site contracts by software exporter company/firm was dispensed with, from February 2007. The company should, however, repatriate the profits of on-site contract after the completion of the said contract.

(ix) In February 2007, AD category-I banks were allowed to approve reduction in the invoice value up to 25 per cent of the invoice, subject to certain conditions, against the earlier limit of 10 per cent.

(x) AD category-I banks were permitted (March 2007) to allow advance remittance, without any limit (as against the earlier limit of US $ 1 million) and without bank guarantee or standby letter of credit, by an importer (other than a public sector company or a department/undertaking of the Government of India/State Government/s) for import of rough diamonds into India from the specified mining companies. The advance remittance would be subject to specified guidelines such as good track record of export, realisation, the bonafides of the transaction and adherence to the KYC norms.

Overseas Investment

IV.26 In order to provide greater flexibility to corporates in regard to their overseas investment, the following measures were taken:

(i) In June 2007, the overseas investment limit (total financial commitments) for Indian parties (companies incorporated in India or created under an Act of Parliament) was enhanced from 200 per cent of their net worth to 300 per cent of their net worth as per the last audited balance sheet. The amount of guarantee is reckoned at 100 per cent of the amount instead of the conversion factor of 50 per cent for determining the total financial commitments. A revised reporting framework on overseas investments was also put in place to capture data on costs and means of funding overseas acquisitions and performance indicators.

(ii) The limit of 25 per cent of net worth for portfolio investment abroad by listed Indian companies in listed overseas companies was enhanced to 35 per cent of net worth in June 2007.

(iii) The limits of remittances for initial/recurring expenses incurred abroad were liberalised in two stages during the year. In April 2006, the limit for remittances for initial expenses was raised to 10 per cent (from two per cent) of the corporate's average annual sales/income/turnover during the last two accounting years; for recurring expenses, the limit was raised to five per cent from one per cent, subject to certain terms and conditions. In December 2006, the limits were further revised to 15 per cent of the average annual sales/income/ turnover or up to 25 per cent of the net worth, whichever is higher, in the case of initial expenses and to 10 per cent of the average annual sales/ income/turnover in the case of recurring expenses. Furthermore, corporates were permitted to make remittances, within the above limits, to acquire immovable property outside India for their business/residential purposes of their staff.

(iv) The aggregate ceiling for overseas investment by mutual funds registered with the Securities and Exchange Board of India (SEBI) was increased from US $ 1 billion to US $ 2 billion in July 2006, to US $ 3 billion in November 2006 and further to US $ 4 billion in May 2007. Moreover, a limited number of qualified Indian mutual funds can now invest cumulatively up to US $ 1 billion in the overseas Exchange Traded Funds as may be permitted by the SEBI. To enable mutual funds to tap a larger investible stock overseas, the requirement of 10 per cent reciprocal shareholding in the listed Indian companies by such overseas companies was dispensed with in July 2006. Furthermore, mutual funds were permitted (June 2007) to invest in (i) overseas mutual funds that make nominal investments (say to the extent of 10 per cent of net asset value) in unlisted overseas securities; (ii) overseas exchange traded funds that invest in securities; and (iii) ADRs/GDRs of foreign companies.

(v) In order to provide operational flexibility to Indian parties for availing fund based and non-fund based facilities overseas, Indian parties were permitted to transfer by way of pledge, the shares held in overseas JV/WOS, to an overseas lender, subject to certain conditions.

(vi) Domestic venture capital funds registered with the SEBI were allowed to invest in equity and equity-linked instruments of off-shore venture capital undertakings, subject to certain terms and conditions.

(vii) Residents with overseas direct investments in equity and debt were permitted to cancel and rebook the forward contracts undertaken to hedge their exchange risk arising out of such investments; earlier, the forward contracts were required to be completed by delivery or rolled over on the due date and not cancelled.

Foreign Investment in India

IV.27 In consultation with the Government of India, foreign investment was allowed in stock exchanges, depositories and clearing corporations, in compliance with the SEBI regulations and subject to the following conditions: (i) foreign investment up to 49 per cent is allowed with a separate FDI cap of 26 per cent and FII cap of 23 per cent; (ii) FDI is allowed with specific prior approval of the Foreign Investment Promotion Board (FIPB); and (iii) FII investment will be allowed only through purchases in the secondary market.

IV.28 In consultation with the Government of India and the SEBI, FIIs were allowed to offer foreign sovereign securities, with AAA rating as collateral to the recognised stock exchanges in India, for their transactions in derivatives segment, subject to the SEBI guidelines. Recognised stock exchanges in India are required to approach the Reserve Bank for specific approvals as may be necessary under the Foreign Exchange Management Act, 1999.

IV.29 In order to facilitate dynamic hedging of foreign exchange exposures and keeping in view the size of the market in India and the large positions held by FIIs, it was decided to implement the flexibility for rebooking cancelled contracts in a gradual and phased manner. Accordingly, in February 2007, AD category–I banks were permitted to allow FIIs to cancel and rebook forward contracts up to a limit of two per cent of the market value of their entire investment in equity and/or debt in India. The limit for calculating the eligibility for rebookings is based upon market value of the portfolio at the beginning of the financial year (April-March). The outstanding contracts must be duly supported by underlying exposure at all times. The AD bank has to ensure that the total outstanding forward contracts do not exceed the market value of portfolio.

External Commercial Borrowings (ECB)

IV.30 In November 2006, corporates were permitted to avail ECBs of an additional amount of US $ 250 million with average maturity of more than 10 years under the approval route. This is over and above the existing limit of US $ 500 million under the automatic route, during a financial year, subject to the compliance with the other ECB criteria such as end-use, all-in-cost ceiling and recognised lender. Prepayment and call/ put options, however, are not permissible for such ECB up to a period of 10 years. Furthermore, with a view to providing greater flexibility to the corporates in managing their liquidity and interest costs, the limit for prepayment of ECB was enhanced from US $ 200 million to US $ 300 million in December 2006 and further to US $ 400 million in April 2007, subject to the compliance with the minimum average maturity period as applicable to the loan.

IV.31 The ECB policy was further reviewed in May 2007. Hitherto, utilisation of ECB proceeds for development of integrated township was permissible. On a review, it was decided to withdraw the exemption accorded to the 'development of integrated township' as a permissible end-use of ECB. Accordingly, utilisation of ECB proceeds is not permissible in real estate, without any exemption. Furthermore, with the sovereign credit ratings of India enhanced to investment grade, the all-in-cost ceilings for ECB were brought down.

IV.32 Based on a review, the ECB policy has been modified (August 2007) as under:

(i) ECB more than US $ 20 million per borrower company per financial year was permitted only for foreign currency expenditure for permissible end-uses of ECB. Accordingly, borrowers raising ECB more than US $ 20 million shall park the ECB proceeds overseas for use as foreign currency expenditures for permissible end uses and shall not remit the funds to India both under the Automatic Route and the Approval Route.

(ii) ECB up to US $ 20 million per borrowing company per financial year would be permitted for foreign currency expenditures for permissible end-uses under the Automatic Route and these funds shall be parked overseas and not be remitted to India. Borrowers proposing to avail ECB up to US $ 20 million for Rupees expenditure for permissible end uses would require prior approval of the Reserve Bank under the Approval Route.

(iii) All other aspects of ECB policy such as eligible borrower, US $ 500 million limit per borrower company per financial year under the Automatic Route, recognised lender, average maturity period, all-in-cost-ceiling, prepayment, refinancing of existing ECB and reporting arrangements remain unchanged.

Anti-Money Laundering (AML) Guidelines for Authorised Money Changers (AMCs)

IV.33 The AML guidelines were amended (June 2006) in view of the difficulties expressed by authorised money changers (AMCs) in implementing some of them. The amended guidelines prescribe that: (i) for purchase of foreign exchange less than US $ 200 or its equivalent, photocopies of the identification document need not be kept on record; however, full details of the identification document should be maintained; (ii) for encashment of foreign exchange between US $ 200 and US $ 2,000 or its equivalent, the photocopies of the identification document should be maintained for one year and completion of statutory audit; (iii) for encashment in excess of US $ 2,000 or its equivalent, the photocopies of the identification document should be maintained for a minimum period of five years; and (iv) requests for payment in cash by foreign visitors/NRIs may be acceded to the extent of US $ 2,000 or its equivalent.

Data Related Issues

IV.34 A 'Working Group on Data Related Issues' was set up to review the data collection/compilation system in pursuance of the recommendation made by the Committee on FCAC. The Group has since submitted the Report.

Outlook

IV.35 The Reserve Bank will continue with its efforts to deepen and widen the money market, the Government securities market and the foreign exchange market in order to enable efficient price discovery in interest rates and exchange rate. Deep and liquid financial markets would enable mobilisation of savings on a greater scale and help to channel these savings to meet the growing investment demands of the Indian economy so as to sustain the current growth momentum. Further development of the term money market, greater flexibility in the use of derivatives in the foreign exchange market, development of the corporate bond market and enhancing liquidity in secondary markets would help in imparting more depth to the domestic financial markets. Efforts will also be aimed at further integration of the various segments of the domestic market so as to strengthen the monetary transmission mechanism and ensure efficient dispersal of risks amongst various market participants, especially in the context of the envisaged move towards fuller capital account convertibility. The Reserve Bank would continue to take steps to maintain integrity and stability of the various segments of the financial market with a view to strengthening macroeconomic and financial stability.