V DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

V.1 During 2007-08, the Reserve Bank continued its efforts to develop the financial markets and provide operational flexibility to participants in the financial markets. Various segments of the financial market in India were generally insulated from the turbulence in the global financial market. The institutional framework for financial markets was further strengthened in terms of new instruments, better market infrastructure and new participants, all of which helped improve the price discovery process. 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. In the Government securities market, the endeavour of the Reserve Bank was to broaden and deepen it in terms of participants, instruments and processes. Consequent upon the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 and withdrawal of the Reserve Bank from the primary segment, development of the Government securities market has assumed vital importance. The Government Securities Act, 2006 has provided enhanced powers to the Reserve Bank in the matter of consolidation and management of Government securities.

V.2 In the foreign exchange market, the Reserve Bank took several initiatives to rationalise and simplify the procedures in the conduct of foreign exchange transactions with a view to facilitating prompt and efficient customer service. Keeping in view the recommendations of the Committee on Fuller Capital Account Convertibility (CFCAC), a number of measures were taken towards liberalisation of foreign exchange transactions. The Reserve Bank of India (Amendment) Act, 2006 provided enhanced operational flexibility and greater manoeuvrability to the Reserve Bank in monetary and financial sector management. The Act empowered the Reserve Bank to regulate interest rate, foreign currency derivatives and credit derivatives. Accordingly, the Reserve Bank took several measures to further develop derivatives in the country. The Technical Advisory Committee (TAC) on Money, Foreign Exchange and Government Securities Markets provided valuable guidance to the Reserve Bank on issues relating to the development and regulation of financial markets.

V.3 This Chapter sets out the various regulatory and development measures initiated by the Reserve Bank during 2007-08 towards further widening and deepening of various segments of the financial market under its jurisdiction, *viz.*, the money market, the Government securities market and the foreign exchange market. In the money market, State Development Loans (SDLs) were made eligible securities under the liquidity adjustment facility (LAF). The reporting platform for over-the-counter (OTC) rupee interest rate derivatives was made operational by the Clearing Corporation of India Limited (CCIL). Recognising the need for a robust interest rate futures market as an effective instrument for management of interest rate risk, a Working Group was set up to go into all the relevant issues and suggest measures to facilitate the development of the interest rate futures market in India. In the Government securities market, the membership of the Negotiated Dealing System - Order Matching (NDS-OM) platform was extended to certain qualified gilt account holders. Short sales and "when issued" transactions were permitted to be covered outside NDS-OM platform and a settlement mechanism was put in place to permit settlement of Government securities transactions through fund accounts maintained with commercial banks. In the foreign exchange market, the limit for remittances by resident individuals under the liberalised remittance scheme (LRS) was raised during 2007-08. The limits on remittances for overseas investments for corporates were further raised to facilitate overseas acquisitions. The guidelines for external commercial borrowings (ECBs) were liberalised by raising the prepayment limits, increasing the all-in-cost ceilings, enhancing the permissible end-uses (rupee capital expenditure) and allowing entities in the service sector to avail ECBs. In view of the experience gained by market

participants in using various hedging instruments such as forward foreign exchange contracts, swaps and options, and improvements in liquidity and accounting systems relating to these instruments, an Internal Working Group on Currency Futures set up to study the international experience and suggest a suitable framework to operationalise the proposal submitted its Report during the year. A Reserve Bank-SEBI Standing Technical Committee constituted to advise on operational aspects with regard to trading of currency futures on exchanges submitted its Report during the year. Accordingly, guidelines were issued to allow resident individuals on trading of currency futures in recognised stock/new exchanges.

MONEY MARKET

V.4 A well developed money market is the key to the effective transmission of monetary policy impulses and integration among various segments of the financial market. 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, a host of measures were undertaken by the Reserve Bank in recent years. These measures helped in improving transparency, facilitating price discovery and providing avenues for better liquidity and risk management.

Liquidity Adjustment Facility

V.5 With a view to widening the collateral base, the SDLs were made eligible securities under the LAF-Repos with effect from April 3, 2007. A margin of 10 per cent has been applied in respect of SDLs.

Reporting Platform for Interest Rate Swaps

V.6 The Reserve Bank issued comprehensive guidelines in respect of interest rate derivatives (IRDs) in April 2007, incorporating the broad regulatory framework for undertaking derivative transactions. In respect of OTC derivative transactions, it became 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. In this context, CCIL was advised to start a trade reporting platform for rupee interest rate swaps (IRS). The reporting platform became operational on August 30, 2007. Banks and primary dealers (PDs) have started reporting the IRS and forward rate agreements (FRAs) on the platform on a daily basis.

Interest Rate Futures

V.7 An anonymous order driven system for trading in interest rate futures was introduced on exchanges in 2003. Banks were allowed to hedge the risk in their underlying investment portfolio, while PDs were also permitted as market-makers. Since then, the Government securities market has undergone numerous developmental changes, 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 TAC on Money, Foreign Exchange and Government Securities Markets, a Working Group on Interest Rate Futures (Chairman: Shri V. K. Sharma) was set up in August 2007 to go into all the relevant issues and suggest measures to facilitate the development of interest rate futures market. The Report of the Working Group was placed on the Reserve Bank's website on March 3, 2008 for public feedback and comments. The Report was finalised by the TAC after taking into account the feedback and comments received from the public, experts, banks, market participants and the Government of India and released on August 8, 2008 (Box V.1).

GOVERNMENT SECURITIES MARKET

V.8 The Reserve Bank initiated significant measures during 2007-08 to further broaden and deepen the Government securities market in consultation with market participants. The salient features of the developmental measures undertaken during the year included: (i) permitting short sales and "when issued" transactions to be covered outside NDS-OM platform; (ii) extension of NDS-OM platform to certain qualified gilt account holders; and (iii) putting in place a settlement mechanism to permit settlement of Government securities transactions

Box V.1
Report on Interest Rate Futures

In the wake of deregulation of interest rates as part of financial sector reforms, a need was felt to introduce hedging instruments to manage interest rate risk. The Reserve Bank had introduced interest rate swaps (IRS) and forward rate agreements (FRA) in March 1999. Subsequently, the National Stock Exchange of India Ltd. (NSE) introduced, in 2003, exchange-traded interest rate futures (IRF) contracts. However, there was muted market response to the product, and liquidity completely dried up subsequently.

Against this backdrop, the Reserve Bank's Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets (TAC) set up a Working Group on Interest Rate Futures (Chairman: Shri V. K. Sharma). The objectives of the Working Group were: (i) to review the experience with IRF with particular reference to product design and make recommendations for activating IRF; (ii) to examine the need for aligning regulatory guidelines for IRF with those for IRS/ FRA; and (iii) to examine the scope of participation of non-residents, including FIIs. The Report of the Working Group was placed on the Reserve Bank's website on March 3, 2008 for public feedback and comments. The Report was finalised by the TAC after taking into account the feedback and comments received from the public, experts, banks, market participants and the Government of India and released on August 8, 2008.

The major recommendations of the Report are:

- Banks may be allowed to take trading positions in IRF, subject to prudential regulations including capital requirements. Furthermore, the current practice of banks' participation in IRF for hedging risk in their underlying investment portfolio of Government securities classified under the available for sale (AFS) and held for trading (HFT) categories be extended to the interest rate risk inherent in their entire balance sheet – including both on, and off, balance sheet items – synchronously with the re-introduction of the IRF.
- Present dispensation to hold the entire SLR portfolio in held-to-maturity (HTM) category be reviewed synchronously.
- Using the powers conferred on it through the RBI Amendment Act, 2006, the Reserve Bank may mandate appropriate accounting standards for IRS, IRF and the underlying Government securities as envisaged in Accounting Standard 30 to ensure that these are symmetrical and aligned.
- The time limit on short selling be extended so that term/ tenor/maturity of the short sale is co-terminus with that of the futures contract.
- A system of transparent and rule-based pecuniary penalty for subsidiary general ledger (SGL) bouncing be put in place in lieu of the regulatory penalty currently in force.
- The liquidity and efficiency of the repo market be improved.
- Considering Reserve Bank's role in, and responsibility for, ensuring efficiency and stability in the financial system, the broader policy on IRF, including those relating to product and participants, should be the responsibility of the Reserve Bank, while the micro-structure details, which evolve through interaction between exchanges and participants, be left to respective exchanges.
- FIIs be allowed to take long position in the IRF market, subject to the condition that the total gross exposure in the cash and the IRF market does not exceed the extant maximum permissible cash market exposure limit. FIIs may also be allowed to take short position in IRF only to hedge exposure in the cash market up to the maximum permitted limit. The same may also apply, *mutatis mutandis*, to non-resident Indians participation in IRF.
- IRF contract based on a notional, coupon bearing, 10-year Government of India (GoI) security be introduced in the bond futures segment at the beginning. Introduction of contracts based on 2-year, 5-year and 30-year GoI securities or those of any other maturities or coupons by the exchanges concerned may be considered based on market response and appetite.
- The contracts should be settled physically and the necessary micro-structure changes be carried out including improvements in the liquidity of the underlying market to support the contract.
- In order to mitigate the possibility of market manipulation, the universe of deliverable securities by exchanges may be restricted to securities with an indicative minimum total outstanding stock of Rs. 20,000 crore.
- As the contract would be physically settled, the trading hours of IRF be synchronised with those of the underlying GoI securities.
- The existing contract on 91-day Treasury Bills futures be retained with settlement price based on the yield discovered at the weekly Reserve Bank auction. A contract based on an index of traded/actual call rates may also be considered.
- Delivery-based, longer term/tenor/maturity short selling be allowed in the cash market only to banks and primary dealers.
- For ensuring symmetry between cash market in GoI securities (and other debt instruments) and IRF, as also imparting liquidity to the IRF market which is an important step towards deepening the debt market, IRF may be exempted from Securities Transaction Tax (STT).
- Options on interest rates may be introduced as a natural sequel.

through fund accounts maintained with commercial banks.

NDS-Order Matching Platform

V.9 Access to NDS-OM – the anonymous order-driven Government securities trading module on NDS – which was launched in August 2005, was initially allowed to commercial banks and PDs but later extended to other NDS members such as insurance companies, mutual funds and bigger provident funds. In addition to the direct access, indirect access through Constituent Subsidiary General Ledger (CSGL) route was permitted from May 2007 to select category of participants, *viz.*, deposit-taking NBFCs, provident funds, pension funds, mutual funds, insurance companies, cooperative banks, regional rural banks and trusts. With effect from November 2007, the CSGL facility was extended to the Systemically Important Non-Deposit taking NBFCs (NBFC-ND-SI). From May 2008, access to the CSGL facility on NDS-OM was further extended to other non-deposit taking NBFCs, corporates and FIIs. These entities are allowed to place orders on NDS-OM through direct NDS-OM members, *viz.*, banks and PDs, using the CSGL route. Such trades will settle through the CSGL account and current account of the NDS-OM member.

Short Sales and When Issued Transaction Outside NDS-OM

V.10 The short sale and “when issued” transactions, introduced in February 2006 and May 2006, respectively, were initially permitted to be undertaken only on NDS-OM. With a view to encouraging wider market participation, the cover transactions of short sales and “when issued” were permitted to be undertaken outside NDS-OM, *i.e.,* through the telephone market or through purchases in primary issuance with effect from January 1, 2008.

Multi Modal Settlements in Government Securities on NDS

V.11 Holding a current account and SGL account with the Reserve Bank was mandatory for settlement of Government security transactions by the NDS members. However, the medium term objective of the Reserve Bank is to allow current account facility only to banks and PDs, which necessitates phasing out of current accounts held by the non-bank and non-PD entities. In this regard, to facilitate the settlement of Government security transactions undertaken by the non-bank and non-PD NDS members, a system of ‘Multi Modal Settlements’ (MMS) in Government securities market was put in place. Under this arrangement, the funds leg of the transactions is settled through the fund accounts maintained by these entities with select commercial banks chosen as ‘designated settlement banks’ (DSB). All Government securities related transactions, *viz.*, secondary market, primary market and servicing of Government securities (interest payments and repayments) for these entities will be carried out through the current account of the ‘DSB’ with whom the non-bank and non-PD entities open the settlement account. Guidelines to this effect were issued on June 2, 2008 and the system became effective from June 16, 2008.

Corporate Bond Market

V.12 The Reserve Bank continued its efforts to implement the recommendations of the High Level Expert Committee on Corporate Bonds and Securitisation (Chariman: Dr. R.H. Patil). One of the recommendations of the Committee was to set up reporting platforms for corporate bonds. The trade reporting platforms have since been set up by the National Stock Exchange of India Limited (NSE), Bombay Stock Exchange Limited (BSE) and the Fixed Income Money Market and Derivatives Association of India (FIMMDA). The Reserve Bank has issued guidelines to its regulated entities to report their OTC trades on the FIMMDA platform. As regards introduction of repos in corporate bonds, the Reserve Bank in its Annual Policy Statement for the year 2008-09, announced that the same would be considered once the prerequisites, *viz.*, efficient price discovery through greater public issuances and secondary market trading, and an efficient and safe settlement system based on delivery *versus* payment (D*v*P) III and straight through processing (STP) are met.

Primary Dealers

V.13 The number of PDs in operation increased to 19 at end-March 2008 from 17 at end-March 2007. Of these, nine were non-bank entities (stand-alone PDs) and the remaining 10 were banks undertaking PD business departmentally (Bank-PDs). In July, 2006, PDs were prohibited from setting up step-down subsidiaries. PDs, which already had step-down subsidiaries (in India and abroad), were required to restructure the ownership pattern of those subsidiaries. These guidelines were complied with by the stand-alone PDs during 2007-08.

V.14 The Government securities market has developed significantly over the years and PDs, which were first allowed in 1996, have made significant contribution to the process of Government securities market development (Box V.2).

FOREIGN EXCHANGE MARKET

V.15 During 2007-08, the Reserve Bank took several initiatives to provide a more conducive environment for the conduct of foreign exchange business. The prime objective was to provide prompt and efficient customer service by progressively liberalising foreign exchange related transactions, removing restrictions and simplifying procedures. Concomitantly, powers were delegated to authorised dealers (ADs) with a view to improving ease of transactions for the common person. India's cautious approach towards opening of the capital account and viewing capital account liberalisation as a process contingent upon fulfilment of certain preconditions has held India in good stead. Keeping in view the recommendations of the Committee on Fuller Capital Account Convertibility (CFCAC), a host of measures were initiated towards further liberalisation of foreign exchange transactions.

Current Account Measures

Exports

V.16 ADs were permitted to allow refund of export proceeds for goods re-imported into India on account of poor quality, subject to submission of evidence of re-import. The condition of submission of evidence of re-import was relaxed, subject to an undertaking by the exporter that the goods would be re-imported within three months from the date of remittance.

Imports

V.17 The following liberalisation/simplification procedures were undertaken with regard to the facilities available to importers:

(i) AD banks were permitted to remit business process outsourcing (BPO) companies in India towards the cost of equipment to be imported and installed at their overseas sites, subject to certain terms and conditions.

(ii) Airline companies, which have been permitted by the Directorate General of Civil Aviation to operate as a schedule air transport service, were allowed to make advance remittance, without bank guarantee up to US$ 50 million. In all other cases, the existing limit of US$ 1,000,000 for advance remittance without bank guarantee/letter of credit continued.

(iii) AD banks were permitted to allow remittance for imports up to US$ 300,000 where the importer of rough diamonds, rough precious and semi-precious stones has received the import bills documents directly from the overseas supplier.

Remittance Facilities

V.18 Indian corporates with a proven track record were allowed to make remittances out of their foreign exchange earnings for setting up chairs outside India as against the earlier practice of case-to-case basis. AD banks were delegated power to allow donations by Indian corporates for specified purposes, subject to a limit of one per cent of the foreign exchange earnings during the previous three financial years or US$ 5 million, whichever was less. The limit for consultancy services procured from outside India by Indian companies executing infrastructure projects was enhanced from US$ 1 million to US$ 10 million per project. In all other cases, the existing limit of US$ 1 million per project continues. AD banks were permitted to allow reimbursement of pre-incorporation expenses incurred in India up to five

Box V.2
Government Securities Market and Primary Dealers

One of the thrust areas of the Government securities market reforms process, initiated in 1992, was to develop a system of dedicated institutional arrangement for facilitating active secondary market trading in Government securities. This led to inception of the primary dealer (PD) system in India in 1996 with the objective of strengthening the institutional infrastructure in the Government securities market. The roles envisaged for the PDs included supporting the primary market issuances and promoting liquidity in the secondary market.

An analysis of data pertaining to auctions conducted by the Reserve Bank for dated Government securities during 2005-06 to 2007-08 shows that PDs have played a key role in primary market activity. This assumes significance in the backdrop of the Reserve Bank's exit from the primary market from April 1, 2006, in terms of the provisions of the Fiscal Responsibility and Budget Management Act, 2003.

PDs have the responsibility to underwrite auctions of dated Central Government securities and also bid for an amount at least equal to their underwriting commitment. Expectedly, a significant portion of market demand for Government securities in the primary market emanates from the PDs. The aggregate bids submitted by PDs in auctions of Treasury Bills and dated securities, as reflected in the bid-cover ratio, have shown an upward trend in recent years. PDs have been particularly competitive in bidding in the auctions of short and medium term securities. The PDs have also maintained a dominant share (over 45 per cent) in primary auction allotments (Chart). However, the success ratio of

Table: Government of India – Market Borrowing

(Rupees crore)

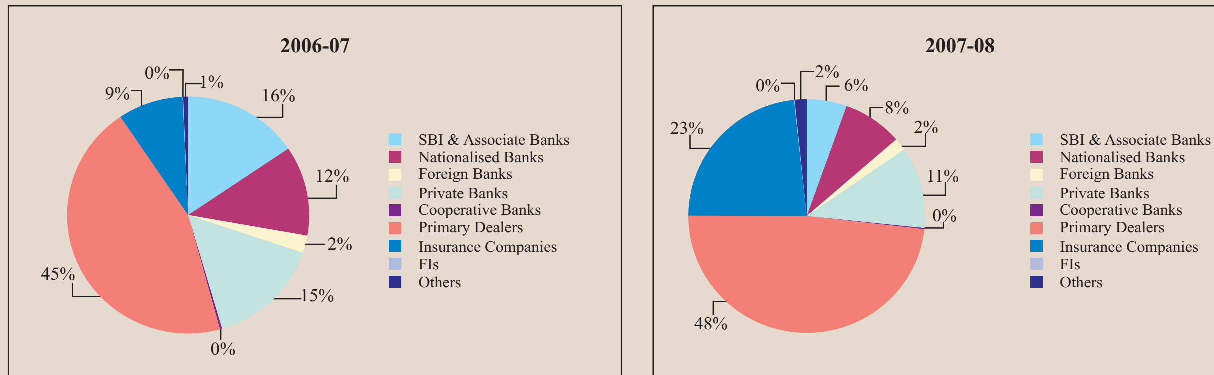
Year	Gross Market Borrowings (Dated securities)	Raised through Auctions	Devolvement on the Reserve Bank
1	2	3	4
1996-97	27,911	27,911	3,698
1997-98	43,390	37,390	7,028
1998-99	83,753	53,753	8,205
1999-00	86,630	59,630	-
2000-01	1,00,183	82,183	13,151
2001-02	1,14,213	86,000	679
2002-03	1,25,000 *	94,000	5,175
2003-04	1,21,500 *	1,00,000	-
2004-05	80,350	80,000	847
2005-06	1,31,000	1,21,000	-
2006-07	1,46,000	1,46,000	-
2007-08	1,56,000	1,56,000	-
2008-09 #	82,000	82,000	-

*: Includes borrowings for pre-payment of external debt.
#: Up to August 11, 2008.

PDs is relatively low compared to other investor groups who do not have minimum bidding obligations.

Reliance on the Reserve Bank in primary issuances has been gradually reduced over the years (Table). With the strengthening of the PD system, Government borrowings have been completed successfully without market disruption, even after the Reserve Bank exited from the primary market with effect from April 1, 2006.

Chart: Investor Category-wise Share in Primary Issues



per cent of the investment brought in or US$ 100,000, whichever is higher (earlier limit was up to US$ 100,000 only).

V.19 Ship-manning/crew managing agencies in India, that are rendering services to shipping companies incorporated outside India, were allowed to open non-interest bearing foreign currency accounts in India for the purpose of undertaking transactions in the ordinary course of their business, subject to certain terms and conditions. AD banks were permitted to allow payment towards cash calls to the operator for the purpose of oil exploration in India, either by credit to the foreign currency or rupee account in India, subject to certain conditions.

V.20 The guidelines for maintaining *vostro* accounts by foreign exchange houses abroad under the Rupee Drawing Arrangements (RDA) was liberalised further in February 2008. In recent years, private remittances under the RDA and Money Transfer Service Scheme (MTSS) increased sharply, reflecting the Reserve Bank's efforts in facilitating such transfers (Box V.3).

Exchange Earners' Foreign Currency Account

V.21 With a view to giving an opportunity to small and medium enterprises (SMEs) to manage challenges in the global markets, all Exchange Earners' Foreign Currency (EEFC) account holders were permitted to maintain outstanding balances to the extent of US$ 1 million in the form of term deposits up to 1 year maturing on or before October 31, 2008.

Box V.3
Rupee Drawing Arrangement and Money Transfer Service Scheme

The sustained expansion in remittances since the 1990s has been underpinned by structural reforms including market based exchange rate, current account convertibility as well as shift in the labour outflow pattern from semi-skilled to increasingly high-skilled categories. Policy initiatives to facilitate remittance flows through speedier and cost effective money transfer arrangements such as the banking channels, money transfer agencies and post offices also contributed to increased remittances. While banking channels account for bulk of the inward remittances to India, the two other schemes, *viz.*, (i) Rupee Drawing Arrangements (RDA) and (ii) Money Transfer Service Scheme (MTSS) have also assumed significance in recent years. These two schemes provide benefits of easier and speedier operations and play an important role in expanding the outreach of remittances services to the remote locations in the country.

Rupee Drawing Arrangements (RDAs)

Under the RDAs Scheme, Category-I ADs are permitted by the Reserve Bank to open *vostro* accounts of Exchange Houses of the Gulf countries, Hong Kong and Singapore for channelising cross-border inward remittances into India. RDAs fall into three categories, *viz.*, Designated Depository Agency (DDA), non-DDA and Speed Remittances. Separate vostro accounts in Indian rupees are required to be opened by the Exchange Houses for each of these arrangements. No cash payments are made under these arrangements. These arrangements cannot be utilised for making donations/contributions to charitable organisations. Under these arrangements, trade remittances up to Rs.2,00,000 (per transaction) can be made. Credit to NRE account is also permitted. However, no outward remittance is envisaged under these arrangements.

By April 2008, 39 banks and 69 Exchange Houses were having tie-ups under RDA. Out of the 69 Exchange Houses, 66 were incorporated in Gulf countries, one in Hong Kong and two in Singapore. The remittances received under these Schemes have increased consistently since 2003 (Table A).

Money Transfer Service Scheme (MTSS)

MTSS is a quick and easy way of transferring personal remittances from abroad to beneficiaries in India. Only personal remittances such as remittances towards family maintenance and remittances favouring foreign tourists visiting India are permissible under the Scheme. Donations/contributions to charitable institutions/trusts are not permitted under the MTSS. The system envisages a tie-up between reputed money transfer companies abroad and agents in India such as ADs and full-fledged money changers who would disburse the funds to the beneficiaries at ongoing exchange rates. The system does not envisage the repatriation of such inward remittances. Under the scheme, the Indian agent pays the beneficiaries first, on instructions from the Overseas Principal and is reimbursed the amount and his/her commission, by the Overseas Principal within a day or two through normal banking channels. A cap of US$ 2,500 has been placed on individual transaction under the scheme. Amounts up to Rs.50,000 may be paid in cash. Any amount exceeding this limit shall be paid by means of cheque/demand draft/pay orders or credited directly to the beneficiary's account. Only 12 remittances can be received by a single individual during a calendar year.

At end-April 2008, there were 26 Indian agents and 11 Overseas Principals under the MTSS. The total remittances received have shown a continuous increase since 2003 (Table B).

Table A: Remittances Received under RDA

Year	US$ million	Variation (Per cent)
1	2	3
2003	5,414	-
2004	6,125	13.2
2005	7,334	19.7
2006	8,834	20.5
2007	11,635	31.7

Table B: Remittances Received under MTSS

Year	US$ million	Variation (Per cent)
1	2	3
2003	836	-
2004	1,261	51.0
2005	1,982	57.1
2006	3,271	65.1
2007	5,344	63.4

The rate of interest on such deposits, however, is determined by the banks themselves. It was decided to withdraw this facility from November 01, 2008. Accordingly, all EEFC accounts were only permitted to be opened and maintained in the form of non-interest bearing current accounts.

Capital Account Measures

Liberalised Remittance Scheme

V.22 With a view to imparting greater flexibility in foreign exchange transactions and simplifying procedures, the limit for remittances under the Liberalised Remittance Scheme (LRS) for resident individuals was enhanced from US$ 50,000 to US$ 100,000 in May 2007 and further to US$ 200,000 per financial year in September 2007. It was also stipulated that banks should not extend any credit facilities to resident individuals to facilitate remittances under the LRS and resist transactions in the nature of margins or margin calls to overseas exchanges/overseas counterparty.

Employees Stock Option Plan

V.23 AD category–I banks[1] were allowed to grant rupee loans to non-resident Indians (NRIs) employees of Indian companies for acquiring shares of the companies under the Employees Stock Option Plan (ESOP) Scheme, subject to certain conditions.

External Commercial Borrowings

V.24 With a view to providing greater flexibility to the corporates in managing their liquidity and interest costs, the limit for prepayment of external commercial borrowings (ECB) was enhanced from US$ 300 million in December 2006 to US$ 400 million in April 2007 and further to US$ 500 million in September 2007, without prior approval of the Reserve Bank, subject to compliance with the minimum average maturity period as applicable to the loan.

V.25 The ECB policy was reviewed in May 2007. It was decided to withdraw the exemption accorded for the 'development of integrated township' as a permissible end-use of ECB. Earlier, the ECB proceeds were allowed to be utilised for the development of integrated township. Furthermore, with the enhancement of sovereign credit ratings of India to investment grade, the all-in-cost ceilings for ECBs were revised downwards from 200 basis points (bps) to 150 bps over 6-month LIBOR for ECBs with an average maturity between three years and up to five years, and from 350 bps to 250 bps for ECBs with average maturity of more than five years.

V.26 Based on a review, the ECB policy was modified in August 2007. According to the revised policy, ECB more than US$ 20 million per borrower company per financial year was permitted only for foreign currency expenditure for permissible end-uses of ECBs. Accordingly, borrowers raising ECB more than US$ 20 million were required to park the ECB proceeds overseas for use as foreign currency expenditures for permissible end uses and were not allowed to remit the funds to India both under the automatic route and the approval route. ECB up to US$ 20 million per borrowing company per financial year was permitted for foreign currency expenditures for permissible end-uses under the automatic route and these funds were required to be parked overseas and not remitted to India. Borrowers proposing to avail ECBs up to US$ 20 million for rupee expenditure for permissible end uses were required to obtain prior approval of the Reserve Bank under the approval route. 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 were left unchanged.

V.27 In May 2008, the ECB policy was further reviewed, wherein it was decided to allow borrowers in the infrastructure sector to avail ECBs up to US$ 100 million for rupee expenditure for permissible end-uses under the approval route. In the case of other

[1] Banks currently authorised to deal in foreign exchange (*viz.*, 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.

borrowers, the existing limit of US$ 20 million for rupee expenditure for permissible end-uses under the Approval Route was enhanced to US$ 50 million. The all-in-cost ceilings were revised upwards from 150 bps to 200 bps over 6-month LIBOR for ECBs with an average maturity between three years and up to five years, and from 250 bps to 350 bps for ECBs with average maturity of more than five years.

V.28 In June 2008, it was decided to allow entities in the service sector, *viz.* hotels, hospitals and software companies to avail ECBs up to US$ 100 million per financial year, for the purpose of import of capital goods under the approval route.

V.29 The all-in-cost ceilings for trade credit up to one year were revised upwards from 50 basis points over six month LIBOR to 75 basis points over six month LIBOR for the respective currency of credit or applicable benchmark.

V.30 With effect from July 11, 2008, prior approval from the Reserve Bank was dispensed with and AD Category-I banks were permitted to convey 'no objection' under the Foreign Exchange Management Act (FEMA), 1999 for creation of charge on immovable assets, financial securities and issue of corporate or personal guarantees in favour of overseas lender / security trustee, to secure the ECB to be raised by the borrower, subject to certain specified conditions.

Overseas Direct Investments

V.31 Corporates were provided greater operational flexibility with regard to their overseas investment. This comprised the following elements.

(i) The overseas investment limit (total financial commitments) for Indian entities (companies incorporated in India under an Act of Parliament) was enhanced from 200 per cent of their net worth to 300 per cent in June 2007 (the limit continued to be 200 per cent for registered partnership firms) and further to 400 per cent, including registered partnership firms, in September 2007 as per the last audited balance sheet. The amount of guarantee was 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 existing limit of 25 per cent of net worth for portfolio investments in the equities of foreign companies listed on recognised stock exchange overseas and having a share holding of at least 10 per cent in Indian companies listed on recognised stock exchanges in India and rated bond/fixed income securities issued by overseas companies was enhanced to 35 per cent (June 2007) of the net worth of the investing company and further to 50 per cent (September 2007). Furthermore, the requirement of reciprocal 10 per cent holding in Indian companies was dispensed with.

(iii) Acquisition of shares by an Indian entity, of a foreign company engaged in bonafide business activity in exchange of ADRs/GDRs issued to the latter was considered as an accepted mode of overseas direct investment, subject to certain terms and conditions.

(iv) In order to provide operational flexibility to Indian entities for availing fund-based and non-fund based facilities overseas, they were permitted to transfer by way of pledge, the shares held in overseas joint ventures (JV)/ wholly owned subsidiaries (WOS) to an overseas lender, provided the lender is regulated and supervised as a bank and the total financial commitments of the Indian party conform to the limits stipulated by the Reserve Bank.

(v) Navratna Public Sector Undertakings (PSUs) were allowed remittances, without any limit, towards investment in the oil sector (*i.e.,* for exploration and drilling for oil and natural gas) in an unincorporated entity overseas.

This facility was extended to ONGC Videsh Ltd. and Oil India Ltd. Other Indian entities were allowed this facility up to 400 per cent of their net worth as on the date of their last audited balance sheet. Investment in excess of 400 per cent would require prior approval of the Reserve Bank.

(vi) Indian companies were allowed, with the prior approval of the Reserve Bank, to invest in excess of 400 per cent of their net worth as on the date of the last audited balance sheet, in the energy and natural resources sectors such as oil, gas, coal and mineral ores.

(vii) With a view to improving the coverage and to ensure monitoring of flows in a dynamic environment, the reporting system for overseas direct investment (ODI) was rationalised and a single form ODI was prescribed.

(viii) Resident entities having overseas direct investments (in equity and loan) were permitted to hedge the exchange risk arising out of such investments by entering into forward/option contracts. Such contracts were required to be completed by delivery or rolled over on due date and not cancelled. With a view to providing greater flexibility to residents, AD banks were permitted to allow cancellation of such forward contracts. Furthermore, 50 per cent of the cancelled contracts were allowed to be rebooked.

V.32 The provisions for overseas investments by mutual funds registered with Securities and Exchange Board of India (SEBI) were further liberalised:

(i) The aggregate ceiling for overseas investments by mutual funds registered with the SEBI was enhanced from US$ 4 billion in May 2007 to US$ 5 billion in September 2007 and further to US$ 7 billion in April 2008. The existing facility to allow a limited number of qualified Indian mutual funds to invest cumulatively up to US$ 1 billion in overseas Exchange Traded Funds as may be permitted by the SEBI continued.

(ii) Indian mutual funds registered with the SEBI were permitted (June 2007) to invest in (a) overseas mutual funds making nominal investments in unlisted overseas securities not exceeding 10 per cent of their net assets; (b) overseas exchange traded funds that invest in securities; and (c) ADRs/GDRs of foreign companies, subject to guidelines issued by the SEBI.

V.33 With a view to further liberalising the policy on overseas investments, it was decided (June 2008) to allow Registered Trusts and Societies engaged in manufacturing/educational sector to make investment in the same sector(s) in a JV/WOS outside India, with the prior approval of the Reserve Bank.

Foreign Direct Investment

V.34 In view of the quality of inflows and in order to capture the details of foreign direct investment (FDI) in a comprehensive manner, the reporting form (FC-GPR) was revised in consultation with the Central Government. In order to provide operational flexibility to non-resident acquirers, AD banks were permitted to open Escrow account and Special account on behalf of non-resident corporates for acquisition/ transfer of shares/debentures through open offers/ delisting/exit offers, subject to the SEBI regulations and directions issued by the Reserve Bank.

V.35 The guidelines on foreign investments in preference shares were revised and it was stipulated that only preference shares coming in as fully and mandatorily convertible into equity within a specified time would be treated as part of share capital. Any other type of preference shares would be considered as debt and shall conform to the ECB norms. The guidelines on foreign investments in debentures were also revised and it was prescribed that only instruments which are fully and mandatorily convertible into equity within a specified time would be treated as part of equity.

V.36 In consultation with the Central Government, a time limit of 180 days from the date of receipt of advance remittance was stipulated for issue of shares to the non-resident investor. In case, equity shares were not issued within 180 days, the advance so received was to be refunded immediately through normal

banking channels or by credit to the NRE/FCNR(B) account of the investor. In exceptional cases, refund of amount was to be considered by the Reserve Bank on a case to case basis. Citizens/entities incorporated in Bangladesh were permitted to purchase shares and convertible debentures of an Indian company under the FDI scheme with prior approval of Foreign Investment Promotion Board (FIPB).

V.37 In consultation with the Central Government and the SEBI, FIIs registered with the SEBI and sub-accounts of FIIs were allowed to short sell, lend and borrow equity shares of Indian companies, subject to certain conditions.

V.38 FDI was permitted in credit information companies up to an aggregate limit of 49 per cent subject to certain conditions. FDI was also permitted in commodity exchange up to composite limit of 49 per cent with FDI limit of 26 per cent and FII limit of 23 per cent, subject to the regulations issued by Forward Markets Commission.

Foreign Exchange Hedging

V.39 For further deepening the foreign exchange market the following measures were initiated to facilitate foreign exchange hedging:

(i) The eligible limit for booking of forward contracts on the basis of declaration of an exposure by importers/exporters and based on the past performance was raised from 50 per cent to 75 per cent. Contracts booked in excess of the eligible limit are on a deliverable basis and cannot be cancelled.

(ii) AD banks, especially authorised by the Reserve Bank were allowed to permit domestic producers/users to hedge their price risk on aluminium, copper, lead, nickel and zinc in international commodity exchanges, based on their underlying economic exposures. Furthermore, AD banks especially authorised by the Reserve Bank in this regard, were allowed the discretion to permit actual users of aviation turbine fuel to hedge their economic exposures in the international commodity exchanges based on their domestic purchases.

(iii) SMEs were permitted to hedge their indirect and direct currency exposures using forwards and options.

(iv) Resident individuals were permitted to hedge their currency exposures in respect of inward/outward remittances using forward contracts up to US$ 100,000 per financial year.

(v) Domestic oil marketing and refining companies were permitted to hedge their commodity price risk to the extent of 50 per cent of their inventory based on their volumes in the quarter preceding the previous quarter. The hedge to be undertaken using OTC/exchange traded derivatives overseas with the tenor was restricted to a maximum of one-year forward.

(vi) Domestic crude oil refining companies were permitted to hedge their commodity price risk on domestic purchase of crude oil and sale of petroleum products on the basis of underlying contracts linked to international prices on overseas exchanges/markets.

(vii) Domestic crude oil refining companies were permitted to hedge their commodity price risk on crude oil imports in overseas exchanges/markets on the basis of their past performance up to 50 per cent of their volume of actual imports during the previous year or 50 per cent of the average volume of imports during the previous three financial years, whichever is higher.

Currency Futures

V.40 In pursuance to the announcement made in the Annual Policy Statement for the year 2007-08, an Internal Working Group on Currency Futures was set up to study the international experiences and suggest a suitable framework to operationalise the proposal within the existing legal and regulatory framework. Accordingly, the Internal Working Group (Chairman: Shri Salim Gangadharan) studied, *inter alia*, the experiences of some emerging market economies where currency futures exchanges were functioning within an environment of capital controls (Box V.4). A Reserve Bank-SEBI Standing Technical

Box V.4
Working Group on Currency Futures

In the context of growing integration of the Indian economy with the rest of the world and gradual deepening of financial markets, the Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore) had recommended that currency futures be introduced, subject to the risks being contained through proper trading mechanism, structure of contracts and regulatory environment. The amendment to the RBI Act, 1934 through the RBI (Amendment) Act 2006, empowers the Reserve Bank to regulate interest rate, foreign currency and credit derivatives. An Internal Working Group on Currency Futures (Chariman: Shri Salim Gangadharan) was set up to study the international experience and suggest a suitable framework to operationalise the proposal, in line with the current legal and regulatory framework.

The Working Group had extensive consultations with a cross section of market participants, including bankers' associations, banks and brokers in both Indian and international exchanges. Based on the discussions with market participants and the experiences drawn from international exchanges, the Group listed out various alternatives for introduction of currency futures, analysing the pros and cons of each option in the Indian context. The analysis was then presented to the Technical Advisory Committee (TAC) for Money, Foreign Exchange and Government Securities Markets. The draft Report of the Group reflecting the views expressed by the TAC was placed on the Reserve Bank's website in November 2007 for wider dissemination and feedback. The feedback/comments received from the public, banks, market participants, academicians and the Government of India were discussed in the meetings of the TAC and the final Report was posted on the Reserve Bank's website on April 28, 2008. The important recommendations of the Working Group were:

- A standardised US Dollar–Indian Rupee (USD-INR) contract be introduced; Euro-INR contract be introduced after a period of six months.
- A single contract of notional value US$ 1,000 be introduced with tenors for the first 12 calendar months replicating the forward markets, and the contracts would be cash settled.
- Initially, participation in the currency futures market be restricted to residents with allotment of unique client identification numbers to distinguish various classes of participants in the futures exchanges.
- Banks be allowed to become direct members of the futures exchanges, both as trading-cum-clearing members in respect of own account and clients account and also as professional clearing members.
- Brokers may be permitted in the currency futures market provided they meet "fit and proper" criteria as well as other eligibility norms.
- Exchange-specific clearing corporation be preferred over centralised clearing approach to encourage competitive pricing and services.
- The right to stipulate or modify the participants and/or fixing participant-wise position limits or any other prudential limits in the interest of financial stability be retained with the Reserve Bank.
- For introduction of currency futures, existing exchanges, which meet the eligibility criteria as also new entities set up for the purpose of trading currency futures, with the basic criteria being net worth and capital adequacy, be considered.

As announced in the Annual Policy Statement for the Year 2008-09, a Reserve Bank-SEBI Standing Technical Committee was set up to advise on operational aspects with regard to trading of currency futures on exchanges. The Report of the Technical Committee was also posted on the websites of the Reserve Bank and the SEBI. The important recommendations of the Committee were:

- A recognised stock exchange having nationwide terminals or a new exchange recognised by the SEBI may be set up for trading currency futures after obtaining the SEBI's approval. The exchange shall have a balance sheet net worth of at least Rs. 100 crore.
- The membership of the currency futures segment be separated from the membership of the equity derivative segment or the cash segment of a recognised stock exchange. The trading member be subject to a balance sheet net worth requirement of Rs. 1 crore, while the clearing member be subject to a balance sheet net worth requirement of Rs. 10 crore.
- Currency futures contracts on USD-INR be permitted at the initial stage with a minimum contract size of US$ 1,000 and a maximum maturity of 12 months with monthly maturities. The currency futures contract be settled in cash in Indian Rupees with settlement on the last working day of the month.
- Only residents be allowed to participate in the currency futures market to begin with.
- Initial margin be stipulated on the first day of trading at a minimum of 1.75 per cent and one per cent thereafter. Furthermore, an extreme loss margin of one per cent on the mark-to-mark value be enforced on a real time basis. The calendar spread margin should be at a value of Rs. 250 for all months of spread.
- The gross open position limits should not exceed six per cent of the total open interest or US$ 5 million, whichever is higher and 15 per cent or US$ 25 million, whichever is higher, for clients and trading members, respectively. No separate position limits be prescribed at the clearing member level.
- Periodical meeting of the Reserve Bank-SEBI Committee be held to sort out issues, if any, arising out of overlapping jurisdiction of the currency futures market.

Guidelines on trading of currency futures in recognised stock/ new exchanges were issued on August 6, 2008.

Committee was also constituted to advise on operational aspects with regard to trading of currency futures on exchanges. In August 2008, persons resident in India were permitted to participate in the currency futures market in India. Accordingly, guidelines on trading of currency futures in recognised stock/new exchanges were issued.

Other Capital Account Measures

V.41 AD banks were permitted to allow remittance of maturity proceeds of FCNR(B) deposits to third parties outside India provided the transaction was specifically authorised by the account holder and the AD was satisfied about the bonafides of the transaction. A uniform period of 180 days was prescribed for surrender of received/realised/unspent/unused foreign exchange by resident individuals from the date of receipt/realisation/purchase/acquisition/date of return of the traveller, as the case may be. In all other cases, the regulations/directions on surrender requirement remained unchanged. The facility of operation of NRO account was extended to the Power of Attorney, subject to certain terms and conditions. AD banks were permitted to allow remittances, out of assets on Indian companies under liquidation under the provisions of the Companies Act, 1956 and subject to certain terms and conditions.

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

V.42 The AML guidelines were amended time to time in view of the difficulties expressed by authorised money changers (AMCs) in implementing some of them. The limit for payment of cash towards encashment by foreign visitors/non-resident Indians was raised from US$ 2,000 to US$ 3,000 in October 2007. It was decided that in addition to the documents in support of the name, address and business activity, certificate of incorporation under the Companies Act 1956, Memorandum of Association, Articles of Association, registration certificate of a firm (if registered), partnership deed, *etc.*, PAN card may also be accepted as a suitable document for establishing the relationship with the company/firm.

Outlook

V.43 Although the domestic financial markets have not been seriously impacted by the turbulence overseas, the impact through the financial flows, in particular, on the equity market and, consequently, on the foreign exchange market in India cannot be ruled out. In view of the uncertainty surrounding global financial markets and the risks emanating therefrom, the Reserve Bank would continue to closely monitor the developments in the various segments of the financial market. It would also be the endeavour of the Reserve Bank to further deepen and widen the various segments of the financial market by improving market infrastructure, increasing the number of participants and introducing new instruments especially, those for hedging market risks. Going ahead, some segments of the financial market such as term money market, derivatives market, and corporate bond market and creation of secondary markets in certificates of deposit and commercial paper may require greater attention of the Reserve Bank. Efforts would also be made to facilitate further integration of the markets so as to strengthen the monetary transmission mechanism and ensure efficient dispersal of risk amongst various market participants, especially in the context of the envisaged move towards fuller capital account convertibility. Furthermore, with increasing liberalisation and integration with global financial markets, the focus would be on ensuring that domestic financial market participants are in a position to absorb unanticipated and large shocks should they arise, so that financial stability is maintained.