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FINANCIAL MARKETS AND FOREIGN EXCHANGE MANAGEMENT

The Reserve Bank continued its efforts to develop and deepen various segments of the financial markets by broadening participation, easing access, strengthening the regulatory framework, and improving the financial market infrastructure. Measures to enhance the ease of doing business and to reduce compliance burden through rationalisation of various regulations relating to foreign exchange were also undertaken during the year.

V.1 During 2021-22, the Reserve Bank continued with its endeavour to develop financial markets in terms of easing access, broadening participation, and also designing a principle-based regulatory framework for the over the counter (OTC) derivatives market, while enabling a safe and sound transition from the London Interbank Offered Rate (LIBOR) regime through a roadmap. Liquidity management operations involved both conventional and unconventional measures for ensuring the availability of adequate liquidity in the system. The Reserve Bank continued to facilitate external trade and payments and promote orderly development of the foreign exchange markets, with ongoing efforts to enhance the ease of doing business and also reduce the compliance burden for regulated entities. Several policy measures were also undertaken to alleviate stress caused on external trade and payments due to COVID-19.

V.2 Against this backdrop, the rest of the chapter is structured into four sections. The development and regulation of financial markets are covered in section 2. The Reserve Bank's market operations are discussed in section 3. In section 4, the focus is on external trade and payments and measures relating to liberalisation and development. Concluding observations are set out in the last section.

2. FINANCIAL MARKETS REGULATION DEPARTMENT (FMRD)

V.3 The Financial Markets Regulation Department (FMRD) is entrusted with the development, regulation and surveillance of money, government securities (G-secs), interest rate derivatives, foreign exchange and credit derivatives markets. The Department undertook several measures in pursuance of this mandate to fulfil the objectives set out for 2021-22.

Agenda for 2021-22

V.4 The Department had set out the following goals for 2021-22:

- Issue of draft directions for implementing the exchange of initial margin on non-centrally cleared derivatives (NCCDs) in India by the second quarter of 2021-22 (*Utkarsh*) [Paragraph V. 5];
- Launch of a government securities lending and borrowing mechanism (GSLBM) to augment 'special repos' by the Clearing Corporation of India Ltd. (CCIL) in the second quarter of 2021-22 (Paragraph V.6); and
- Strengthening of aggregation and transparency under the Legal Entity Identifier (LEI) requirements for reporting

of derivative transactions by implementing the Unique Transaction Identifier (UTI) framework in India in line with the progress made internationally in this regard (Paragraph V.7).

Implementation Status

V.5 The Directions for mandating margin requirements for NCCDs will be phased in during 2022-23 taking cognisance of the extension in timelines by one year for the implementation of margin requirements globally in the wake of the pandemic.

V.6 Directions to enable the GSLBM will be issued after completion of the ongoing market consultations and completion of the development of certain aspects of legal and market infrastructure.

V.7 Globally, the progress with regard to the implementation of the UTI has been gradual on account of certain evolving standards. The implementation of UTI in India has accordingly been calibrated to take cognisance of the progress made internationally in this regard.

Major Initiatives

Easing Access and Broadening Participation in the Money Market

V.8 Several measures were undertaken during the year to develop money markets such as for call/notice/term money, commercial papers (CPs), certificates of deposit (CDs) and non-convertible debentures (NCDs) of original maturity of less than a year. Regulations were reviewed after due consultation with the public/stakeholders, with a view to bringing greater consistency across these instruments in terms of issuers, investors and participants. The participant base was expanded by permitting regional rural banks (RRBs) to access the call,

notice and term money markets and to issue CDs. Participants were allowed the flexibility of setting their own lending limits in the call, notice and term money markets within extant prudential regulatory norms. Issuers were permitted to buy back their CDs before maturity to provide them with greater flexibility in liquidity management. A separate prudential limit of 225 per cent of net owned fund as at the end of the previous financial year was stipulated for borrowings by standalone primary dealers in the term money markets. Revised Directions on the call, notice and term money markets and CDs were issued on April 1, 2021 and June 4, 2021, respectively.

Ease of Doing Business for Foreign Portfolio Investors in the Debt Market

V.9 The regulatory framework for non-resident investment in the debt market was fine-tuned to encourage greater participation and to facilitate long term stable debt flows:

- On June 4, 2021, Authorised Dealer (AD) category-1 banks were permitted to lend to Foreign Portfolio Investors (FPIs) for placing margins with the CCIL for the settlement of transactions in government securities within their credit risk management frameworks. On June 7, 2021, FPIs/custodian banks were provided with an extended time window for reporting their government securities transactions to Negotiated Dealing System-Order Matching (NDS-OM).
- In pursuance of announcement in the Union Budget 2021-22, directions were issued on November 8, 2021 to permit FPIs to invest in debt securities issued by Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs).

- Directions were issued on February 10, 2022, increasing the investment limit under the Voluntary Retention Route (VRR) by ₹1,00,000 crore to ₹2,50,000 crore with effect from April 1, 2022.

Creating Principle-based Regulatory Framework for Over the Counter (OTC) Derivative Market

V.10 The “Comprehensive Guidelines on Derivatives (CGD)” were reviewed during the year with the objectives of (i) creating a principle-based regulatory framework; (ii) addressing overlaps between the CGD and other Directions; and (iii) adding new provisions to cater to the increasing sophistication of derivative markets in line with international best practices. After taking into account feedback from the public/stakeholders, the Reserve Bank of India (Market-makers in OTC Derivatives) Directions, 2021, were issued on September 16, 2021. The Directions set out the regulatory requirements pertaining to governance arrangements, risk management and customer suitability and appropriateness for OTC derivative business.

Review of Credit Default Swaps (CDS) Guidelines

V.11 Guidelines for Credit Default Swaps (CDS) were reviewed, and revised Directions (Credit Derivatives) were issued on February 10, 2022. The Guidelines permit non-retail users such as regulated financial entities and FPIs to sell protection. They also allow non-retail users to buy protection for hedging or expressing their views on credit risk while retail users are permitted to buy protection only for hedging.

Permitting Banks to Deal in Offshore Foreign Currency Settled Rupee Derivatives Market

V.12 With a view to further deepening the interest rate derivatives market in the country, removing

the segmentation between onshore and offshore markets and improving the efficiency of price discovery, Directions were issued on February 10, 2022, allowing market-makers having Authorised Dealer Category-I (AD Cat-I) licence under FEMA, 1999 to undertake transactions in the offshore Foreign Currency Settled Overnight Indexed Swap (FCS-OIS) market with non-residents and other market-makers through their branches in India, foreign branches or International Financial Services Centre (IFSC) Banking Units.

Roadmap for LIBOR Transition

V.13 With a view to enabling an orderly, safe and sound transition from the LIBOR regime, banks and other Reserve Bank-regulated entities were advised on July 8, 2021 to (i) cease entering into new financial contracts that reference LIBOR and instead use any widely accepted alternative reference rate (ARR) as soon as practicable and in any event by December 31, 2021; (ii) incorporate provisions for fallbacks to ARR in financial contracts that reference LIBOR and the maturity of which falls after the cessation of the LIBOR setting; (iii) undertake a comprehensive review of all direct and indirect LIBOR exposures and put in place a framework to mitigate risks arising from such exposures; and (iv) continue efforts to sensitise clients about the transition. The details relating to the roadmap of LIBOR transition are presented in Box V.1.

Agenda for 2022-23

V.14 For the year 2022-23, the Department has set the following goals:

- Directions for introducing variation margin requirements for NCCDs in India will be issued in the first half of 2022-23 (*Utkarsh*); and

Box V.1 Roadmap for LIBOR Transition

The year 2022 marks the beginning of the cessation of publication of LIBOR, the financial benchmark which has been used widely so far in the global financial system. Extensive consultations and discussions across the globe and in India have ensured a reasonably smooth transition into a post-LIBOR regime. All non-USD LIBOR settings, and USD LIBOR settings of 1-week and 2-months ceased to be published after December 31, 2021. The publication of remaining USD LIBOR settings will cease on June 30, 2023.

Alternative reference rates (ARRs) [e.g., Secured Overnight Financing Rate (SOFR) and Sterling Overnight Index Average (SONIA)] are overnight secured/unsecured rates and unlike LIBOR (which was poll based), they are based on transacted verifiable rates with a wide participant base (both banks and non-banks). Unlike the forward-looking LIBOR, ARR are backward-looking as they are obtained by compounding the daily overnight rates.

Contracts referencing LIBOR and whose maturity extend beyond the cessation of the LIBOR will have to adopt fallbacks. Fallback templates published by various industry bodies such as the International Swaps and Derivatives Association (ISDA), Asia Pacific Loan Markets Association (APLMA) and Indian Banks' Association (IBA) typically include a spread adjustment to ensure comparability between the term LIBOR and term ARR¹.

Regulatory Initiatives in India

With respect to the LIBOR benchmark, the challenges for India are similar to those faced by other jurisdictions. The Reserve Bank and other authorities have taken various regulatory steps to ensure a smooth LIBOR transition. The Reserve Bank issued an advisory on July 8, 2021 to its regulated entities to (a) ensure adoption of fallbacks in financial contracts that reference LIBOR [including Mumbai Interbank Forward Outright Rate (MIFOR)] and

which mature after the cessation of LIBOR; (b) cease entering into new financial contracts that reference LIBOR as a benchmark (including MIFOR) and transact in widely accepted ARR as soon as practicable and in any event by December 31, 2021, and (c) ensure client sensitisation on issues around LIBOR transition. Certain specific transactions referenced to USD LIBOR are permitted after December 31, 2021 for the purpose of managing the risks around the LIBOR transition.

Reform of MIFOR

MIFOR, the domestic benchmark that references USD LIBOR, has been reformed by the Financial Benchmarks India Pvt. Ltd. (FBIL) in consultation with the rates and methodology workstream of IBA. Publication of adjusted MIFOR (which can be used as a fallback for legacy contracts that reference MIFOR) and the modified MIFOR (which can be used for new financial contracts) has commenced. The modified MIFOR has been included in the ISDA definitions. Market participants have started using modified MIFOR in transactions. Adjusted MIFOR has also been included in the ISDA IBOR fallback protocol/supplement.

Other regulatory initiatives include measures to make provision for use of ARR in export credit, FCNR (B) deposits, external commercial borrowings (ECBs) and trade credit. To take into account differences in credit and term premia between LIBOR and the ARR, the all-in-cost ceiling has been revised upwards by 100 basis points (bps) for existing ECBs/trade credits (TCs) and by 50 bps for new ECBs/TCs. As the change in reference rate from LIBOR is a "force majeure" event, it has been clarified that changes in the terms of a derivative contract on account of changes in reference rate from LIBOR/LIBOR-related benchmarks to an ARR will not be treated as restructuring.

Source: RBI.

- Revised Directions on Rupee Interest Rate Derivatives (IRD) will be issued in 2022-23, after reviewing the feedback obtained from public with a view to allow

greater product innovation, ease non-resident access to the domestic market and rationalise procedures.

¹ Unlike LIBOR, term ARR does not include a term premia and credit premia.

3. FINANCIAL MARKETS OPERATIONS DEPARTMENT (FMOD)

V.15 The Financial Markets Operations Department (FMOD) is entrusted with two primary responsibilities: conduct of the liquidity management operations of the Reserve Bank consistent with the stance of monetary policy; and ensuring orderly conditions in the forex market through operations in onshore and offshore markets.

Agenda 2021-22

V.16 During the year, the Department had set out the following goals:

- To carry out liquidity management operations effectively using all available liquidity management tools, in line with the stance of monetary policy (*Utkarsh*) [Paragraph V.17];
- To continue to conduct foreign exchange operations in an effective manner to curb undue volatility in the USD/INR exchange rate (Paragraph V.18 - V.19); and
- To undertake policy-oriented research on financial markets (Paragraph V.20).

Implementation Status

Liquidity Management

V.17 Details relating to liquidity management operations encompassing money and G-sec markets are covered in Chapter III of this Report.

Foreign Exchange Market

V.18 During the year, the rupee traded with a depreciating bias, reflecting broad-based gains by the US dollar. A rally in crude prices and bouts of risk-off sentiments due to the spread of new COVID-19 variants also weighed on the

rupee. While robust foreign portfolio investment inflows into Indian equity markets supported the rupee towards the start of the year, these flows moderated towards the second half due to drying up of overall flows to emerging market economies in response to rising prospects of tightening of monetary conditions in the US, besides renewed uncertainty associated with the Omicron variant of COVID-19.

V.19 The Reserve Bank engaged in the forex market through operations in the onshore/offshore OTC and exchange traded currency derivatives (ETCD) segments in order to maintain orderly market conditions by containing excessive volatility in the exchange rate.

Research/Analytical Studies

V.20 The Department carried out research/analytical studies on several topical issues such as management of exchange rate volatility during COVID-19; impact of the pandemic on factors determining the spread of weighted average call rate (WACR) from repo rate; fixed price open market operations; and barometer for financial markets.

Agenda for 2022-23

V.21 During the year 2022-23, the Department plans to achieve the following goals:

- To carry out liquidity management operations effectively using all available liquidity management tools as may be necessary, in line with the stance of monetary policy (*Utkarsh*);
- To continue to conduct foreign exchange operations in an effective manner to curb undue volatility in the USD/INR exchange rate; and
- To undertake policy-oriented research on financial markets.

4. FOREIGN EXCHANGE DEPARTMENT (FED)

V.22 The Foreign Exchange Department (FED) is entrusted with the responsibility of fulfilling the objectives envisaged under the Foreign Exchange Management Act (FEMA), 1999. With its ongoing efforts to enhance the ease of doing business and reduce the compliance burden, the Department strives to facilitate external trade and payments and also promote orderly development of the foreign exchange markets.

V.23 During the year, the Department continued its efforts to review/rationalise the extant regulations/rules/notifications issued under the FEMA as part of the ongoing process of aligning the regulatory framework with prevailing macroeconomic conditions and the evolving business practices and models. The Department also took several steps and measures to alleviate stress caused on external trade and payments due to COVID-19.

Agenda for 2021-22

V.24 The Department had set out the following goals for 2021-22:

- Continue rationalisation of the FEMA regulations by consolidating existing regulations of similar subjects, remove hard-coding to obviate frequent issuance of amendment notifications and aligning definitions across notifications/regulations (Paragraph V.25 - V.26);
- Take the exercise of rationalising the overseas investment regulations forward (Paragraph V.27);
- Timely completion of ongoing software projects, viz., Software Platform for External Commercial Borrowings and Trade Credits Reporting and Approval

(SPECTRA) and Authorised Person (AP) connect (*Utkarsh*) [Paragraph V.28];

- Issue a revised Master Direction on Foreign Investment in India as Foreign Exchange Management (Non-debt Instruments) Rules have been notified by the Government (Paragraph V.29); and
- Conduct awareness programmes and create digital content on an ongoing basis (*Utkarsh*) [Paragraph V.30].

Implementation Status

Rationalisation of FEMA Guidelines

V.25 During the year, a review of the existing guidance note on computation matrix for calculation of compounding amount under FEMA was initiated with a view to have a simple and standard guidance matrix. A proposal to amend Foreign Exchange (Compounding Proceedings) Rules with a view to enable electronic and other online modes of payment of compounding fees is under consideration and is in line with *Utkarsh 2022*, which, *inter alia*, emphasises deepening of digital payments.

V.26 While setting up of Alternative Investment Funds (AIFs) in an overseas jurisdiction, including International Financial Services Centres (IFSCs) in India, is under the automatic route as per the overseas direct investment (ODI) guidelines, the status of sponsor contribution to these AIFs under ODI guidelines was not well-defined. To provide clarity in this regard, financial contribution from an Indian sponsor to an AIF set up in an overseas jurisdiction, including IFSCs in India, is now treated as overseas direct investment.

Rationalisation of Overseas Investment Regulations

V.27 The overseas investment regulations were reviewed during the year. The draft rules/regulations were placed on the Reserve Bank's

website for public comments. Based on the feedback/suggestions received, the modified draft has been forwarded to the Government of India for its finalisation.

Ongoing Software Projects, viz., SPECTRA and AP Connect

V.28 In its endeavour to automate the complete lifecycle of external commercial borrowings (ECBs) and trade credits, the Department is in the process of implementing the SPECTRA project. SPECTRA would encompass the lifecycle of ECB/trade credits, from receipt of application to approval stage either at the level of Authorised Dealer (AD) Bank or the Reserve Bank, as well as reporting of transactions. It will incorporate all policy provisions related to ECBs and trade credits. The development of the software has since been completed and the user acceptance testing (UAT)² is near completion. Also, the software project, 'AP Connect', relating to licensing, renewal, reporting, cancellation, and inspection of full-fledged money changers (FFMCs)/upgraded FFMCs, has been developed and UAT has been completed.

Master Direction on Foreign Investment in India

V.29 The Master Direction on Foreign Investment in India has been updated in view of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (NDI Rules) issued by the Government of India.

Conducting Awareness Programmes and Creation of Digital Content

V.30 With a view to familiarise the public and stakeholders on FEMA, 1999, a circular has been issued to the regional offices (ROs) on conduct of

various financial literacy programmes, exhibitions, seminars and conferences, for different target groups.

Major Initiatives

Redefining Benchmark Rate for External Borrowings

V.31 In view of the imminent discontinuance of LIBOR as a benchmark rate, the benchmark rate in case of foreign currency external commercial borrowings (FCY ECB) and trade credit (TC) has been redefined. The benchmark rate now refers to any widely accepted interbank rate or alternative reference rate (ARR) of 6-month tenor, applicable to the currency of borrowing (also refer to Box V.1). Further, AD category-I banks have been permitted to use any other widely accepted/ARR in the currency in place of LIBOR in respect of import/export transactions.

Legal Entity Identifier (LEI)

V.32 For ease of identification of parties undertaking cross border financial transactions, AD category-I banks have been directed to obtain legal entity identifier (LEI) number from the resident entities (non-individuals) in respect of capital or current account transactions of ₹50 crore and above (per transaction) under FEMA, 1999, with effect from October 1, 2022. Banks have also been advised to encourage concerned entities to voluntarily furnish LEI, while undertaking transactions even before October 1, 2022. Further, to avoid disruptions, the banks have been directed to process cross-border financial transactions even in case of non-availability of LEI information, in respect of non-resident counterparts/overseas

² User Acceptance Test is a phase subsequent to completion of development of a software project. The end-users test the software in terms of functionalities and can flag defects or give suggestions for improving the software, especially the critical components.

entities. The LEI, once obtained by an entity, is required to be reported in all transactions of that entity, irrespective of transaction size.

Measures to Alleviate COVID-19 Related Stress

V.33 Borrowers are permitted to park unutilised ECB proceeds in term deposits with AD category-I banks in India for a maximum period of 12 months. To provide relief to borrowers, a one-time relaxation was provided on April 7, 2021, allowing unutilised ECB proceeds drawn down on or before March 1, 2020 to be parked in term deposits with AD category-I banks in India prospectively up to March 1, 2022.

Authorised Persons and Remittances

V.34 The Reserve Bank, in public interest and in consultation with the central government, has decided that Indian passport holders as well as persons of Indian origin carrying the Overseas Citizen of India Card along with their passports travelling to Gurdwara Darbar Sahib, Kartarpur, Narowal, Pakistan through the Sri Kartarpur Sahib Corridor, shall be allowed to carry outside and bring into India at the time of his/her return, only Indian currency notes and/or foreign currency in USD, the total value of which should not exceed ₹11,000.

Agenda for 2022-23

V.35 The Department's strategy for 2022-23 is to focus on consolidating and carrying forward all the above initiatives. The emphasis will remain on ensuring that the FEMA operating framework is in conformity with the needs of the evolving macroeconomic environment. Accordingly, the Department has formulated the following strategic action plan for 2022-23:

- Continue rationalisation of the FEMA regulations by consolidating existing regulations of similar subjects, remove

hard-coding to obviate frequent issuance of amendment notifications and aligning definitions across notifications/regulations;

- Implementation of the revised computation matrix for compounding of contraventions under FEMA 1999 (*Utkarsh*);
- A comprehensive review of the Liberalised Remittance Scheme (LRS) to address various issues and inconsistencies in the scheme;
- To continue with automation of process of submission of various returns for regulatory compliance by leveraging technology;
- Conducting awareness programmes and creation of digital content on an ongoing basis (*Utkarsh*); and
- To continue to delegate more powers to AD banks and regional offices (ROs) for faster implementation of policy changes.

5. CONCLUSION

V.36 In sum, the Reserve Bank employed several conventional and unconventional measures to provide adequate liquidity to aid economic recovery that was interrupted by successive waves of the pandemic. Apart from targeting liquidity to specific sectors and rebalancing of surplus liquidity, the Reserve Bank also ensured stable and orderly evolution of the yield curve through committed purchases of pre-announced quantum of G-secs in the secondary market. The liquidity measures along with the Reserve Bank's forward guidance and comfortable foreign exchange reserve cover engendered stability in financial markets. At the same time, the Reserve Bank pushed the financial market development agenda forward, keeping also in view global developments in

market practices, such as LIBOR transition. Going forward, the Reserve Bank has set an agenda for furthering financial market reforms, covering money, government securities and foreign exchange market, focusing on derivatives and bond markets. It also plans to further rationalise

foreign exchange regulations and make strides in strengthening market infrastructure. The financial market operations will continue to be aligned with the stance of the monetary policy, while the foreign exchange operations will continue to curb undue volatility in the exchange rate of the rupee.