V DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

The Indian financial markets, particularly the foreign exchange market, turned volatile against the backdrop of weakening domestic macroeconomic fundamentals and the euro area sovereign debt crisis, since August 2011. The Reserve Bank took a slew of measures to contain the volatility in the forex market as also to encourage foreign inflows. The Reserve Bank also continued with its efforts to impart liquidity to the secondary G-sec market and to develop the corporate bond market further by providing for risk transfers.

V.1 The Reserve Bank has systematically focussed on developing and regulating the financial markets in view of the cross-linkages with other sectors of the economy. Further, a healthy, robust and vibrant financial market is crucial for stronger monetary policy transmission. To enable the smooth functioning of the market and to contain systemic risks that can adversely impact the real economy, the Reserve Bank continues to play a strategic role.

GOVERNMENT SECURITIES MARKET

V.2 During 2010-11, the Reserve Bank undertook various measures related to the development of the government securities (G-sec) market. In particular, a working group was set up to examine ways to enhance liquidity in the G-sec and interest rate derivatives markets.

Change in Auction Timing of G-secs

V.3 To improve the efficiency of the auction process of G-secs, *viz.,* Government of India dated securities, treasury bills (T-bills), cash management bills, and state development loans, the timings for primary auction under competitive bidding have been revised from 10.30 am-12.30 pm to 10.30 am-12.00 noon from April 13, 2012. This will permit more time for secondary market transactions for the securities auctioned on that day.

Extension of DvP-III facility to Gilt Account Holders

V.4 To extend the benefits of net settlement of securities and funds in the G-sec market to gilt account holders (GAHs), the D*v*P III facility was extended in July 2011, to all transactions undertaken by GAHs, except those undertaken between GAHs of the same custodian.

Revised Guidelines for Authorisation of PDs

V.5 To make the primary dealer (PD) authorisation policy more transparent and ensure that new PDs have sound capital and adequate experience/expertise in the G-sec market, the PD authorisation guidelines were revised in August 2011. The applicant entity is required to be registered as an NBFC and should have exposure in the securities business, in particular to the G-sec market, for at least one year prior to the submission of an application for undertaking PD business.

Working Group on Enhancing Liquidity in the G-sec and Interest Rate Derivatives Markets

V.6 Considering the important role of the G-sec market and the prominence of G-sec in the investment portfolio of financial institutions, particularly banks, the Reserve Bank has been constantly reviewing the developments to further broaden and deepen this market. Despite the developments in the G-sec market in the past two decades, it was deemed necessary to promote liquidity in the secondary market for G-secs, especially across the yield curve. As part of this endeavour, the Reserve Bank set up a working group (Chairman: Shri R. Gandhi) in December 2011, comprising various stakeholders, to examine

and suggest ways to enhance secondary market liquidity in the G-sec and interest rate derivatives (IRDs) markets (Box V.1). The group submitted its Report on August 10, 2012.

Direct Access to Negotiated Dealing System-Order Matching (NDS-OM)

V.7 In November 2011, direct access to NDS-OM was extended to licensed urban co-operative

Box V.1
Working Group on Enhancing Liquidity in the G-Sec and Interest Rate Derivatives Markets

Deeper and broader financial markets play a critical role in improving the efficiency of capital allocation within the economy with benefits accruing to the issuers, (*i.e.*, the central and state governments) as well as the investors (*i.e.*, banks, financial institutions, corporates, individual investors, *etc.*). However, liquidity in the secondary market in G-sec is restricted to a handful of securities. Further, the market for IRDs too has not taken off despite the reintroduction of interest rate futures (IRFs), both physical as well as cash-settled. The market for interest rate swaps (IRS) has been active but is not broad-based and is primarily dominated by banks, especially foreign banks.

A working group comprising internal and external experts, was constituted by the Reserve Bank with the following terms of reference:

- Analyse the evolution of the market for G-sec and IRDs;
- Study the determining and influencing factors on liquidity of G-sec and IRD from the perspective of the primary, secondary, and IRD markets and other factors;
- Examine factors that enable/ inhibit secondary G-sec market liquidity, especially across the sovereign yield curve, and suggest ways to strengthen/ address them;
- Examine factors that enable/ inhibit the growth of the IRD market and suggest ways to strengthen/ address them;
- Suggest measures to promote retail participation in the G-sec market; and
- Examine related issues.

Some of the recommendations of the working group are:

a) **G-Sec Market**

- Consolidation of the outstanding G-sec, for which a framework may be prepared for the next 3-4 years, beginning with the issuance of securities at various maturity points in conjunction with steps such as issuance of benchmark securities over a longer term horizon, buybacks and switches;
- A roadmap to gradually bring down the upper-limit on the HTM portfolio. While doing so, the possible impact of reduction in the limit on HTM classification on the balance sheet of banks/PDs and any measure aimed to address this issue should be calibrated appropriately to make it non-disruptive to the entities and other stakeholders;
- Allocation of specific securities to each PD for market making in them and if required, rotate the stock of securities among the PDs, by turn at periodic intervals;
- Increase the investment limit for FIIs in G-secs in gradual steps. This can be reviewed every year, keeping in view the country's overall external debt position, current account deficit, size of the central government borrowing programme, *etc.*;
- Simplified access for investors like trusts, corporates, *etc.* to the G-sec market. Long-term gilt funds may be encouraged through appropriate incentives (such as tax-breaks, liquidity support, *etc.*); and
- The restrictions on selling/repo of securities acquired under market repo may be reviewed to promote the term-repo market with suitable restrictions on 'leverage' and consider introducing an appropriate tripartite repo in G-sec.

b) **Improving retail in G-sec**

- Utilising the services of banks (and post offices if possible at a later stage and in consultation with the central government) as a distribution channel and nodal point for interface with individual investors;
- A centralised market maker for retail participants in G-sec in the long-term, who would quote two-way G-sec prices for retail/ individual investors; and
- Simplified operational procedures for seamless movement between SGL and de-mat formats.

c) **IRD market**

- An electronic swap execution facility (electronic trading platform) for the IRS market, and consider introducing a CCP who may provide guaranteed settlement of trades executed through the electronic platform;
- Introduction of futures contracts that have high probability of attracting participant interest subject to regulatory approval. To begin with IRF based on overnight call borrowing rate can be considered; and
- Permitting cash-settled 10-year IRF subject to appropriate regulations such as restricted participation, entity-based open position limit, price band, *etc.* Also to consider fine tuning the existing product design of the delivery-based 10-year IRF by permitting single-bond contracts, larger contract sizes, *etc.*

banks and systemically important non-deposit taking non-banking financial companies (NBFC-ND-SIs) that fall under the purview of Section 45-I (c) (ii) of the Reserve Bank of India Act, 1934, subject to compliance with the stipulated financial norms and procurement of an NOC from the respective regulatory departments.

Introduction of a Web-based System for Access to NDS-Auction and NDS-OM

V.8 To facilitate direct participation by retail and mid-segment investors in G-sec auctions, the Reserve Bank has allowed web-based access to the negotiated dealing system (NDS)-auction developed by the Clearing Corporation of India Ltd. (CCIL). The system allows GAHs to directly place their bids in the G-sec auction through a primary member's portal, as against the earlier practice wherein the primary member used to combine bids of all constituents and bid in the market on their behalf. A similar web-based access to the NDS-OM system for secondary market transactions has been permitted since June 2012.

Extension of Short Sale Period from Five Days to Three Months

V.9 Short selling plays an important role in price discovery, promoting liquidity and better risk management. With the re-introduction of IRFs on exchanges, there was a need to revisit the guidelines on short selling to ensure parity between the cash and futures market *vis-à-vis* short selling. Accordingly, the period of short sale was extended from five days to three months from February 1, 2012. This is expected to give a fillip to the IRF market by helping participants to hedge/ arbitrage more effectively, and to develop the term repo market.

FOREIGN EXCHANGE MARKET

V.10 During 2011-12, the primary concern of the Reserve Bank was to stem the volatility in the forex market. The policy initiatives in this area were directed towards rationalising and simplifying procedures, and providing incentives to encourage foreign inflows, aside from sustaining the liberalisation process.

Foreign Investment

Foreign Direct Investment (FDI)

V.11 In May 2011, authorised dealers (ADs) were permitted to open non-interest bearing escrow accounts in Indian rupee, towards payment of share purchase consideration or for keeping securities to facilitate FDI transactions without prior approval from the Reserve Bank. This measure aimed at providing operational flexibility and easing the procedures for such transactions. Further, AD banks were permitted to pledge shares acquired under the FDI route for loans for genuine business purpose in India or overseas. In November 2011, the transfer of shares under the FDI scheme of Indian companies in the financial sector and/ or where the relevant SEBI pricing guidelines were met, was allowed without the prior approval of the Reserve Bank. Foreign investment through issue/ transfer of 'participating interest/ right' in oil fields by Indian companies to a non-resident will be treated as FDI.

V.12 With prior approval from the FIPB, capitalisation of import payables and pre-incorporation expenses under the FDI scheme, and also up to 100 per cent FDI in single-brand retail trade has been allowed.

Foreign Portfolio Investment

V.13 Various measures were taken during 2011-12, to further simplify, rationalise and liberalise the regulations governing foreign portfolio investment in India. Qualified foreign investors (QFIs) were allowed to invest in units of mutual funds (MFs), listed equity shares and listed corporate debts, in order to widen the universe of foreign portfolio investors into India and consequently create an environment for more stable portfolio capital inflows into India. Non-resident long term investors (SWFs, endowment funds, insurance funds, pension funds, multilateral agencies), FIIs and NRIs were allowed to invest in infrastructure debt funds (IDFs) set up

as MFs or NBFCs in India so as to provide an avenue for long-term foreign investors to access the debt markets in India as well as to channelise foreign capital flows in to the vital infrastructure sector in India.

V.14 FVCIs were allowed to invest by way of third party private arrangements as well as to invest in listed securities subject to relevant SEBI guidelines.

FII Flows in G-secs and Corporate Bonds

V.15 To encourage FII flows in the G-sec and corporate bond markets, the limits on investment in such instruments were enhanced to US$ 20 billion and US$ 45 billion, respectively, during 2011-12. It was also decided to expand the universe of non-resident investors in G-secs in June 2012, by allowing long term investors to also invest in G-secs for the entire limit of US$ 20 billion.

V.16 The terms and conditions for the FII investment scheme in infrastructure debt and non-resident investment scheme in IDFs were further rationalised in terms of the lock-in period and residual maturity. QFIs were allowed to also invest in MF debt schemes that hold at least 25 per cent of their assets (either in debt or equity) in the infrastructure sector under the current US$ 3 billion sub-limit for investment in mutual funds related to infrastructure.

V.17 Further, NBFCs categorised as infrastructure finance companies (IFCs) by the Reserve Bank and IDFs were deemed eligible to issue bonds for the purpose of investment by FIIs under the corporate debt long-term infrastructure category.

Liberalised Remittance Scheme

V.18 In terms of extant instructions, a resident individual is eligible to remit up to US$ 200,000 per financial year for any permissible capital or current account transactions under liberalised remittance scheme (LRS). During 2011-12, resident individuals were permitted to lend or make a gift in rupees to close NRI relatives within the overall limit.

Report of the Committee to Review the Facilities for Individuals under the Foreign Exchange Management Act (FEMA), 1999

V.19 Following the announcement in the Monetary Policy Statement for 2011-12, and recognising the need to facilitate genuine foreign exchange transactions by individuals – residents/ NRIs and persons of Indian origin (PIOs) – under the current regulatory framework of FEMA, the Reserve Bank constituted a committee (Chairperson: Smt. K.J. Udeshi) to review the current regulatory framework under FEMA for individuals and recommend measures to further streamline and simplify the procedures.

V.20 Some important recommendations of the committee implemented by the Reserve Bank include: an increase in the limit for foreign exchange remittance for miscellaneous purposes without documentation formalities from US$ 5,000 to US$ 25,000; permitting residents to gift/ lend in rupees to/ repay loans of close relatives of NRIs (within the overall limit of US$ 200,000 per financial year as permitted under the LRS); permitting residents to gift shares/ securities/ convertible debentures *etc.* up to US$ 50, 000 subject to the conditions on a resident foreign currency account/ exchange earners foreign currency (EEFC) account/ resident bank account with a close NRI relative as the joint holder with the resident, and permitting a resident to bear medical expenses of visiting close NRI/ PIO relative. An NRI/ PIO can transfer funds from an NRO account to an NRE account within the overall ceiling of US$ 1 million per financial year.

V.21 General permission was granted to resident individuals to acquire qualification shares/ shares in consideration of professional services to an overseas company for holding the post of a director. Resident Indian employees or directors were permitted to accept shares offered through an ESOP scheme globally, on a uniform basis, in a foreign company that has an equity stake, directly or indirectly, in the Indian company. Banks were allowed to freely determine interest rates on both

savings and term deposits of maturity of one year and above under NRE deposits and savings deposits under NRO accounts.

Administrative Measures to Curb Volatility in the Indian Forex Market

V.22 In view of the excessive volatility in the Indian forex market during H2 of 2011-12, the Reserve Bank initiated various administrative steps to curb speculation, such as withdrawing the facility of cancellation and rebooking of contracts available under contracted exposure to residents and FIIs; reducing the limit under past performance facility for importers to 25 percent of the current limit available; making the past performance facility available to exporters and importers only on a delivery basis, mandating that all cash/ tom/ spot transactions by ADs on behalf of clients were to be undertaken for actual remittances/ delivery only and could not be cancelled/ cash settled; reducing the net overnight open position limit (NOOPL) of ADs across the board; and mandating that the intra-day position/ daylight limit of ADs should not exceed the existing NOOPL approved by the Reserve Bank.

V.23 The taking of position by banks, in the currency futures segment, was also curbed, because it was rampantly used for arbitrage between the OTC and the currency futures, which exacerbated the volatility in the forex market. Accordingly, the following was decided: the current NOOPL of banks as applicable to the positions involving the rupee as one of the currencies should not include the positions undertaken in the currency futures/options segment in the exchanges; the positions in the exchanges (both futures and options) cannot be netted / offset by undertaking positions in the OTC market and *vice-versa*; the positions initiated in the exchanges should be liquidated/ closed only in the exchanges; the position limit for the trading member AD category-I bank, in the exchanges for trading currency futures and options, should be US$ 100 million or 15 per cent of the outstanding open interest, whichever is lower. In order to provide some operational flexibility to the exporters, they have been allowed since July 31, 2012, to cancel and rebook 25 per cent of the total contracts booked for hedging their export exposure.

V.24 The EEFC scheme is intended to enable exchange earners to save on conversion and transaction costs while undertaking forex transactions. It is not intended to enable exchange earners to maintain assets in foreign currency, as India is still not fully convertible on capital account. In view of recent developments in the forex market, it was decided that: 50 per cent of the balances in the EEFC accounts would be converted into rupee balances and credited to the rupee accounts according to the directions of the account holder within a fortnight from May 10, 2012. For all future forex earnings, an exchange earner is eligible to retain 50 per cent (as against the previous limit of 100 per cent) in non-interest bearing EEFC account. The remaining 50 per cent should be surrendered for conversion to rupee balances.

V.25 For operational convenience, the regulations were reviewed on July 31, 2012 and it was decided to restore erstwhile stipulation of allowing credit of 100 per cent foreign exchange earnings to the EEFC account subject to the condition that the sum of the total accruals in the account during a calendar month should be converted into rupees on or before the last day of the succeeding calendar month after adjusting for utilisation of balances for the approved purposes or forward commitments.

Measures and Challenges in Regard to ECBs

V.26 One of the challenges regarding external commercial borrowings (ECBs) is the ever increasing demand to liberalise their terms of end-use and eligibility *vis-a-vis* the sustainability of the external debt.

V.27 During 2011-12, the annual limit for ECBs under the automatic route was enhance for companies in manufacturing, infrastructure sector, service sector companies in hotel, hospital and

software and NGOs engaged in micro-finance activities. Besides, micro-finance institutions (MFIs) were permitted to raise ECBs for onward lending to micro-finance activities. Moreover, eligible borrowers were permitted to avail of ECBs designated in Indian rupee from foreign equity holders. To facilitate this non-residents were allowed to hedge their currency risk in ECBs denominated in Indian rupee. Companies in the manufacturing and infrastructure sector that have foreign exchange earnings were also permitted to avail of ECBs under the approval route to repay rupee loan(s) availed from the domestic banking system and/or for fresh rupee capital expenditure.

V.28 The universe of non-resident entities eligible to provide credit enhancement under the automatic route was expanded to include foreign equity holders.

V.29 In view of the tight liquidity conditions and widening of credit spreads due to recent developments in international financial markets, the all-in-cost ceiling of trade credit and ECBs was enhanced. Refinancing of existing ECBs at a higher all-in-cost was permitted under the approval route. Simultaneously, borrowers were instructed to repatriate immediately the proceeds of the ECBs raised abroad that were intended for rupee expenditure in India and credit them to the borrowers' rupee accounts with banks in India.

V.30 Liberalisation in ECB policies also aimed at channelising more external funds to the infrastructure sector. The important infrastructure specific measures introduced during 2011-12 allow: 25 per cent of the fresh ECBs raised by corporates to be used to repay their rupee loan/s from the domestic banking system for completed infrastructure projects, with 40 per cent being allowed for the power sector; ECBs in renminbi (RMB) up to an annual cap of US$ 1 billion; interest payment during construction (IDC) as a permissible end-use; the facility of short-term credit (including buyers'/ suppliers' credit) as 'bridge-finance' to import capital goods (to be replaced with an ECB at a later date); and developers of national manufacturing investment zone (NMIZ) to avail of ECBs for providing infrastructure facilities within the NMIZ.

Measures Relating to Foreign Currency Convertible Bonds (FCCBs)

V.31 The global financial crisis and consequent decline in equity prices led to FCCBs not getting converted into equity and a resultant redemption pressure on Indian companies. The immediate challenge for Indian corporates is to meet the redemption obligations of FCCBs that fall due in the next couple of years. The other challenge is to rekindle the appetite for FCCBs which has been receiving lukewarm response from investors. To mitigate the hardship faced by issuers in redeeming their FCCBs, Indian companies have been allowed to raise fresh ECB/ FCCB to refinance their outstanding FCCBs according to the ECB guidelines under the automatic route. Proposals for restructuring FCCBs that do not involve a change in conversion price are considered under the approval route.

Swap Arrangement for SAARC Member Countries

V.32 To strengthen regional financial and economic cooperation, the SAARC swap arrangement was announced at the 24th SAARCFINANCE Governors' Meeting held on May 16, 2012. Under the arrangement, the Reserve Bank will offer a swap facility of US$ 2 billion both in foreign currency and Indian rupee to all SAARC member countries, *viz*., Afghanistan, Bangladesh, Bhutan, Maldives, Nepal, Pakistan and Sri Lanka. India will contribute the entire fund. The swap will be offered in US dollar, euro or Indian rupee against the domestic currency or domestic currency denominated G-sec of the requesting country. The requesting member countries can access US dollar, euro or Indian rupee in multiple tranches. Each drawal will be of three months tenor

and can be rolled over twice. The swap arrangement is intended to provide a back stop line of funding for SAARC member countries to meet any balance of payments and liquidity crises, until longer-term arrangements are made, or if there is a need for short-term liquidity due to market turbulence.

Overseas investment – Major Policy Changes

V.33 To provide greater operational flexibility in overseas investments by Indian corporates, the regulations for overseas direct investment were further liberalised/ rationalised during 2011-12.

Management of Foreign Exchange Reserves

V.34 The guiding objectives of foreign exchange reserves management in India continued to be safety, liquidity and returns in line with general international practices. The level of foreign exchange reserves has traditionally been the outcome of the Reserve Bank's intervention in the foreign exchange market to contain excessive exchange rate volatility and valuation changes due to movement in the prices of securities and of the US dollar against other currencies. Moreover, the reserves, which are mainly built up from volatile capital flows, do not represent surplus earnings through international trade as in the case of some other countries and hence, are required to be held as a buffer during periods of sudden stops and reversal in capital flows. The Reserve Bank of India Act, 1934 provides the legal framework for deployment of the Reserve Bank's foreign currency assets.

DERIVATIVES MARKET

Issuance of Final Guidelines on Credit Default Swaps (CDS)

V.35 Based on the recommendations of the internal working group on introducing plain vanilla over-the-counter (OTC) single-name CDS for corporate bonds for resident entities, guidelines on CDS were issued after considering the feedback and suggestions from market participants (see Annual Report 2010-11: Box V.1). CDS was notified as a derivative for the purpose of Chapter IIID of the Reserve Bank of India Act, 1934 on October 19, 2011. Guidelines for capital adequacy and exposure norms for banks and PDs were issued in November 2011. With the necessary infrastructure that included trade repository, documentation, publication of the CDS curve for valuation, standardisation of contracts, *etc.*, in place, participants were permitted to enter into CDS from December 1, 2011. The reporting of CDS transactions on the CCIL's platform by market-makers was also made mandatory. FIMMDA has been conducting workshops to create awareness about the product among market participants and help prepare policies for their CDS.

V.36 A trade repository - CCIL online reporting engine (CORE) – has been set up for reporting CDS trades. Value-free transfer of securities has also been permitted to meet margin requirements.

Introduction of 2-year and 5-year Cash Settled IRF

V.37 The second quarter review of Monetary Policy 2010-11 (November 2010) indicated that exchange traded IRFs on 2-year and 5-year notional coupon bearing G-secs and 91-day T-bills would be introduced after taking into account the experiences of cash-settled IRF regimes in other countries. The guidelines on 91-day T-bill IRFs were issued on March 7, 2011. Further, the guidelines for cash-settled 2-year and 5-year IRFs were issued on December 30, 2011.