H R Khan: Musings on the FEDAI, the forex market and the Indian rupee

Keynote address by Shri H R Khan, Deputy Governor of the Reserve Bank of India, at the 7th Annual Conference of the Foreign Exchange Dealers Association of India (FEDAI), Zurich, 5 April 2012.

* * *

The speaker acknowledges the valuable contributions of Shri. G Padmanabhan, Shri. G Mahalingam, Shri. Chinmoy Kumar, Shri. Rakesh Tripathy, Shri S. C. Rath and Shri. Surajit Bose.

Dr. T V Nagendra Prasad, Charge d'Affairs, Embassy of India, Mr. Phillipe Welti, former Ambassador of Switzerland to India & Bhutan, Mr. Beat Siegenthaler, Executive Director, UBS, Ms. Varsha Vasant Purandare, Chairperson, Foreign Exchange Dealers Association of India (FEDAI), Mr. D. G. Patwardhan, Chief Executive Officer, FEDAI, Mr. N. S. Venkatesh, Chairman, The Fixed Income Money Market and Derivatives Association of India (FIMMDA), Mr. C.E.S Azariah, Chief Executive Officer, FIMMDA, Mr. G Mahalingam, Chief General Manager, Reserve Bank of India, and distinguished delegates to the 7th Annual Conference 2012 of FEDAI.

It is a pleasure to be with you in this beautiful city of Zurich and discuss some of the contemporary issues which are likely to pave way for the new order that is being ushered in for creating a more robust, more transparent and less risky financial sector. As you would be aware, a host of committees under the aegis of the Bank for International Settlements (BIS), which is headquartered close to Zurich in Basle, are rewriting rules governing the banking and market practices and India is a part of most of these committees. The regulatory regime of the international financial architecture is undergoing a metamorphosis post recent global financial crisis. In this scenario, it is perhaps appropriate that a forum like this reviews the relevance of the existing order, with particular reference to our foreign exchange market, in the light of fast changing developments around us.

I shall start my address by revisiting the role of the FEDAI. I shall focus more generally what should be the role of a Self-Regulatory Organization (SRO) in today's context and particularly what should be the role of FEDAI in the changed environment of our forex market. Moving over to some of the core issues relating to the forex market in India, I will briefly touch upon some of the recent measures taken by the Reserve Bank. Finally, I will briefly discuss the issue of internationalization of Indian Rupee, a subject which is assuming critical importance in the context of search for alternative reserve currencies and the role for currencies of major Emerging Market Economies (EMEs) like China and India.

Evolution of FEDAI in the changing environment of Indian forex market

As you may be aware, in the early post-Independence years, under the Foreign Exchange Regulation Act (FERA), 1947, a few foreign banks, designated as Exchange Banks were permitted to transact foreign exchange business. The terms and conditions for undertaking such business were being laid down by the then Exchange Banks' Association. With the increase in India's foreign trade, several scheduled commercial banks were authorized by the Reserve Bank to deal in foreign exchange business. This led to the formation of FEDAI on August 16, 1958 with a mandate to lay down the terms and conditions which were mandatory in nature for the Authorized Dealers (ADs). With developments in the Indian foreign exchange market and growth in external trade, the role and responsibility of FEDAI underwent changes. I am happy to note that FEDAI, through its members, continues to play a pivotal role in dissemination of the foreign exchange related banking expertise across the country which has led to significant improvement in the customer service.

Let me now highlight two important milestones in the evolution of Indian forex market. In the year 1994, an Expert Group on Foreign Exchange Market in India was set up under the Chairmanship of Shri. O. P. Sodhani, the then Executive Director, Reserve Bank of India (popularly known as the Sodhani Committee). The Committee had made wide ranging recommendations ranging from methodology for correct computation of Open Exchange Position to introduction of Rupee based options and these suggestions had laid the foundation for a modern foreign exchange market in India. FEDAI played an important role in supporting the Reserve Bank in implementing these pioneering measures and suggestions aimed at major reforms in the market. The second milestone was the replacement of restrictive FERA with the Foreign Exchange Management Act (FEMA) in the year 2000. This provided further fillip to the development of the foreign exchange market which can be gauged from the rise in the average daily forex market turnover from approximately US$ 6 billion in 2000 to nearly US$ 60 billion in 2010–11. This figure excludes the daily turnover in the exchange traded currency futures market which would add up to another US$ 5 to 7 billion a day. The depth of the foreign exchange market can also be gauged from the fact that the bid offer spread in USD INR pair is now around half a paisa. The average daily foreign exchange turnover has, however, showed a dip since the second half of December 2011. One plausible reason for the decline could be the administrative measures taken by the Reserve Bank of India to moderate the excessive volatile conditions prevalent in the foreign exchange market but I will touch upon this issue a bit later in my address.

Future role and responsibilities of FEDAI

Having briefly touched upon the significant role played by the FEDAI so far, let me now turn to the possible future role and responsibilities of the FEDAI with special focus on should FEDAI become a full-fledged SRO.

Many countries rely on self-regulation because expansive resources are required to regulate the financial markets effectively, especially in large and complex markets. With the existence of an effective SRO, often referred to as frontline regulator, the statutory regulator (the Regulator) relies on the SRO to carry out supervision of operations and activities of the market participants. The supporters of the idea of self-regulation claim that it offers significant advantage over direct government/statutory regulation. This can be attributed to the fact that SROs have thorough domain knowledge of their respective area and regulatory framework within which they operate. Therefore, they are considerably more flexible, context-driven and are able to respond faster to the changes in market conditions. This also allows the Regulator to spare its resources more on identifying and responding to major systemic risks and to other priorities outside the ambit of self-regulation. It is believed that self-regulation system works effectively because of the business incentive to operate in a fair, financially sound and competitive marketplace. The critics, on the other hand, argue that private profit seeking enterprises cannot be trusted to regulate their own activities as such self-regulation tends to create an illusion of regulation. In addition to the conflict of interest, critics of self-regulation point to certain other inefficiencies, such as, widespread collective action problems, lack of effective enforcement capabilities, inability to gain or maintain legitimacy and the failure of accountability.

Having weighed the views of the supporters and critics of the SRO system and in view of the increasing complexities of financial markets and activities, it is important to realize and emphasize that industry self-regulation cannot fully replace government regulation and supervision of the financial services sector. At the same time, it may not be out of place to say that co-operation amongst the statutory regulators and SROs in an increasingly complex financial environment is no longer an option but a necessity. Co-ordination and communication should be structured to address potential problems before they occur. One of the important regulatory lessons learnt from the recent global financial crisis is the need for a concerted response. The Government or the Regulator alone cannot provide an effective response. Active engagement of market participants, in particular through industry

organizations, such as, SROs and other industry bodies with some self-regulatory capacity, is essential to craft practical regulatory responses and to act effectively on policy changes.

In this era of fast paced liberalizations and developments, FEDAI should gradually assume the role of a full-fledged SRO. Typically, a generic and effective SRO in its template of elements cover, *inter alia*, internal rulemaking process, authorisation and access to market-place, including fitness/qualification standards for market intermediaries, surveillance of market activities, administration of dispute resolution, sharing information and cooperating with other SROs and the regulators, etc. SROs enable members to exercise self-discipline, make regulations more responsive to market demand and also promote innovation and development in a market based approach. This is critical for the development of the financial markets in order to make them competitive, regionally and globally, and improve standards of conduct by self-regulation.

Developmental role of FEDAI

When the Reserve Bank issues instructions, it is expected that the instructions are understood, interpreted and implemented in a uniform and customer friendly manner by all ADs without building up system level stresses. In the absence of unambiguous clarity of instructions to the base level official, the objectives of various measures initiated by the Reserve Bank may not yield the desired results. With the advent of FEMA which aims at facilitating external trade and payments besides promoting orderly development and maintenance of forex market in India, the economy has been witnessing rapid liberalizations. In such a scenario, FEDAI needs to monitor the level of customer service and consumer protection provided by its members and try to fill the gaps arising out of inadequate knowledge or operational bottlenecks. The Reserve Bank has been emphasizing the need for designing some basic training module covering the rules & regulations and also the operational guidelines for the frontline staff at the branch and corporate office levels. Such a module will help them in improving the foreign exchange related customer service, reduce incidents of complaints and bring down the level of correspondence seeking clarifications both within the bank and from the Reserve Bank. Member banks of FEDAI and the Reserve Bank have since formed a Group which is working to develop an elearning module to address these concerns. Another related area where FEDAI is expected to play an important role is in framing of a Citizens' Charter in the area of foreign exchange business.

Role of market participants – freedom with responsibility

Let me now turn to the second part of my address, perhaps more relevant to many in the audience in our current context.

An efficient market not only requires proper infrastructure, knowledge, skills and enabling environment but also a great degree of market discipline reflected through responsible behaviour by all the market participants. As was experienced during the recent global financial crisis, among other reasons, the greed of insensitive financial engineers for short term gains caused huge financial and economic damages to some of the most developed nations and markets. This has, in fact, become a major focus of discussions across the jurisdictions after the financial crisis.

In the past, it has been argued that market discipline can play a key role in incentivizing market participants to limit their excessive risk taking activities. The events of the last few years, however, have proved the inadequacy of market discipline. Bankers have been found to be actively engaged in risktaking activities disguised as value-creation. Time and again market participants have engaged in herd behaviour and put the financial system at risk, at times by encouraging speculative build-up in the name of hedging for risk management. The events of the past few years tell us that market discipline expressed via market prices cannot be expected to play a major role in constraining risk taking. Therefore, the primary constraint

needs to come from regulation and supervision. Since the ADs are the major players in the domestic foreign exchange market in India, one would expect much higher responsibility from them. Reserve Bank has come across instances where a few banks failed to live up to that kind of expectations and have deviated from the ethics by misselling forex derivative products which resulted in enormous problems for the banks as also for the corporates some of which were carried away by the greed of making money from activities other than their core business operations.

As you may recall, the existing guidelines on OTC foreign exchange derivatives were revised in December 2010 in the context of developments in the international and as well as the domestic markets. The revised guidelines put more emphasis on the suitability and appropriateness aspects of products being offered. Market-makers have been advised to undertake derivative transactions with a sense of responsibility and cautioned to avoid, among other things, misselling. These products are to be offered to corporates who understand the nature of the risks inherent and have a well laid down risk management policy. Such policy must clearly lay down, *inter-alia*, guidelines on risk identification, management and control, prudent accounting and disclosure norms and must be capable of ascertaining the mark to market positions on an on-going basis. In fact, the Reserve Bank has made it mandatory for the market participants to offer a tool or a calculator which would enable the corporate to mark to market these products on a continuous basis. Though the objective of the policy is prudential in nature as it protects the market participant against the credit, reputation and legal risks, it is important to realize that the policy protects the interest of the corporates as well.

Let me also reiterate that banks need to closely monitor the un-hedged foreign currency exposures of corporates as they had hedged approximately only 60 per cent and 38 per cent of their trade and non-trade related exposures respectively till December 2011. Excessive risk taking by corporates could lead to severe distress to them and large credit loss to the banks in event of sharp adverse movements in currencies. In 2008, it was conveyed to the banks that they should have a Board approved policy covering un-hedged foreign exchange exposure of all the clients including Small and Medium Enterprises. Banks while extending fund and non-fund based credit facilities to corporate, should rigorously evaluate the risks arising out of un-hedged foreign currency exposure of the corporates and price them in the credit risk premium as we have recently reiterated in our circular following the announcements made in the Second Quarter Review of the Monetary Policy 2011–12.

During the recent episode of excessive volatility leading to sudden and sharp depreciation of Indian Rupee against US Dollar, it was noticed that the flexibility given to banks for fixing their intra-day limits, which were in many cases, significantly higher than their net overnight open positions limits, were often being used for building up speculative positions and taking a directional bet on Rupee. The facilities given to corporates by way of cancellation and re-booking of their forward contracts and booking of forward contracts under past performance criterion were also not being used in the right spirit. As you would appreciate such speculative forces tend to be self-reinforcing and often result in a situation where exporters keep on deferring their receipts and importers rush in to buy forwards, thus aggravating the situation in hand. The administrative measures undertaken by Reserve Bank in the month of December 2011 were aimed at curbing these speculative behaviour of such entities. The measures did achieve the intended policy objectives and also led to an immediate fall in the volumes of the markets. The actual hedging requirements of the real sector, however, were not left unattended as we subsequently relaxed some of the measures to accommodate customer needs. Within the overarching prerequisite of facilitating genuine hedging needs of the customers, Reserve Bank would consider relaxations, in particular those relating to intra-day position limits, in a calibrated manner at appropriate time.

Let me assure you that Reserve Bank will continue with its calibrated and gradual approach towards liberalisation of the foreign exchange market in India but at the same time we will expect greater degree of responsibility and accountability from all the participants. In the

context of our measured approach to market liberalisation, there has been a lot of debate on scope of wider usage of Indian Rupee both in the region/abroad, or in other words, internationalization of Indian Rupee. I will now briefly touch upon the issue in the third and last part of my address.

Challenges for Internationalization of Indian Rupee

In view of the recent crisis in the financial market which resulted in a slowdown in the world economy, some views have emerged from various quarters on whether the Indian Rupee could play a larger role as an international currency. This issue assumed a topical and, if I may add, patriotic significance when the symbol for Indian Rupee was unveiled amidst huge media publicity. Proposals for use of local currencies of the EMEs under bilateral and multi-lateral arrangements including the initiatives taken by China for Yuan and the recent suggestions emanating from BRICS nations have provided renewed focus to this. It is a known fact that wide acceptance by participants in trade and financial markets makes a currency a popular option for trade settlement and for maintenance of reserves. The characteristics which a currency needs to possess before it could become popular as a transactions currency would include free convertibility, ability to invest, borrow, issue marketable instruments, significant volumes of international trade in different regions, stability of the exchange rate, the currency being a favoured choice for invoicing which would, *inter-alia* depend on the mutual negotiating strength of trading partners, availability of deep foreign exchange markets, cost-effective hedging facilities including forward cover, availability of efficient banking arrangement/market infrastructure, etc.

Based on the analysis of Prof. Peter Kenen of Princeton University, we can lay down the following seven broad prerequisites for the process of internationalization of a currency.

i. Domestic entities are permitted to invoice some of their exports in the country's currency, and similarly foreign entities are also allowed to invoice their exports in that country's currency;

ii. There should be no restrictions on any entity, domestic or foreign, to buy/sell its country's currency in the spot and forward markets. In other words, there should be freedom of foreign-exchange trading by domestic and foreign entities and no limits be imposed on holding the domestic currency and derivative instruments denominated in it;

iii. Foreign entities/financial institutions/official institutions, and individuals, are permitted to hold the country's currency and financial instruments denominated in it as a part of prudent investment strategy/the official reserves;

iv. Foreign entities, including official institutions, are able to issue marketable instruments in the country's currency. These may include both equity and debt instruments, not only in the country's domestic markets but also in foreign markets, including, the home country markets of the foreign entities;

v. The issuing country's own financial institutions and other entities are able to issue in foreign markets instruments denominated in that country's currency;

vi. International and regional financial institutions are able to issue debt instruments in a country's market and use its currency in their financial operations;

vii. The currency may be included in the "currency baskets" of other countries, in consideration of their own exchange-rate policies.

Measured against the above pre-requisites for internationalization of currency, Indian Rupee is certainly far away from any meaningful internationalization. Of course, a few measures taken in the recent years deserve some attention. Since the introduction of FEMA, the Indian Rupee invoicing is a permitted form of invoicing under the current trade and FEMA

regulations. In order to facilitate greater use of Indian Rupee in trade transactions, the Reserve Bank of India has now allowed non-resident importers and exporters to hedge their currency risk in respect of exports from and imports to India, invoiced in Indian Rupees. In this regard, forward foreign exchange contracts with Indian Rupee as one of the currencies and foreign currency – Indian Rupee options are the available products for the purpose of hedging the risks. Non-resident exporter/importer can avail of the facility either directly from ADs in India or through their banker overseas. The AD, on the basis of the documentary evidence and undertakings provided by the non-resident, has to be satisfied of the bona-fides of the customer as well as of the transaction. As with all other hedging facilities available to non-residents, these contracts once cancelled cannot be rebooked. We would be happy to have your feedback on this particular measure announced by the Reserve Bank of India as it is almost nine months since the same was announced.

Eligible borrowers have been permitted to avail of ECBs designated in Indian Rupee from their foreign equity holders under the automatic/ approval route. In order to hedge the currency risk arising out of such ECBs, forward foreign exchange contracts with Indian Rupee as one of the currencies, foreign currency-Indian Rupee options and foreign currency-Indian Rupee swaps have been permitted.

The debate on internationalization of a currency often goes hand-in-hand with that on capital account convertibility. It is a known fact that capital controls can co-exist with an international currency. Economic history is rich with examples of countries, especially advanced countries with an international currency, imposing a variety of capital controls to stem the depreciation/appreciation of their currencies and/or to regulate short-term capital flows. While internationalization of a currency is not a pre-requisite for capital account convertibility, its large scale externalization has the potential to impose significant costs, especially over the medium- to long-term as the real and financial sectors of a country grow and develop strong linkages with the world economy.

The pace and the process of internationalization of a currency is of course dependent on the acceptable degree of capital account convertibility. This, in turn, involves the extent to which non-residents are allowed to participate in the domestic forward foreign exchange markets to obtain cover and invest in the domestic markets for any Indian Rupee balances that they may accumulate. At the same time, the benefits and costs of the Indian Rupee becoming an international currency needs to be reckoned. The benefits broadly include reduction of exchange risk for domestic exporters/importers as risks would instead have to be taken by the overseas party and extensive use of Indian Rupee by non-residents would mean increased seigniorage. Domestic entities can also access international financial markets without exchange rate risk and can avail of larger amounts of investment at a lesser cost than in the domestic market. Expanded investor base and reduction in the cost of capital may help both the financial sector intermediation and the real sector. Governments, particularly those with high fiscal deficit, may benefit by foreign participation in its debt market and get the benefit of higher flows to finance the current account deficits. The costs would include difficulty in managing the implications for monetary policy and exchange rate management besides the administrative costs. Under the "Impossible Trinity" framework higher internationalization would severely limit either the country's flexibility to influence the monetary condition, such as, interest rate, money supply. or manage exchange rate under stress situations. Coming to the issue of benefit to domestic entities/government by way of easy access to external resources, the huge risk in terms of increased vulnerabilities arising out of sudden stops, panic outflows unrelated to fundamentals of the economy, speculative bets by large pools of international funds, loss of confidence in the context of size of reserves in relation to external debt, particularly short term debt, have to be reckoned with. These vulnerabilities have now been accentuated in the context of the recent global financial crisis.

It is also imperative to understand that unlike countries with current account surpluses, India generally has a sizeable quantum of current account deficit. The exchange rate of Indian Rupee remains susceptible to ebb and flow of external capital, especially outflows during

periods of stress. Given the growing level of our twin deficits of fiscal and current account hasty internationalization could only add to our external sector vulnerabilities. As has been witnessed in the past, sudden reversal of capital flow imparts significant volatility to the exchange rate which at times needs to be curbed by the Reserve Bank. In the event of internationalization of the Indian Rupee, the exchange rate would be largely determined by the sentiments of the market forces and the present policy measures to curb such volatilities may not prove to be as effective as they are today. These are some initial thoughts on the subject which you would be discussing in detail tomorrow. We would look forward to views/suggestions that would emerge from the deliberations of the panel here and thereafter, particularly if we can identify some low risk but macro-economically beneficial areas, such as, progressive use of Indian Rupee in trade account given the need to further boost to our exports sector.

Concluding thoughts

Economy and financial markets of India are in the midst of rapid transformation due to its increasing linkages with the rest of the world. In keeping with the changing needs, Reserve Bank of India has been striving for more simplification, liberalization and rationalization of the policies and the processes in the area of foreign exchange administration without jeopardizing the financial stability. Market-players, therefore, now have more freedom to undertake transactions as compared to the earlier days. These flexibilities, however, should be utilized in a responsible manner that is transparent, fair and beneficial to the customers and the economy as a whole and not mis-utilized for short term gains of a few market-players with adverse consequential effects on our financial sector. Therefore, the role of FEDAI assumes greater significance in the present context. There is, thus, a need to have a closer look at the working and functions of FEDAI and strategize on how to transform it to a full-fledged and responsive SRO. This would be a win-win proposition for all the stakeholders including the banks, customers and the regulators like the Reserve Bank of India. I am sure that the deliberations in this conference will generate practical ideas on the future role of FEDAI, especially as we continue to make progress in our calibrated approach towards capital account convertibility coupled with the measures being taken to deepen and broaden our forex market and facilitate greater use of Indian Rupee, particularly in the trade account.

I wish you all the very best for productive business sessions followed by the pleasure of exploring the sublime and scenic beauty of Switzerland.