

RBI Allows Rupee Derivative Trading Through International Financial Service Center

written by Akshay Ramesh | November 11, 2019

RBI has dived into the ocean of the international financial market to protect the interest of the onshore rupee derivative market[1] which is getting financially fractured due to the overactive offshore

rupee derivative markets[2]. The offshore rupee derivative markets has an adverse effect on the

Indian currency value. This bothered the RBI, who is responsible to maintain the financial health of the Indian Economy in par with international requirements. As a reformative measure, the RBI established a task force to look into this issue and suggest a way forward to curb the negative effects caused by the offshore rupee derivative market upon the onshore rupee derivative markets. Wherefore, the task force chaired by Deputy Governor, Dr. Usha Thorat has successfully submitted its recommendations with high hope of strategically strengthening the onshore rupee derivative market.

Present day's

need of International Financial Service Centre ("IFSC") in the global economy

By understanding the services provided by the IFSCs, we can infer the requirement of having our own IFSC in India. The services provided by the IFSCs are as below:

- Fund-raising for individuals, corporations, and governments,
- Asset management and global portfolio diversification are undertaken by pension funds, insurance companies, and mutual funds,
- Wealth management;
- Global tax management and cross-border tax liability optimization, which provides a business opportunity for financial intermediaries, accountants, and law firms,
- Global and regional corporate treasury management operations that involve fund-raising, liquidity investment, and management and asset-liability matching,
- Risk management operations such as insurance and reinsurance, and
- Merger and acquisition activities among trans-national corporations.

Establishment

of India's first IFSC

RBI and the Government of India have taken some effective decisions to make people trade the currencies through the onshore rupee derivative markets. One such decision was the establishment of India's first IFSC at GIFT City in Gandhinagar, Gujarat. The Government of India decided to set up this unified authority for regulating all financial services

in the IFSCs in the country. Currently, the banking, capital markets and insurance sectors in IFSCs are regulated by multiple regulators like the RBI, Securities and Exchange Board of India ("SEBI"), and Insurance Regulatory and Development Authority ("IRDAI") respectively.

Recent actions

which are taken by the RBI

After a thorough examination of the recommendations made by the task force headed by Smt. Usha Thorat, the central bank of India decided to take up the following actions to boost the onshore rupee derivative market.

- To allow domestic banks to freely offer foreign exchange prices to non-residents at all times, out of their Indian books, either by a domestic sales team or through their overseas branches; and
- To allow rupee derivatives (with settlement in foreign currency) to be traded in International Financial Services Centres (IFSCs).

However, the directions for implementing the above two recommendations will be issued by the RBI in consultation with the Central

Government. On the other hand, the RBI has decided to enhance the overall scope

of non-interest-bearing special non-resident rupee ("SNRR") account by permitting individuals resident outside India to open such accounts and facilitate the rupee-denominated External Commercial Borrowing ("ECB"),

trade credit and trade invoicing. These decisions taken by the RBI shall also indirectly impact Non-Deliverable Forward ("NDF"), the opaque and non-transparent, Over the Counter ("OTC") Rupee derivatives market active in London and in the United States of America.

Major recommendations by the task force are:

- Enabling rupee derivatives (settled in foreign currency) to be traded in the IFSC in India;
- To allow users to undertake forex transactions up to USD 10,00,00,000 million in OTC currency derivative market without the need to establish underlying exposure (security that must be delivered when a derivative contract is exercised);
- To facilitate non-residents to hedge their foreign exchange exposure onshore rupee derivative markets by:
 1. Establishing a central clearing and settlement mechanism for non-resident transactions in the onshore market;
 2. Implementing margin requirements for non-centrally cleared OTC derivatives and allowing Indian banks to post margins abroad;
 3. Aligning the tax treatment of foreign exchange derivatives with that in major international centres; and
 4. Centralizing the KYC requirements across financial markets with uniform documentation requirements.
- On the other hand, the task force has recommended extending the onshore market hours to improve access of overseas users and permit Indian banks to freely offer prices to global clients around the clock.

Highlights on

the reasons behind having an IFSC in India

The establishment of IFSC would no doubt create a

mega trajectory in the performance of the onshore rupee derivative market in India. The reason behind this is IFSC seeking to bring to India, these types of

financial services and transactions that are currently carried on outside India

by overseas financial institutions and overseas branches/ subsidiaries of Indian financial institutions. The policy objective behind establishing an IFSC

in India is to provide a platform for international financial services to operate from India and to specialize in exports of high value-added International Financial Services.

Legal

provisions on IFSC in India

Section 18 and Section 55 of India's Special Economic Zone Act, 2005 provides for the establishment of an IFSC within a Special Economic

Zone in India and enables the Central Government to regulate IFSC activities respectively. However, as per Section 18 of Special Economic Zone Act, 2005, the Central Government of India can approve for the establishment of only one International

Financial Services Centre in a particular Special Economic Zone.

Also, IFSC shall be designated for all practical purposes as a 'deemed foreign territory' which would have the same ecosystem as other offshore locations, but which is physically on Indian soil.

Conclusion

Government of India and RBI has decided to establish IFSCs in GIFT City in Gandhinagar, Gujarat through the International Financial

Services Centers Authority Bill, 2019[3] to bring back the financial services and transactions that are

currently carried out in offshore financial centres by Indian corporate entities and overseas branches or subsidiaries of financial institutions (FIs) in

India. In order to ensure this, the business and regulatory environment must be

comparable to other leading IFSCs in the world like London and Singapore. In order to compete with other IFSCs such as Dubai International Financial Centre

and Shanghai International Financial Centre, which are located within SEZs, Indian IFSC needs to meet the basic requirements such as rational-legal regulatory framework, stable political environment, developed infrastructure, strategic location, and sustainable local economy. Also, wide access to the forex-retail trading platform to non-residents would be a major incentive to use the onshore market.

For instance, in the year 2013, the Indian currency value received a strong blow due to the rising influence of the offshore rupee derivative market.

Also, the quantum of trading in the onshore market is shrinking at the expense of the offshore rupee market in recent times. One evident example for the previous statement is the latest report of Bank for International Settlements ("BIS") which stated that London has surpassed India's financial capital Mumbai to become the top centre for trading rupee.

Henceforth, it is well understood that the

off-shore rupee derivative markets are all capable of weakening the local markets in India. However, in order to strengthen the local economy from the grass-root level, the RBI has now allowed the local banks to freely offer foreign currency prices to non-residents. This shall attract more foreigners as well as non-resident Indians to approach the onshore rupee derivative markets.

- [1] 'Onshore' currencies simply mean buying the currencies locally
- [2] 'Offshore' currencies mean buying the currencies outside the national boundaries.
- [3] <https://pib.gov.in/newsite/PrintRelease.aspx?relid=188144>

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