Role played by FMC in the Indian Economy and Merger of Forward Market Commission in SEBI

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ABSTRACT

Foreign exchange market in India started three decades ago when in 1978 the government allowed banks to trade foreign exchange with one another. Today over 70% of the trading in foreign exchange continues to take place in the inter-bank market. The market consists of over 90 Authorized Dealers (mostly banks) who transact currency among themselves and come out “square” or without exposure at the end of the trading day. Trading is regulated by the Foreign Exchange Dealers Association of India (FEDAI), a self-regulatory association of dealers. Since 2001, clearing and settlement functions in the foreign exchange market are largely carried out by the Clearing Corporation of India Limited (CCIL) that handles transactions of approximately 3.5 billion US dollars a day, about 80% of the total transactions. This paper is divided into four sections: section one deals with the introduction of the study along with the exchange rate systems, section two tries to explain the trends in the Indian foreign exchange market whereas section three explains the features of the different components of the foreign exchange markets, section four assess and analyse the regulations and the role played by the forward market commission in India till its merger. The Financial Sector Legislative Reforms Commission (FSLRC) had earlier stressed on the need to move away from sector-wise regulation. It proposed a system in which RBI would regulate the banking and payments system, and a Unified Financial Agency (UFA) would subsume all other financial sector regulators such as SEBI, IRDA, PFRDA and FMC, to regulate the rest of the financial markets, which results in the merger of the FMC with SEBI. Hence section four focuses on the recent merger of this organisation with SEBI.

1. INTRODUCTION

Management development is a systematic process of training and growth by which managerial personnel gain and apply skills, knowledge, attitude and insight to manage the work in their organization efficiently and effectively. Thus, any process for improving the effectiveness of an The liberalization process has significantly boosted the foreign exchange market in the country by allowing both banks and corporations greater flexibility in holding and trading foreign currencies. The Sodhani Committee set up in 1994 recommended greater freedom to participating banks, allowing them to fix their own trading limits, interest rates on FCNR deposits and the use of derivative products. The growth of the foreign exchange market in the last few years has been nothing less than momentous. In the last 15 years, trading volume in the foreign exchange market (including swaps, forwards and forward cancellations) has more than tripled, growing at a compounded annual rate exceeding 25%. About two-thirds of all transactions has the rupee on one side. According to the triennial central bank survey of foreign exchange and derivative markets conducted by the Bank for International Settlements, the Indian Rupee featured in decent position among all currencies in terms of being on one side of all foreign transactions around the globe and its share has increased many times since 1998.

Exchange rate Systems

An exchange-rate regime is the way an authority manages its currency in relation to other currencies and the foreign exchange market. It is closely related to monetary policy and the two are generally dependent on many of the same factors.

The basic types are a floating exchange rate, where the market dictates movements in the exchange rate;
a pegged float, where a central bank keeps the rate from deviating too far from a target band or value; and a fixed exchange rate, which ties the currency to another currency, mostly more widespread currencies such as the U.S. dollar or the euro or a basket of currencies.

Floating rates are the most common exchange rate regime today. For example, the dollar, euro, yen, and British pound all are floating currencies. However, since central banks frequently intervene to avoid excessive appreciation or depreciation, these regimes are often called managed float or a dirty float.

Fixed rates are those that have direct convertibility towards another currency. In case of a separate currency, also known as a currency board arrangement, the domestic currency is backed one to one by foreign reserves. A pegged currency with very small bands (< 1%) and countries that have adopted another country’s currency and abandoned its own also fall under this.

**Trends in the Indian Foreign Exchange Market**

Recent developments in forex management in India are undergoing rapid transformation. It is increasingly getting integrated within the broad ambit of financial markets. Over the last fifteen years, momentum changes have happened in the financial sector. The global foreign exchange markets have grown manifold in the recent years. The BIS Triennial Central Bank Survey on forex and derivatives markets indicates a substantial rise in activity in foreign exchange markets across the world.

Both global factors, such as search for yield and a secular deepening in Asian financial markets contributed to the strong growth. In this context, it is important to note that the share of trading between banks and financial customers is rising significantly. The currency composition are: dollar in 89 percent of all transactions, followed by the Euro (37 percent), the Yen (20 percent) and the Pound Sterling (17 percent).

In terms of currency pairs, US dollar/ Euro continues to be by far the most traded currency pairs according for 28 percent of global turnover, followed by US dollar/ Yen with 17 percent and US dollar/ Pound Sterling with 14 percent. The percentage share of the Indian Rupee, though minuscule, has almost trebled to constitute 0.3 percent of total daily turnover.

**Options in Foreign Exchange Market**

A foreign-exchange option is a derivative financial instrument that gives the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date.

The foreign exchange options market is the deepest, largest and most liquid market for options of any kind. Most trading is over the counter (OTC) and is lightly regulated, but a fraction is traded on exchanges.

**Features of Forward Market & Futures Market**

Futures and forwards share some common characteristics:

- Both futures and forwards are firm and binding agreements to act at a later date. In most cases this means exchanging an asset at a specific price sometime in the future.

- Both types of derivatives obligate the parties to make a contract to complete the transaction or offset the transaction by engaging in another transaction that settles each party’s obligation to the other. Physical settlement occurs when the actual underlying asset is delivered in exchange for the agreed-upon price. In cases where the contracts are entered into for purely financial reasons (i.e. the engaged parties have no interest in taking possession of the underlying asset), the derivative may be cash settled with a single payment equal to the market value of the derivative at its maturity or expiration.

- Both types of derivatives are considered leveraged instruments because for little or no cash outlay, an investor can profit from price movements in the underlying asset without having to immediately pay for, hold or warehouse that asset.

- They offer a convenient means of hedging or speculating. For example, a rancher can conveniently hedge his grain costs by purchasing corn several months forward. The hedge eliminates price exposure, and it doesn’t require an initial outlay of funds to purchase the grain.

- The rancher is hedged without having to take delivery of or store the grain until it is needed. The rancher doesn’t even have to enter into the forward with the ultimate supplier of the grain and there is little or no initial cash outlay.

- Both physical settlement and cash settlement options can be keyed to a wide variety of underlying assets including commodities, short-term debt, Eurodollar deposits, gold, foreign exchange, the S&P 500 stock index, etc.

Trade in forwards is comparatively more complicated as well as high in quantum. Thus, in every advanced Foreign Exchange Market, there is a specific regulator to control & regulate and also to guide the trading in this market.
In India also, a separate regulator – Forward Market Commission was established in 1953 under the provisions of Forward Contracts Regulation Act, 1952.

**Features of Forward Premium on the Indian rupee**

The Indian rupee has had an active forward market for some time now. The forward premium or discount on the rupee (the US dollar, for instance) reflects the market’s beliefs about future changes in its value. The strength of the relationship of this forward premium with the interest rate differential between India and the US—the Covered Interest Parity (CIP) condition—gives us a measure of India’s integration with global markets. The CIP is a no-arbitrage relationship that ensures that one cannot borrow in a country, convert to and lend in another currency, insure the returns in the original currency by selling his anticipated proceeds in the forward market and make profits without risk through this process.

There are interest rate differential between India & U.S and that explains about 20% of the total variation in the forward discount between the INR & USD. The deviation of the Indian rupee-US dollar from the covered interest parity, however, exhibits long-lived swings on both sides of the zero line. This would indicate arbitrage opportunities and market imperfections provided we could be sure of the comparability of the interest rates considered. Therefore, while the behaviour of the forward premium on the Indian rupee is broadly in lines with the CIP, more careful empirical analysis involving directly comparable interest rates is necessary to measure the strength of the covered interest parity condition and the efficiency of the foreign exchange market.

Under market efficiency, the forward exchange rate is considered to be an unbiased predictor of the future spot rate, with random prediction errors. While the prediction errors of forward rates on the rupee appear to show some degree of persistence, any conclusion in this matter too must await more rigorous analysis. Forward and future trade also takes place in commodities market in India. Thus it is also important to understand its composition.

**Composition of Commodity market exchanges in India**

- Multi Commodity Exchange of India Ltd., Mumbai (MCX)
- National Commodity & Derivatives Exchange Ltd., Mumbai (NCDEX)
- National Multi Commodity Exchange of India Ltd., Ahmedabad (NMCE)
- Indian Commodity Exchange Ltd., Mumbai (ICEX)
- Derivatives & Commodity Exchange Ltd., Mumbai (ACE)
- Universal Commodity Exchange Ltd., Navi Mumbai (UCX)

There are 17 Commodity Exchanges (6 National and 11 Regional Exchanges) regulating futures trading in commodities. During the period under review (January to March 2014), the total value of trade in all commodities traded at the recognized Exchanges was 18.98 lakh crore as against 16.88 lakh crore during the previous quarter (October 2013 to December 2013) and 40.84 lakh crore during the corresponding period of last year. The six national commodity Exchanges contributed 99.44 % to the total value of trade in the Commodity futures market. These are MCX, Mumbai (78.25 %), NCDEX, Mumbai (15.70 %), NMCE, Ahmedabad (2.38 %), ICEX, Mumbai (1.13 %), ACE Mumbai (0.63%) and UCX, Navi Mumbai(1.34%).

**Regulation of Foreign Exchange Market**

The Foreign Exchange Management Act, 1999 (FEMA) is an Act of the Parliament of India “to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India”.

Traditionally Indian forex market has been a highly regulated one. Till about 1992-93, government exercised absolute control on the exchange rate, export-import policy, FDI (Foreign Direct Investment) policy. The Foreign Exchange Regulation Act (FERA) enacted in 1973, strictly controlled any activities in any remote way related to foreign exchange. FERA was introduced during 1973, when foreign exchange was a scarce commodity. Post-independence, union government’s socialistic way of managing business and the license raj made the Indian companies non-competitive in the international market, leading to decline in export. Simultaneously India import bill because of capital goods, crude oil & petrol products increased the forex outgo leading to severe scarcity of foreign exchange. FERA was enacted so that all forex earnings by companies and residents have to reported and surrendered (immediately after receiving) to RBI (Reserve Bank of India) at a rate which was mandated by RBI.

FERA was given the real power by making “any violation of FERA was a criminal offense liable to imprisonment”. It a professed a policy of “a person is guilty of forex violations unless he proves that he has not violated any norms of FERA”. To sum up, FERA prescribed a policy—
“nothing (forex transactions) is permitted unless specifically mentioned in the act”. Post liberalization, the Government of India, felt the necessity to liberalize the foreign exchange policy. Hence, Foreign Exchange Management Act (FEMA) 2000 was introduced. FEMA expanded the list of activities in which a person/company can undertake forex transactions. Through FEMA, government liberalized the export-import policy, limits of FDI (Foreign Direct Investment) & FII (Foreign Institutional Investors) investments and repatriations, cross-border M&A and fund raising activities.

Prior to 1992, Government of India strictly controlled the exchange rate. After 1992, Government of India slowly started relaxing the control and exchange rate became more and more market determined. Foreign Exchange Dealers’ association of India (FEDAI), set up in 1958, helped the government of India in framing rules and regulation to conduct forex exchange trading and developing forex market In India.

**Forward Markets Commission (India)**

Established in 1953 under the provisions of the Forward Contracts (Regulation) Act, 1952, it consists of not less than two but not exceeding four members appointed by the Central Government, out of them one being nominated by the Central Government to be the Chairman of the Commission. Currently Commission comprises three members among whom Shri Ramesh Abhishek, IAS is the Chairman, Dr M. Mathisekaran, IES and Shri Nagendra Parakh are the Members of the Commission. Currently, the Commission allows commodity trading in 22 exchanges in India, of which 6 are national.

**Vision/Mission of FMC**

- To ensure that the futures trading in the commodities is conducted in a way so as to meet the twin economic functions of price discovery and price risk management in an efficient and transparent way.
- The commodity Exchanges in the country come up as professional organizations so as to effectively meet the aspirations of various intermediaries in the commodity’s market including the farmers.
- The basket of commodities in which futures trading is permitted should progressively grow so that the participants of these commodity markets can also benefit from the futures market.

**Objective**

- To ensure smooth and orderly development of the commodity futures markets to enable it to perform the economic functions of the price discovery and price risk management efficiently, through effective regulation of the market.

**Functions**

The functions of the FMC under the Forward Contracts (Regulation) Act, 1952 are as follows:

1) To advise the Central Government in respect of the recognition of, or the withdrawal of recognition from any association or in respect of any other matter arising out of the administration of the FC(R) Act, 1952.

2) To keep forward markets under observation and to take such action, in relation to them as it may consider necessary in exercise of the powers assigned to it by or under the FC(R) Act, 1952.

3) To collect and whenever the Commission thinks it necessary, publish information regarding the trading conditions in respect of goods to which any of the provisions of this Act is made applicable, including information regarding supply, demand and prices and to submit to the Central Government periodical reports on the operation of the Act, and the working of forward markets relating to such goods.

4) To make recommendations generally, with a view to improving the organization and the working of forward markets.

5) To undertake the inspection of the accounts and other documents of (any recognized association or registered association or any member of such association) whenever, it considers it necessary and

6) To perform such other duties and exercise such other powers as may be assigned to the Commission by or under the FC(R) Act, 1952 or as may be prescribed.

**Important development and regulatory steps taken by FMC**

The Forward Markets Commission is committed towards the development of institutional capability of the commodity market. The Commission has taken several steps in this direction, which includes

- Sensitizing policy makers and all other co traders improving the efficiency of all the participants in the marketing chain.
- Organizing awareness programs, workshops, subject specific consultancies, study tours, lectures, etc., members.
- FMC has set itself an ambitious target for reaching out to various market segments and grass roots level participants.
• FMC solicits active collaboration with Universities, Educational Institutions and other organizations desiring to spread awareness about Futures Trading in commodities.
• The developmental measures also include the price dissemination among the farmers through APMCs (spot market regulators).

Regulation of Commodity Exchanges:
• Approval to the amendment to the Bye-laws: The Commission, in January, 2014 approved the Bye-laws of ACE Derivatives and Commodity Exchange Ltd., Mumbai regarding sharing of information among Exchanges about defaulter members.
• Approval to the amendment to Rules: The Commission, on in January, 2014 conveyed the approval of the Commission for the amendments to the deletion of Clause 141 related to the “Permanent/ non-retiring Director” and also insertion of the Clause 185(3) and 185A, regarding the appointment of Vice-Chairman (without executive Powers), of the Articles of Association to the Universal Commodity Exchange Ltd, Navi Mumbai.

Revision in the Regulatory Measures:
• The Commission on 20th February, 2014 directed NMCE to closely monitor the transactions on the Exchange platform and ensure that, the trade volumes and price of the commodity derivatives are not manipulated.
• The Commission on 26th February, 2014 approved the proposal sent by NCDEX regarding enhancement of Tick Size in Jeera futures contracts from 2.50 per quintal to5.00 per quintal. This modification will be applicable from all running contracts onwards.
• Withdrawal of additional Margin of 5% in castor seed: The Commission in February, 2014, conveyed its approval to NCDEX for withdrawal of the additional margin of 5% on long side and short side imposed by Exchange on Castor seed contracts w.e.f. 14th February, 2014 due to subdued volatility in the prices.
• Additional Margins on Potato Contracts: In view of price volatility and other trading developments in the potato contracts at MCX, the Commission on approved the proposal of MCX to impose an additional margin of 20% in March 2014 contract and 10% in April 2014 contract with immediate effect.
Waterhouse Coopers (PWC). The PWC submitted its interim report to the Commission. The Commission on 11th February, 2014 directed the Chairman, Board of Directors, MCX to place the report submitted by PWC before the Board of Directors of MCX at the next Board Meeting for discussion and for taking necessary action.

- **Common/uniform client registration form/process:** As per the existing KYC document, the clients who had opted for obtaining Contract Notes in electronic form had to give a declaration every year. Since receiving Contract Notes in electronic form is only an option exercised by the client which can be revoked, the Commission on 13th March, 2014 directed the National Exchanges to make amendments in the KYC Document that declaration to obtain Electronic Contract Note (ECN) once given, need not be renewed every year.

- **Membership registration:** The total number of members registered from 1st January, 2014 to 31st March, 2014 was 41. Members declared as surrendered/deactivated/suspended by the Commodity Exchange(s) during the above period are 70. The total number of registered members as on 31st March, 2014 stands at 5502.

- **Merger Issues:** The Forward Contracts Regulation Act (FCRA) stands repealed, and the regulation of the commodity derivatives market shifts to Sebi under the Securities Contracts Regulation Act (SCRA), 1956. SCRA is a stronger law, and gives more powers to Sebi than FCRA offered to FMC. Market players feel that commodity markets will now be better regulated, with more stringent processes—and will thus evoke greater confidence.

- The FMC only regulated the exchanges, and had no direct control over brokers. Also, Sebi has a far superior surveillance, risk-monitoring and enforcement mechanism that market participants say will give more confidence to investors, and may help businesses grow. Among other powers, Sebi now also has the power to access call data records.

Why is Sebi seen to be better equipped to monitor commodities trading

While foreign institutional investors are allowed to invest in Indian equities and debt markets, they are currently restricted from participating in commodities trading at exchanges. According to sources, Sebi may allow FII participation in commodities trading going forward, which would provide more depth to the markets, and increase liquidity, investor participation and better price discovery. Brokers also feel Sebi may introduce option contracts (call and put options) in commodities trading, thereby providing better hedging tools to investors. Sebi has said that it will oversee price determination of commodities. “Price discovery has been a major issue in commodities trading, and if the regulator addresses that concern, it will be a big confidence-booster for participants,” said Sugandha Sachdev of Religare Commodities.

Proposal of the merger

The NSEL episode underlined the need for a better and stronger regulator to safeguard investor interest and restore confidence. The Financial Sector Legislative Reforms Commission (FSLRC) had earlier stressed on the need to move away from sector-wise regulation. It proposed a system in which RBI would regulate the banking and payments system, and a Unified Financial Agency (UFA) would subsume all other financial sector regulators such as SEBI, IRDA, PFRDA and FMC, to regulate the rest of the financial markets.

What challenges could Sebi face

Sebi has all necessary infrastructure to regulate the commodities market, but some feel it lacks knowledge of the commodities market. However, since several FMC officials will move to Sebi in line with the merger, such issues are likely to be sorted out.

CONCLUSION

The NSEL episode underlined the need for a better and stronger regulator to safeguard investor interest and restore confidence. The Financial Sector Legislative Reforms Commission (FSLRC) had earlier stressed on the need to move away from sector-wise regulation. It proposed a system
in which RBI would regulate the banking and payments system, and a Unified Financial Agency (UFA) would subsume all other financial sector regulators such as SEBI, IRDA, PFRDA and FMC, to regulate the rest of the financial markets. The Forward Market Commission is a very important part of India’s Commodity Trading Market. The commission acts as a watchdog of the market happenings and also advises the Government on issues related to the market apart from inspecting & controlling the trade.

The Forward Market Commission helps in stabilising the prices of the commodities in the market as well as leads to an integrated price structure throughout the economy.

Its regulation helps in balancing the supply of the traded commodities and also encourages healthy competition amongst traders.

Its existence and regulation on the market is very crucial for the government to take part in the Forwards market.

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