FIMMDA /PDAI meet

Financial markets in India – recent developments in Regulations and the key challenges ahead

Introduction

1. Financial markets plays a crucial role in the growth and development of an economy as it helps in allocation of resources efficiently and enables sharing of risks. What is needed is a combination of well-developed, efficient financial market and institutions, together with a diverse array of financial products and instruments, supported by suitable legal and regulatory structures. This can cater to the need of market participants and the overall economy. As such developing the financial markets regulated by it has always remained one of the key priorities of the Reserve Bank.

Approach to Regulation

2. The regulatory approach in the initial years was more of a prescriptive one with RBI prescribing rules governing product design, eligible participants, risk limits, etc. However, changing market dynamics, increased financialization, integration with global markets, entry of newer market participants, need for tailored products, availability of efficient market infrastructures, sophistication of trading technology, etc., require a fresh approach to regulation making.

3. Reserve Bank is shifting from prescriptive to principle-based regulations. The shift is needed to promote greater market autonomy, encourage innovation and market growth while ensuring fair market conduct, customer protection and financial stability. The approach is to provide a broad framework within which market participants can operate and the contours of regulations are set out through consultation. Forward looking agenda in terms of intent communicated through monetary policies, approach papers/roadmaps and consultative documents allows markets to prepare for the future opportunities.

4. From the RBIs perspective we would like that the banks should take a pro-active approach in designing products to satisfy the requirements of their clients, while educating their clients about the associated risks. Greater autonomy requires greater responsibilities. The banks should ensure that market conduct is in line with the principles laid out by the Reserve Bank, which can be achieved by the boards institutionalizing framework relating to risk management, operational control, dispute

resolution and customer protection. Market bodies such as FIMMDA should take a lead in promoting self-regulations, dispute resolutions among banks and better co-ordinations. RBI expects markets to behave responsibly through conduct self-regulations. It goes without saying, RBI is also strengthening its surveillance to ensure markets operate in a fair and transparent way.

5. With this background, let me briefly list some of the **key initiatives** we have taken to strengthen the financial markets. I will cover these measures under 4 broad heads:

(A) Rationalisation of various regulations (B) Convergence of regulation for onshore and off-shore participants (C) Development of market Infrastructure (D) Customer facilitation (E) Market conduct and surveillance

Rationalisation of various regulations

Rationalization of Commercial Paper directions

6. Commercial Paper (CP) directions were reviewed in August 2017 to broaden access by allowing new sets of issuers ; strengthen disclosure requirements by issuers of CPs by providing for end-use specification. Further related Party transactions were disallowed and we had put in place an information dissemination mechanism.

Interest Rate Derivative(IRD) Directions

7. The IRD directions was revised on June 26, 2019 and User classification framework was introduced to categorise users under retail and non-retail categories. It was specified that retail users can only undertake transactions in plain vanilla products for hedging purposes. Non-retail users were permitted to undertake transactions for both hedging and trading purposes in plain vanilla products as well as structured products. Non-retail users have also been given the option of self-classifying themselves as retail users.

Rupee Interest Rate swaptions

8. Both Interest Rate Swaps and Interest Rate Options are permitted product under IRD directions. However, in June 2018, rupee interest rate swaptions were introduced in response to market demand as it provides better timing flexibility in hedging the interest rate risk.

Comprehensive Review of Money Market directions

9. As announced in the Monetary Policy of June 2019, regulations covering different money market products will be rationalised and simplified, with the objective to bring in consistency across products in terms of issuers, investors and other participants which will eventually lead to efficiency and transparency in the market. The draft directions would be issued shortly.

(B) Convergence of regulation for onshore and off-shore participants

Interest Rate hedging facility for Non-residents

10. It is seen that Rupee IRS market, though liquid, lacks depth to enable large banks to manage risks. Thin participation and consequent absence of divergence of views result in pricing inefficiencies, which further discourages participation. Further we also see that Non-residents are increasingly participating in the Indian debt market. With the objective to deepening the IRD market and attracting divergent views, Reserve Bank has issued directions allowing non-residents to access the IRD market for the purpose of hedging and otherwise, subject to a PVBP limit.

Simplified hedging facility for residents and non-residents

11. A simplified hedging facility was introduced in November 2017 with a view to

- Reducing the documentation requirements,
- Avoiding prescriptive stipulations regarding products,
- Providing hedging flexibility, and
- Encouraging a more dynamic and efficient hedging culture.

The guidelines remove the requirement of underlying documentation and allow transfer of net gains on evidence of the cash flow. It is expected that this facility would ease the process of hedging.

Review of facilities for hedging foreign exchange risk by Residents and Non-residents

12. Forex hedging facilities for both residents and non-residents have been reviewed and a draft directions on this subject has been issued. The revised directions would help to reduce the administrative requirements for undertaking derivative transactions, introduce the facility of hedging anticipated exposure, and allow users having valid exposure to hedge foreign exchange risk using any available instrument.

13. A **Task Force on Offshore Rupee Markets** has recently submitted its report to the governor recommending policy measures for incentivising non-residents to access the onshore foreign exchange market. The key recommendations of the Task Force are as follows:

- Extend onshore market hours to improve access by overseas users;
- Permit Indian banks to freely offer prices to global clients around the clock;
- Enable Rupee derivatives (settled in foreign currency), to be traded in the International Financial Services Centers (IFSC) in India, to begin with on exchanges in the IFSC.
- Allow users to undertake forex transactions up to USD 100 million in OTC currency derivative market without the need to establish underlying exposure.

(C) Development of market Infrastructure

Framework for Authorising Electronic Trading Platforms (ETP)

14. Trading on ETPs is being encouraged across the world as it enhances pricing transparency, processing efficiency and risk control. The Reserve Bank has put in place a framework for authorisation of ETPs for financial market instruments regulated by the Bank. The framework, inter alia, includes detailed eligibility criteria such as net-worth, technology requirements and reporting requirements. ETP has to adhere to risk management, surveillance, transparency requirements specified by RBI. After the introduction of this framework a total number 16 ETPs have applied to Reserve Bank for authorisation. The ETPs which meet the eligibility criteria are being given authorisation gradually.

Tri-Party Repo

15. Tri-party Repo directions was introduced by RBI in August 2017 and CCIL has commenced the tri-party repo in Government Securities. The The exchanges have also introduced tri-party repo in corporate debt instruments

Regulation of Financial Benchmarks

16. Post the LIBOR crisis, Reserve Bank constituted P Vijaya Bhaskar committee on financial benchmarks for strengthening of governance framework of benchmark administrators. The committee recommended creation of a separate entity for administration of financial benchmarks. Accordingly, the Financial Benchmarks of

India Ltd. (FBIL) was constituted in December 2014. FBIL has taken over benchmarks such as MIBOR, Term MIBOR, FC- Option Volatility Matrix, Forward Premia Curve etc from FIMMDA and FEDAI. In recognition of the key role played by financial benchmarks in the financial system and to improve the governance of the benchmark processes, the Reserve Bank has introduced a **regulatory framework for financial benchmarks administrators.** Reserve Bank can notify a benchmark as a significant benchmark and specific directions have been issued for administering significant benchmarks.

(D) Customer facilitation

Foreign Exchange Trading Platform for Retail Users

17. The issue of transparent and fair pricing for retail users in the foreign exchange market has been raised in various fora and public interactions. This issue has also attracted attention of regulators worldwide. RBI has announced the launch of an electronic trading platform for buying/selling foreign exchange by retail customers of banks (including individuals and MSME). Such a mechanism will provide transparency while enhancing competition and will lead to better pricing for retail customers (single transaction not exceeding $5 mn). This electronic trading platform, Fx-Retail, has been developed by the Clearing Corporation of India Limited (CCIL) and has been rolled-out on August 05, 2019. A volume of more than $1 mn has been recorded in the first day itself.

(E) Market conduct and surveillance

18. Market conduct, plays an important role in maintaining the integrity of the market and serving the need of end users. Institutions, market bodies and regulators need to play a role in creating an eco-system which encourages fair market conduct. Between the RBI and the market bodies, We have taken a few steps to promote fair market conduct.

Market abuse regulations

19. Reserve Bank has recently issued Market Abuse Regulations, in line with the best global practices, to discourage and prevent negative practices in markets regulated by it. The regulations define market abuse practices such as Market Manipulation, Benchmark Manipulation and Misuse of information, etc. Regulatory action such as

denial of access to markets in one or more instruments for a period that may not exceed one month is specified in the directions.These regulations shall ensure the fairness of trading and pricing mechanism of the marketplace and providing adequate deterrence on market manipulation.

FIMMDA Fair Practice Code (FPC)

20. The code of fair practices was reissued by FIMMDA in 2018. As a document it is providing broad principles and outlining illustrative examples to give members an idea of what constitutes fair market practice. It has provided examples of acceptable and unacceptable market practice. FIMMDA should play an active role in ensuring all its members adhere to the code.

FX Global Code

21. The FX Global Code (FXGC) was developed by a partnership between central banks (which included RBI) and Market Participants from 16 jurisdictions around the globe. The Code sets out principles that promote a robust, fair, liquid, open and appropriately transparent market, underpinned by high ethical standards. The Code is voluntary and applies to wholesale FX market participants. Reserve Bank through a press release encouraged market participants to demonstrate their commitment to adhere to the Code through the Statement of Commitment, which is published as part of the Code. As on date, 102 Indian institutions have agreed to adhere to the Code.

Challenges

22. Looking at the Current Market status (Money Market, G-sec and derivative market)in the financial markets regulated by us, we find some issues which still need to be addressed. As far as Money markets go, the overnight market is the most active segment in the money markets in terms of trading volume. The average daily trading volume in the overnight market since has grown from Rs.1,690 bn in FY18 to Rs.2,016 bn in the current FY. Among the overnight money markets, the Tri- Party Repo Dealing Systems (TREPS) is the dominant segment (65%) followed by market repo (25%) and call markets (10%). The key challenges appear to be

- Alignment of timings of the various market segments

    - Large segment of the call trades being handled through the reported segments
    - Dealing with fund requirements in a NEFT 24X7 environment
    - Development of term money markets

23. In case of the G Sec markets , we find that the average daily volume in G-Sec market has increased from Rs. 371 bn in FY19 to Rs. 532 bn in the current year. This has been aided by factors such as fall in yields, monetary policy action, inflation expectation etc. Again we see some structural issues which need to be addressed

- Lack of liquidity across the curve. Liquidity is confined to a few benchmark securities
- Low participation in the trading
- Lack of presence of MFs and Insurance companies for securities lending which hinders short selling
- Poor response to the When Issued guidelines

24. Coming to the currency markets the foreign exchange market continues to be largely an OTC market. The average daily volume has increased in the FX market from $32 bn in FY18 to $36 bn in FY19. In the CF segment the volumes are around USD 9 billion.The key challenge here is to achieve convergence between the off shore and on shore markets and bringing the markets onshore.

25. In the derivatives markets lack of liquidity in the IRS markets is a key issue, most of the contracts (87%) are linked to MIBOR while about 13% of the contracts are linked to MIFOR. The IRS contracts linked to INBMK are largely minimal.The OI for IRF contracts is about Rs.63 bn. The majority of IRFs are referenced to the benchmark G-Sec. Low participation of institutions and banks seems to be a problem here.. The participation of banks is rather limited in this market. Clients and Proprietary trades constitute the major part of this IRF market. While we find IRO markets have not taken off either in the OTC or in the exchange traded segments.

26. While we have taken several measures, we find that the derivatives markets in India are not commensurate with the requirements in terms of liquidity or for risk management. We also face the challenge that several of the markets operate off shore rather than on shore. We should therefore deliberate on what exactly needs to be

done to develop these markets so that the requirements of the financial market participants in terms of a complete bouquet of financial products to enhance liquidity and manage risks on shore is enabled. In addition I would also like to flag what I feel are a few key challenges that we need to deliberate and discuss to further strengthen our financial markets.

Discontinuation of LIBOR: Development of alternative benchmarks

27. In the wake of LIBOR scandal of 2012 and as a response to this, Financial Conduct Authority (FCA), UK, has announced cessation of LIBOR benchmark after end 2021 . Different countries have started the process of developing alternative benchmarks to LIBOR. USA has introduced Secured Overnight Financing Rate (SOFR), UK has launched Sterling Overnight Index Average (SONIA), Switzerland: SARON, Euro Area: ESTER, India- MROR, etc. Currently, large amount of financial products (derivatives and loans- aggregating US$400 trn- approx) are linked to LIBOR. The valuation of the existing contracts/products, post discontinuation of LIBOR, pose a challenge and there would be a need to develop a robust fall-back mechanism for efficient pricing and smooth transition. There would also be a need for calculating a term benchmark for pricing of such loans/bonds and derivatives. The current term LIBOR is forward looking, while term benchmark calculated from new overnight benchmarks (eg: SOFR) would be a backward looking derived benchmark. Such derived benchmarks needs to be back-tested before being used for pricing/valuation. The market bodies like FIMMDA and IBA have role to play in this transition.

Development of deep and liquid corporate bond market including repo in corporate bonds

28. Despite a host of regulatory measures we still bemoan the lack of a deep and liquid corporate debt market in India. When the annual corporate bond issuance and outstanding have increased to a level of Rs. 8 trn and Rs.31 trn (16% of GDP) respectively. Both are growing at very fast pace, more than bank loans, we need to deliberate on deepening of both the funding market (corporate bonds repo) and secondary market liquidity in this product. We need to discuss the challenges like (i) more than 85% of issuance by AA and above rated issuer (ii) issuance dominated by private placements (iii) lack of liquidity in corporate bond repo (iv) lack of CDS market (v) Small outstanding stock of individual issuance, lack of reissuance etc.

Customer protection

29. Customer protection and customer conduct of financial intermediaries is another area which is a point of attention for the global regulators. Industry body like FIMMDA has a role in sensitising and disciplining their members in this regard. The Fair Practices Code (FPC) of FIMMDA has provided examples of acceptable and unacceptable market practice.

Conclusion

30. Reserve Bank regulates segments of financial markets such as Government Securities, money market, foreign exchange market and interest rate derivatives market. We have been conscious of the need to deepen and widen these markets. We have also tried to move away from a prescriptive framework while ensuring that the markets operate in a healthy manner. In framing our approach to regulation of financial markets, we look at four major building blocks for development of financial markets viz., financial products, financial market participants, market infrastructures and suitable legal and regulatory structures. We also are open to listening to the markets and the participants on what requires to be done. However in the end we need to ensure that we have a supportive and rapidly expanding financial market with suite of financial market products which can meet the needs of one of the fastest growing economies in the world today.

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