*Evolution of Financial Markets in India: Charting the Future**

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It is my pleasure to be here at the FIMMDA-PDAI annual conference. This year (2024-25) is particularly special for the Reserve Bank. The RBI has entered its 90th year on April 1, 2024. I, therefore, thought it appropriate to dwell upon the journey of the Reserve Bank, especially in the context of its role in developing the financial markets in India in the recent period. I also propose to share some of my thoughts on the way forward.

To give a brief background, the Reserve Bank was set up in 1935 on the recommendations of the Hilton Young Commission with the objective of regulating the issue of bank notes, securing monetary stability and operating the country's currency and credit system. The statutory basis for its functioning was provided by the Reserve Bank of India Act, 1934[1]. The nationalisation of the Reserve Bank, which had started as a joint stock company took place in 1949.

Over the years, the Reserve Bank has performed a wide range of functions to support the Indian economy. Its developmental role came into focus during the planning period, when one of its major roles was to channelise credit to the needy sectors of the economy. With the commencement of the process of liberalisation in the 1990s, the Reserve Bank focused more sharply on core central banking functions like monetary policy, regulation and supervision of the financial sector, development of financial markets and payment systems. Today, the RBI is a full service central bank and an enabler of the market economy.

The journey of the Reserve Bank and its focus on emerging areas has been reflected in the amendments to the RBI Act, 1934 and various other statutes from which the Reserve Bank draws its mandate. The notable changes over the last couple of decades include the statutory amendments for (i) strengthening the legal framework for oversight of non-banking financial companies (NBFCs) (1997)[2]; (ii) consolidating the laws related to government securities into Government Securities Act (2006)[3]; (iii) providing the legal framework for regulation of key financial markets (2006)[4]; (iv) enactment of the Payment and Settlement Systems Act to vest the Reserve Bank with the authority to regulate and supervise the payment systems in India (2007)[5]; (v) institutionalisation of the flexible inflation targeting framework (2016)[6]; (vi) vesting the Reserve Bank with the authority to regulate housing finance companies through an amendment of the National Housing Bank Act, 1987 (2019)[7]; (vii) strengthening the regulatory framework for cooperative banks by amendment of the Banking Regulation Act, 1949, (As Applicable to Cooperative Societies) (2020); and (viii) enabling the issuance of the central bank digital currency (2022)[8]. These changing priorities and the quest to keep pace with developments, including technological changes, have been reflected in the Reserve Bank's

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[1] The Reserve Bank of India Act, 1934.

[2] In response to the perceived need for better regulation of the NBFC sector, the Reserve Bank of India (RBI) Act, 1934 was amended in 1997, providing for a comprehensive regulatory framework for NBFCs. The RBI (Amendment) Act, 1997 conferred powers on the RBI to issue directions to companies and its auditors, prohibit deposit acceptance and alienation of assets by companies and initiate action for winding up of companies.

[3] The Government Securities Act, 2006.

[4] The RBI Act was amended to insert Chapter III D (Section 45U, V, W and X,), providing Reserve Bank the power to regulate transactions in money market, government securities market and the foreign exchange, rupee interest rate and the credit derivative markets.

[5] The Payment and Settlement Systems Act, 2007.

[6] The Act was amended in 2016, to provide for a statutory and institutionalised framework for a Monetary Policy Committee, for maintaining price stability, while keeping in mind the objective of growth.

[7] The National Housing Bank Act, 1987.

[8] The Act was amended in 2022 to enable the issuance of the central bank digital currency.

organisational structure, examples of which include the setting up of the Department of Payment and Settlement Systems (2005); the Financial Stability Unit (2010), now called the Financial Stability Department; the Financial Markets Regulation Department (2014); the Financial Market Operations Department (2014); and the FinTech Department (2022).

Financial markets: Fostering trust, stability and innovation

Let me now focus on the journey of our financial markets, a journey in which the Reserve Bank has collaborated with many stakeholders including the FIMMDA and the PDAI who have been valuable partners in the Reserve Bank's endeavor to develop markets, institutions and practices.

The onset of the Global Financial Crisis (2008) altered the way the world looked at financial markets. At that stage, our financial markets were just beginning to develop, buoyed by the needs of a growing economy and in the background of the transition to market-determined interest rates and exchange rates, convertibility in the current account and gradual liberalisation of the capital account. Significant institutional and market infrastructure developments had also taken place. These included the setting up of the Clearing Corporation of India Limited (CCIL) and the operationalisation of RTGS, the NDS-OM platform and a trade repository for derivatives. Nonetheless, the markets remained in the early throes of development. Bank-intermediated finance was the preferred funding option. Diversity in financial products and participants was limited. The approach to foreign participation in domestic markets was guarded. At the same time, the economy's growing aspirations was placing increasing demands on financial markets while successive global crises necessitated prudent risk management. Meanwhile, global interest in the Indian Rupee, and the offshore Rupee markets, continued to grow. The onshore and offshore Rupee markets remained segmented.

Against this backdrop, the Reserve Bank's efforts in recent years to develop the financial markets focused on meeting the needs of a more confident and aspirational economy. Our reform endeavours have also fostered trust, stability and innovation by (i) making capital raising more efficient; (ii) removing segmentation between onshore and offshore markets; (iii) expanding the participation base by easing access to markets for hedging and expressing views on market movements; (iv) promoting innovation through a larger suite of products; (v) ensuring the integrity and resilience of markets and market infrastructure; and (vi) ensuring fair conduct by market participants.

Let me discuss the major reforms undertaken in the recent years.

Markets for Funding

Government securities market

A key objective of the Reserve Bank has been to foster a robust G-sec market and yield curve, which I have often referred to as a public good. A Benchmark Security Issuance Strategy[9] was introduced in 2020 to facilitate the development of the yield curve by providing liquidity at important tenor points. Last year, monthly (instead of fortnightly) issuance of select G-secs was commenced to widen the window between successive auctions and foster greater liquidity.

The regulatory frameworks for the 'when issued' market[10] and short selling in G-secs[11] were liberalised to enable better management of auction risk and price discovery (2018). The Request for Quote (RFQ) dealing mode on NDS-OM was introduced to enable market

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[9] From FY2020-21, the primary market issuance strategy was fine-tuned to issue securities in six "key" tenors viz., 2-year, 5-year, 10-year, 14-year, 30-year and 40-year with each security being issued/reissued once in a fortnight. This strategy was aimed at facilitating the early build-up of sufficient float for trading in the secondary market and provide certainty about the exact tenor of security issuances. Subsequently, securities in 3, 7 and 50 year tenors were also introduced.

[10] When Issued Transactions (Reserve Bank) Directions, 2018 dated July 24, 2018.

[11] Short Sale (Reserve Bank) Directions, 2018 dated July 25, 2018.

participants to negotiate trades electronically (2020). Sovereign green bonds were introduced in January 2023. Lending and borrowing of G-secs was also permitted to facilitate wider participation by different classes of investors in the securities lending market[12].

The Reserve Bank, in consultation with the Government, has been progressively liberalising the regulations for foreign investment in G-secs. The Fully Accessible Route (FAR) was introduced to enable Foreign Portfolio Investors (FPIs) to invest in specified G-secs without restrictions (2020)[13]. The suite of specified securities under FAR was enhanced (2022 and 2023)[14]. Measures were also taken to facilitate "ease of doing business" by FPIs. For instance, extended timings were allowed for reporting of transactions[15] and banks were permitted to fund margins for G-Sec trades of FPIs[16]. These measures contributed to the recent inclusion of Indian G-secs in certain global bond indices reflecting a growing confidence of global investors in the Indian financial markets and the economy.

Measures have been taken to expand retail participation in G-secs. The 'RBI Retail Direct' scheme, launched in 2021, have enabled individuals to directly access the primary and secondary G-sec markets, including sovereign gold bonds and floating rate savings bonds. A market-making arrangement through primary dealers has been put in place. The National Automated Clearing House (NACH) facility has been introduced allowing investors to create a one-time mandate and use it multiple times for making payments (December 2023). As announced in the recent monetary policy statement on April 5, 2024, a mobile app for accessing the Retail Direct portal will be launched shortly.

Corporate bond market

The Reserve Bank, with co-operation from other stakeholders, has been making efforts to develop a vibrant corporate bond market which is an important enabler of longer-term funding. To attract greater non-resident participation in corporate bonds, the FPI investment limit in corporate debt under the Medium-Term Framework was increased from 9% to 15% of outstanding corporate bonds (2020)[17]. The Voluntary Retention Route (VRR) was introduced in 2019[18]. The regulatory framework for repo in corporate bonds was rationalised in 2018[19]. Legal recognition was provided for bilateral netting of repo in corporate bonds and credit derivative contracts through requisite notifications under the Act for Bilateral Netting of Qualified Financial Contracts, 2020. The regulatory framework for credit derivatives was revised in 2022[20]. The AMC Repo Clearing Limited was authorised to offer tri-party repos in corporate bonds in 2023. The measures taken by the Reserve Bank during the COVID-19 pandemic, especially the liquidity measures like the Long Term Repo Operations (LTROs), the Targeted Long Term Repo Operations (TLTROs) and the TLTRO 2.0 were also critical in ensuring that the market continued to function smoothly.

Money markets

The regulatory framework for the markets for call, notice and term money; certificates of deposits

12 Reserve Bank of India (Government Securities Lending) Directions, 2023 dated December 27, 2023.

13 'Fully Accessible Route' for Investment by Non-residents in Government Securities dated March 30, 2020.

14 'Fully Accessible Route' for Investment by Non-residents in Government Securities – Additional specified securities dated July 07, 2022 and 'Fully Accessible Route' for Investment by Non-residents in Government Securities – Inclusion of Sovereign Green Bonds dated January 23, 2023 and November 08, 2023.

15 Transactions in Government securities by Foreign Portfolio Investors: Reporting dated June 7, 2021.

16 Payment of margins for transactions in Government Securities by Foreign Portfolio Investors dated June 4, 2021.

17 Investment by Foreign Portfolio Investors (FPI): Investment limits dated March 30, 2020.

18 'Voluntary Retention Route' (VRR) for Foreign Portfolio Investors (FPIs) investment in debt dated May 24, 2019.

19 Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018 dated June 24, 2018.

20 Reserve Bank of India (Credit Derivatives) Directions, 2022 dated February 10, 2022.

(CDs); commercial paper (CP) and non-convertible debentures (NCDs) with original maturity up to one year, was comprehensively rationalised in April 2021, June 2021 and January 2024 respectively. The participant base was widened by extending access to the call, notice and term money markets to Payment Banks, Small Finance Banks[21] and Regional Rural Banks (RRBs)[22]. The RRBs were also permitted to issue CDs[23]. To foster efficiency, call money market participants have been mandated to obtain membership of the NDS-Call platform[24]. Banks have been provided the flexibility of setting their own limits for call and notice borrowings within the prudential limits for inter-bank liabilities[25] and the option of buying back CDs. The operational requirements for CPs and NCDs with original maturity up to one year have been eased, and compliance and disclosure requirements strengthened[26].

Development of OTC Derivative Market

The regulatory framework for OTC transactions in interest rate, FX and credit derivatives has transformed over the last few years[27]. The revised framework is based on the principles of easing access and operations, enabling flexibility and ensuring fair market conduct, customer protection, transparency and risk management, while eschewing detailed procedural prescriptions.

Access to financial markets has been eased. Non-residents can now access the domestic markets at par with residents. Large participants (non-retail users) can access derivative markets to hedge their risks as also express views[28]. The market-maker base has been expanded by granting authorised person licences to standalone primary dealers. Market-makers have been permitted to offer bespoke or custom-made products to enable efficiency and flexibility in hedging, subject to necessary risk management capabilities. Retail customers can only be offered a set of simple products. New products such as interest rate options, swaptions and FX swaptions have been permitted. Non-deliverable FX derivatives can be offered to residents for hedging[29]. It is expected that market-makers and banks exercise due caution and diligence while designing and offering such products to customers, keeping in mind the profile of customers.

A significant policy initiative has been to permit the banks to access offshore INR markets for (i) FX derivatives (in 2020)[30], subject to the presence of an operating IFSC Banking Unit (IBU); and (ii) for interest rate derivatives (in 2022)[31] with a view to improve the efficiency of price discovery and provide greater opportunities to domestic participants. Market-makers have been permitted to deal in such products beyond domestic markets hours. Rupee derivatives settled in foreign currency have also been permitted

[21] Payments Banks and Small Finance Banks– access to Call/Notice/Term Money Market dated October 29, 2018.

[22] Regional Rural Banks- Access to Call/Notice/Term Money Market dated December 04, 2020.

[23] Reserve Bank of India (Certificate of Deposit) Directions, 2021 dated June 4, 2021.

[24] Reserve Bank of India (Call, Notice and Term Money Markets) Directions, 2021 dated April 01, 2021.

[25] Reserve Bank of India (Call, Notice and Term Money Markets) Directions, 2021-Review dated June 08, 2023.

[26] Reserve Bank of India (Commercial Paper and Non-Convertible Debentures of original or initial maturity upto one year) Directions, 2024 dated January 03, 2024.

[27] Interest rate derivatives (2019) - Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019 dated June 26, 2019, FX derivatives (2020) - Risk Management and Inter-bank Dealings – Hedging of foreign exchange risk dated April 7, 2020, FX derivatives (2024) - Risk Management and Inter-bank Dealings – Hedging of foreign exchange risk dated January 5, 2024, Credit derivatives (2022) – Reserve Bank of India (Credit Derivatives) Directions, 2022 dated February 10, 2022.

[28] Authorised dealers can offer FX deliverable derivative products to non-residents for hedging their risks and on non-deliverable FX derivatives to non-residents without restrictions in terms of purposes. Market makers can offer Rupee and foreign currency settled MIBOR-based OISs to non-residents without restrictions in terms of purposes, subject to a risk limit.

[29] Risk Management and Inter-Bank Dealings - Non-deliverable derivative contracts (NDDCs) dated June 6, 2023.

[30] Risk Management and Inter-bank Dealings- Participation of Banks in Offshore Non-deliverable Rupee Derivative Markets.

[31] Rupee Interest Rate Derivatives (Reserve Bank) Directions – Review dated February 10, 2022.

in GIFT City, both through OTC markets and on the exchanges.

Integrity of markets and market infrastructure

Ensuring the integrity of financial markets and market infrastructure has underpinned many reform initiatives of the Reserve Bank.

A framework for authorisation of electronic trading platforms was put to place in 2018[32] to ensure that only entities adhering to a robust set of conditions function in RBI-regulated financial markets. This framework is being updated in view of the recent developments in technology that have accelerated the electronification of financial markets. Considering the complaints of cheating and fraud by unauthorised trading platforms, necessary cautionary advice has been issued against undertaking forex transactions on such platforms[33]. An 'Alert List' of entities offering or promoting unauthorised forex trading facilities has also been issued[34].

A risk-based regulatory framework for benchmark administrators was put in place in 2019[35] and fine-tuned in 2023[36] to ensure robust governance in benchmark administration in RBI-regulated markets. Regulations for market abuse were put in place in 2019[37]. Similar frameworks have been put in place for (i) governance, risk management and conduct, including customer suitability and appropriateness assessment by market-makers in OTC derivatives (2021)[38]; and (ii) margins for non-centrally cleared derivatives. Exchange of variation margin was mandated in 2022[39]. The framework for exchange of initial margin will be issued shortly.

Requirements for transparency in pricing of OTC derivative products for retail investors were also set out. In 2019, the FX Retail platform was introduced to create a market infrastructure that would ensure fair and transparent pricing[40].

Way forward

The recent financial market reforms undertaken by the Reserve Bank are aimed at providing a strong bedrock for markets to move to the next trajectory for meeting the growing funding requirements in the economy, providing cost effective hedging options and competing effectively in global markets.

The response to the regulatory measures has been encouraging. The participation base has been widening. Retail participation in G-secs through the Retail Direct scheme has been growing. The VRR scheme has attracted interest from FPIs, especially for corporate bonds. In recent months, robust foreign inflows in G-secs have been witnessed. Non-resident participation in OTC derivative markets has increased, adding to liquidity and diversity. Many of you have started participating in the offshore derivative market for the INR. Prices and spreads in the domestic and overseas markets have converged to a great extent.

There are, however, some areas which call for attention. While lot of progress has been made by banks and other market participants, I wish to highlight six specific areas where more can be done. First, participation of domestic banks in derivative markets remains limited with only a small set of active market-makers. Participation of Indian banks in global markets is growing but it is quite small. Domestic

[32] The Electronic Trading Platforms (Reserve Bank) Directions, 2018 dated October 05, 2018.

[33] RBI Cautions against unauthorised forex trading platforms dated February 03, 2022.

[34] Alert List, Updated as on November 24, 2023.

[35] Financial Benchmark Administrators (Reserve Bank) Directions, 2019 dated June 26, 2019.

[36] Reserve Bank of India (Financial Benchmark Administrators) Directions, 2023 dated December 28, 2023.

[37] Reserve Bank of India (Prevention of Market Abuse) Directions, 2019 dated March 15, 2019.

[38] Reserve Bank of India (Market-makers in OTC Derivatives) Directions, 2021 dated September 16, 2021.

[39] Reserve Bank of India (Variation Margin) Directions, 2022 dated June 01, 2022.

[40] Rollout of the foreign exchange trading platform for retail participants – FX-Retail dated June 20, 2019.

banks are dealing with market-makers in global markets rather than with end clients and are yet to emerge as market-makers of note globally. Of course, banks need to do their own due diligence, assess their risk appetite, and then move forward carefully in this direction. Going forward, our focus should be on enhancing and widening the participation of Indian players in markets for INR derivatives, both domestically and offshore, while being prudent.

Second, liquidity in OTC derivatives markets, especially interest rate derivatives, remains confined to a few products, constraining efficient hedging by the larger economy. The market for credit derivatives which is an important enabler for the lower rated corporate bonds is yet to take off. I am, however, happy to note that the first credit default swap (CDS) transaction after the issuance of the revised guidelines came into effect in May 2022 was undertaken last week. In many ways, all domestic market participants are yet to fully embrace the new regulatory framework and exploit the opportunities it presents.

Third, transparency in pricing remains work in progress and more can be done. The retail customer is yet to get a deal at par with large customers. There is a need for effective market-making and finer pricing for smaller deals on NDS-OM. Divergence in pricing in FX markets for the small and large customers are wider than what can be justified by operational considerations. Banks may need to do more to facilitate the use of the FX Retail platform. We continue to see banking channels being used by certain persons or entities to fund activities on unauthorised FX trading platforms. This warrants enhanced vigilance by the banks.

Fourth, efforts are being made to leverage technology for achieving greater efficiency while also meeting the objectives of market reforms. For example, we are exploring the use of technological platforms to expand the reach of financial markets, in particular the reach of the RBI Retail Direct and FX Retail. In the derivative markets, efforts are underway to introduce electronic trading platforms for a larger number of derivative products and to expand the central clearing of products. To foster greater efficiency, Application Programming Interfaces (APIs) for reporting trades to NDS-OM and accessing the RFQ dealing mode are being contemplated. Introduction of bond forwards is being considered to enable long-term investors to manage their interest rate risks efficiently – draft guidelines in this regard were issued in December 2023[41]. The Reserve Bank remains engaged with stakeholders to assess the need for the introduction of new products and infrastructure based on evolving market developments.

Fifth, bank treasuries need to scale up their dynamism to utilise the opportunities presented in the context of the recent regulatory reforms. This is very critical for achieving efficient market intermediation, effective management of financial risks and alignment of financial variables across different segments and markets. From this financial year (2024-25), the new prudential framework for investment by banks has come into effect. The new regulations provide increased flexibility to banks in managing their treasuries and offer scope for increased efficiency, provided banks manage their treasury function actively. The framework of assessment of a bank's treasury should take into account risks arising out of action and risks arising out of inaction i.e., missed opportunities.

Sixth, appropriate safeguards should be put in place to address the new challenges posed by new products, participants and markets. For example, as sophisticated OTC derivative products are introduced, they must be accompanied by adoption of certain safeguards, both by the market-makers as well as

[41] Draft Reserve Bank of India (Bond Forwards) Directions, 2023 – dated December 28, 2023.

customers. As our markets get integrated with global markets and non-resident participation increases, transmission channels from global developments will become stronger and speedier. This will require greater watchfulness and proactive management of the associated risks by market participants even as the opportunities are grabbed.

Conclusion

To conclude, the Reserve Bank's efforts in recent years has been to develop the financial markets in a manner that can continue to meet the needs of a growing and globally connected economy while fostering trust, stability and innovation. Trust in financial markets has been sought to be promoted through market reforms which have focused on ensuring fair market conduct by preventing market abuse; fair customer conduct through robust market-marking regulations and ensuring price transparency; and enhanced disclosures by market participants. Stability in financial markets has been made possible by ensuring orderly functioning of the financial markets and financial market infrastructure[42]. Innovation has been sought to be promoted through a move towards principle-based regulation, widening of the participant base, introduction of new products and platforms as well as enabling access to offshore markets.

The achievement of desired outcomes will be contingent on financial institutions and market participants taking forward the reform agenda so that we have vibrant and internationally competitive financial markets. Market participants and their associations including FIMMDA and PDAI will have to play a critical role in this.

As we look forward to the next decade coinciding with RBI@100, we have to work together and usher in the next generation reforms to place India at a position it rightly deserves.

Thank you.

[42] These include trade reporting, central clearing, trading platforms and benchmark administrators.