

The Roadmap for Fixed Income and Derivatives Market*

Friends,

I am thankful to the Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI), the organisers, for inviting me to deliver the keynote address today. I have had the pleasure of being closely associated with FIMMDA and PDAI since their inception. Reserve Bank of India has been taking active interest in the development of fixed income markets and the role of FIMMDA is becoming increasingly important in this regard. It has played a pivotal role in the design of documentation of repos, Commercial Paper and Certificate of Deposits, finalising the daily/annual valuation methodology for fixed income securities. RBI consistently seeks its views on various G-Sec market related issues. It is also involved in standardisation of market practices for fixed income securities/money market instruments/fixed income derivatives. It has been emphasising the importance of best practices in the OTC interest rate derivatives market and has circulated a Guidance Note for Best Practices to its members in this regard. We, in the RBI, understand the need for continued collaborative relationship with FIMMDA and PDAI. It is in this spirit that I look forward to the deliberations today in the sixth Annual Conference being organised jointly by FIMMDA and PDAI.

I am somewhat reluctant to elaborate on the subject of the day, namely, the road map of fixed income and derivatives market, in my keynote address for several reasons. My views in this regard were articulated in a seminar and then published in a BIS paper titled "Issues and challenges in the development of the debt market in India". The subject was subsequently updated, elaborated and improved upon comprehensively by my friend and former colleague Dr. Rakesh Mohan, when he addressed this gathering last year in Dubai. Dr. Mohan has already indicated the "Road Ahead", which I fully endorse. Moreover, one should wait for free and frank discussion on the subject in this conference, in which distinguished persons with several perspectives are participating. Let me assure you that we in RBI do look forward to the deliberations of this conference and the suggestions made will be, to the extent possible, examined by the various Technical Groups in the RBI that have

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been set up recently. It is our intention to place the reports of the Groups on Money Market, Government Securities Market and Forex Market in the public domain soon. Hence, the subject of the Sixth Annual Conference is both well-timed and significant for us.

To justify my presence here, let me take this opportunity to mention some of the recent developments which should be kept in view in the deliberations of the conference.

First, under the provisions of the Fiscal Responsibility and Budget Management Act, 2003, the Reserve Bank will not be participating, in the normal circumstances, in the primary market for the government securities from the start of 2006-07. The Technical Group that I referred to is currently working on the operational, technological and institutional aspects of this. Hence, the market perspectives on the implications of this development can best be articulated in the conference today.

Second, the Twelfth Finance Commission has made certain recommendations which would mean that the State Governments would approach the market instead of obtaining loans from the Government of India. Several operational and other issues will have to be addressed in the management of the borrowing programme of the State Governments, in future. We are convening a Conference of the State Finance Secretaries on 8th April 2005, which will be addressed by Dr. C. Rangarajan, Chairman, Economic Advisory Council to the Prime Minister and the former Chairman, Twelfth Finance Commission, to discuss these issues. The road map that this Conference would indicate in this regard will be helpful for our discussions and further policy formulation in regard to debt-papers of the State Governments.

Third, the Central Government budget has proposed a Special Purpose Vehicle (SPV) for raising resources for investment in infrastructure. The issuance of debt-paper with relatively longer maturity, outside the Government of India's normal borrowing programme, is yet another recent dimension added to the debt-market developments in the country.

Finally, several legislative changes on the anvil provide new opportunities for further development of fixed income markets. For example, the long awaited Government Securities Bill is at an advanced stage of processing. The Finance Minister, in his budget speech, announced the intention of the Government to bring

about amendments to the RBI Act and the Banking Regulation Act and the amendments relating to statutory pre-emptions could have implications for fixed income markets.

In this context, it is useful to recognise that the stake of the RBI in the fixed income and derivatives market arises on account of several reasons. First, RBI as a monetary authority is most concerned with the transmission of monetary policy. Second, it must be recognised that in the Indian conditions, we are neither a closed economy nor an open economy. In reality, we are an opening economy and a careful management of the process of opening is critical for growth and stability. Third, for the Reserve Bank of India, as the central bank, financial stability is one of the increasingly important considerations and an important subset of the financial stability is determined by the stability in the external sector. Fourth, government securities market, which is currently the dominant segment of the fixed income markets, is also a legitimate concern for the Central Bank, since it provides the benchmark interest rates. The government securities market, in our setting, has policy signalling although the rates are largely market determined. Fifth, the Reserve Bank of India is a regulator of the banks and also of the primary dealers, which together constitute large holders of Government papers. Hence, there is a significant linkage between RBI's prudential regulations and the fixed income markets. Finally, in an economy like ours which is attempting structural transformation, RBI has to have a developmental role also, apart from being a regulator of money markets, Government securities markets and forex markets. It is in this context that the Reserve Bank of India goes into close interactive mode with organisations like FIMMDA and PDAI.

RBI's developmental role in the context of Self Regulatory Organisations (SROs), is perhaps worth exploring at some length. A good beginning may be the Report of the Advisory Group on Securities Market Regulation, 2001 (Chairman: Shri Deepak Parekh) which made certain observations on self regulation by the SROs and the RBI. The relevant extract from Section 2.4 reads as follows:

“Further, the slow evolution of the Association of Mutual Funds of India (AMFI) as a SRO has meant continuation of substantial regulatory burden on SEBI. In this regard, the Group suggests that SEBI assist the

AMFI to develop into a full-fledged SRO. Similarly, in money and government securities markets, Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) are operating as industry level associations, who are gradually taking on the role of SROs. There is as yet no regulatory oversight of the RBI over these emerging SROs. However, to facilitate these associations to emerge as full-fledged SROs, the RBI is engaging them in a consultative process, which needs to be further intensified. On their part, to promote integrity of the markets, FIMMDA and PDAI need to establish a comprehensive code of conduct and best practices in securities transactions and also have a mechanism to enforce such codes. The RBI can play a supportive role here”.

There has been a recent review (December 2004) of the recommendations of the Advisory Groups constituted by the Standing Committee on International Financial Standards and Codes published in January 2005 RBI Bulletin. An extract from this “Report on the Progress and Agenda Ahead” is useful, though, as the disclaimer says, it is an assessment by the professional staff of the RBI and not necessarily the view of the Reserve Bank:

“The proposal to accord legal status as an SRO to FIMMDA has been examined in detail by RBI and was not found feasible at present. However, FIMMDA has established a code of conduct and undertaken related responsibilities appropriate to an industrial body. According self-regulatory status to PDAI is a non-issue since all PDAI members are also members of FIMMDA”.

There are several concepts which are addressed in the Reports cited, in particular, ‘industry body’; ‘Self Regulatory Organisation’ and ‘legal status as SRO’. There is considerable merit in debating these concepts and their relevance to FIMMDA, keeping in view the way forward that is being contemplated in the conference today.

Self-regulation has a long history of working effectively. Some of the earliest signs of self-regulation were evident in the utterance of the Hippocratic oath by the

medical professionals at the time of their graduation. Almost a thousand years ago, Maghribi traders had probably one of the first self-regulatory schemes based on market incentives for regulating their trade. The Maghribi were Jewish traders who lived in the Abbasid caliphate (centered in Baghdad) until the first half of the tenth century, when they emigrated to North Africa. They operated through business associates to handle some of their business dealings abroad. Merchants could never be sure that agents actually handed over the entire proceeds of business done abroad on their behalf. Courts were generally unable to verify agents' claims and actions or track down an agent who absconded with the merchant's money. The Maghribi traders solved the problem by organizing themselves into a coalition that served as a grapevine for information on honest and dishonest agents. Any agents who treated a member unfairly could never hope to do business again with other members. In Europe, in the eleventh and twelfth centuries, as more and more rural folk moved to towns and cities, a new class of merchants emerged to meet the demands of the growing urban population. It was during this period that the basic concepts and institutions of modern Western mercantile law (*lex mercatoria*) were formed.

The self-regulation has evolved significantly since then and linkages with regulatory authorities, often on a sound legal basis, were established mainly in the financial sector. Self-regulation generally imposes lower cost than official regulation whenever a shift is feasible. SROs possess the flexibility to adapt to regulatory requirements of rapidly changing business environment. They provide an intimate knowledge of the markets and products. Self-regulation, typically involving a unique combination of private interests with government or regulatory oversight over them, is an effective and efficient form of regulation for the complex, dynamic and ever-changing financial services industry. The role of self-regulation and, indeed, its very existence, differs from country to country, across market sectors and across the developed and emerging markets. In its most complete form, self-regulation encompasses the authority to create, amend, implement and enforce rules of conduct with respect to the entities subject to the SRO's jurisdiction, and to resolve disputes through arbitration or other means.

The advantages of self-regulation are very clear, especially in terms of minimising the cost of regulation as well as cost of compliance of regulation in the financial sector, while improving the quality of regulation. However, there are a number of issues particularly in the financial sector which are often cited. For instance, there is a well-known observation about the “regulatory capture”, that is, the regulated entities, in the organised form, have a tendency to capture the regulator to protect their own interests. It is also argued that the SROs protect the interests of the members if they are in conflict with interests of the system. In this regard, I find that the model for effective regulation, brought out in the Report of the SRO Consultative Committee of the International Organization of Securities Commissions in May 2000, is useful. Perhaps these issues will also be addressed in this Conference as part of the way forward.

Let me again thank the organisers for giving me this opportunity and wish the Conference all success.