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Regulation of Indian Debt & Derivatives Markets : Some thoughts on post -crisis paradigm

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Regulation of Financial Markets

- Wayne Byres, Secretary General, BCBS described *financial market participants* as *'glass half full' people,* and *regulators* as their *'glass half empty' counterparts*
  - Market participants will first see opportunity for reward whereas regulators will first see exposure to risk
- Recent financial crisis has amply demonstrated the need for effective regulation – inadequacy of "free market paradigm"
- Global initiatives for regulating financial markets besides fiscal and monetary measures
- Strengthening micro-prudential and market conduct regulations with effective macro-prudential framework with focus on build-up of systemic risks
- G-20 initiatives - Volcker Rule - Dodd-Frank – Vicker's commission, EMIR
- Focus also on market activities, institutions, infrastructure, FMIs
- From '*light touch*' to '*comprehensive regulation & efficient supervisory framework*'

Indian Perspective

- RBI’s approach to regulation and development of the financial markets

- Guided by three broad principles
  - wider menu of financial products to enable economic agents to hedge emergent risks & meet funding requirements
  - introduction of new products should follow a graduated process
  - improved robustness of the market infrastructure for trading, settlement and reporting

Indian Perspective..2

- Preference for safety and stability of the financial system over the considerations of short term market activity

- RBI's policy imperative to broaden and deepen financial markets and increase their liquidity and resilience so that they can help allocate and absorb the risks entailed in financing India's growth (one of the five pillars of Governor Rajan)

- Our regulatory and developmental measures have two main focus – building resilience and increasing liquidity

Building Resilience of Debt & Derivatives Markets

Requirements for registration and reporting

- To ensure that safe & financially strong entities have access to the financial system [e.g. Primary Dealer authorisation; criteria to enter CDS market]
- To promote transparency [e.g. reporting requirements for G-Sec trades, OTC derivatives]

Requirements for capital and collateral

- To ensure that strong financial firms are doing business in financial sector- Basel 3 guidelines for banks
- Ensure credit risk in transactions is managed through appropriate collateral – margins for derivatives

Building Resilience of Debt & Derivatives Markets..2

Orderly market rules

- To protect the integrity of market prices for encouraging wider market participation & providing credible price information for the economic agents

- FIMMDA code of conduct
  - Dispute Resolution Mechanism

- CDS linked to underlying exposure

- Short sale rules

- Limits on IRF positions

- "Suitability and appropriateness requirements for derivatives"

Enhancing Liquidity in Debt & Derivatives Markets

- Liquid debt markets are essential for both issuers and investors

- Liquidity in government securities market remains patchy with trading concentrated in few tenor points especially at 10 year maturity despite regular issuances across yield curve and state-of-the-art infrastructure in place

- Actions have been initiated/completed in nearly 70% of the recommendations of the Gandhi Committee

Enhancing Liquidity in Debt & Derivatives Markets..2

Market Making

- Allocate specific securities to each PD for market making in them and if required, rotate the stock of securities among the PDs by turn at periodic intervals (recommendation of Gandhi Committee)
- Consultation with the PDAI is on and plans to operationalise the market making scheme in the next fiscal

Short selling

- Recent regulatory action on limiting short sale in American and European markets underscores the need for appropriate regulation of short selling
- RBI increased the short sell limits in a sequential manner; would take appropriate action keeping in view the needs of market participants and imperatives of financial stability.

It is the participants that make markets. Regulator plays only a facilitator's role. All it requires is a few participants taking the first step

Recent Measures

Interest Rate Futures

- Cash settled
- Unique design
- Settlement price based on single benchmark bond
- Introduced after wide market consultation
- Useful as hedging and trading tool
- Launched on three exchanges
- After large volumes initially, moderation of interest
- Limited participation by commercial banks
  - Lack of awareness?
  - Delay in approvals?
  - Cash market volatility?
- Based on market acceptance new products would be considered
  - Cash settled single bond futures with other benchmarks
  - Money market futures

Recent Measures..2

Term Repo

- Variable rate term repo facility [now available upto a tenor of 28 days] introduced to provide market participants with additional access to primary liquidity, as well as greater flexibility in managing their reserve requirements

- To encourage them to actively transact in the term money market paving the way for development of a liquid term money market

- Going forward, RBI would consider extension of tenor of term repos keeping in view the overall liquidity conditions in the banking system

CD/CP

- DvP I based Settlement introduced for OTC trades in CDs and CPs
- CP guidelines have been comprehensively reviewed
- “March Mania” - deleterious impact on money market rates and creates avoidable stress – FIMMDA may engage with members for corrective steps

Recent Measures..3

Repo in Corporate Debt

- Eligible category of collateral has been expanded to include short term instruments like CP, CD and NCD
- Minimum haircut requirement has been further reduced
- To widen the participant base Scheduled Urban Cooperative Banks have been permitted to participate in repo in corporate bond
- There is, however, no activity in the corporate bond repo markets
- Progress in signing Global Market Repo Agreement is slow
- Need for RBI to make GMRA mandatory (?)

Emerging Issues: Enhancing Foreign Investment Limits in G-Sec and Corporate Bonds

- Pursuing our policy of enhancing foreign investment in domestic financial markets in a gradual manner, the total limit for investment in Government Securities presently stands at US$ 30 billion

- Focus on long-term investors

- Should we move faster in opening up our debt market?
  - Risk-Reward Trade Off

Emerging Issues: Financial Benchmarks

- Financial Benchmarks are “public goods”
  - credibility is critical - financial stability implications
- Recent events like LIBOR fixing roiled financial markets
- Global regulatory action – reform measures
- Reforms in the sector undertaken/underway
  - LIBOR notified as a regulated activity under FSMA (Financial Services and Markets Act 2000),provisions for criminal sanctions for manipulation of the benchmark, Administration of LIBOR has recently been transferred to Intercontinental Exchange (ICE) Benchmark Administration Limited.
  - European Commission has issued the draft legislation for regulation of financial benchmarks in the Euro region.
  - Monetary Authority of Singapore (MAS) has issued proposed regulations of the financial benchmarks with stringent provisions such as licensing of administrators and submitters, designation of key benchmarks, criminal and civil sanction for benchmark manipulation

Emerging Issues: Financial Benchmarks..2

Committee on Financial Benchmarks (Chairman: Shri P Vijaya Bhaskar)

- Methodologies used for determination of major Indian benchmarks were found generally satisfactory
- Recommended for bringing in several improvements on the lines of international developments
- Recommended measures for strengthening the governance framework and setting methodology of benchmarks
- Benchmark calculation to be based on observable transactions subject to appropriate threshold.
- Overnight MIBOR fixing is to be shifted from the existing polling method to volume weighted average of Call trades
- Measures for strengthening the governance frameworks with the benchmark administrators, calculation agents as well as the submitters recommended
- FIMMDA and FEDAI to create a separate independent structure for administration of the benchmarks

Emerging Issues: Financial Benchmarks..3

- The FIMMDA and FEDAI should adhere to the timeline of three months prescribed by the Committee to complete the reality self-check of their governance framework vis-à-vis the recommended principles and report to RBI

- The Reserve Bank is currently examining the recommendations of the Committee for implementation

- SDL pricing and valuation need to be examined
  - Price should reflect true value and valuation should reflect market reality
  - Is pricing SDL as a corporate bond appropriate?
  - Should we not keep the fiscal health of the strong States in view?

Emerging Issues: OTC Derivatives Market Reforms

- India is committed to achieve the G-20 reform agenda – Reporting – Standardization – Electronic/Exchange trading - Central Clearing - Margining

- Implementation Group for OTC Derivative market reforms has been constituted with representation from RBI and market participants with Shri R. Gandhi, Executive Director, RBI as the Chairman which provided roadmap for implementation with timelines.

- The Group recommended, among others,
  - Tentative timelines for implementation of reform measures spanning till end 2015
  - all the stakeholders to strive for implementation of the reforms as per the recommended roadmap

- India has made reasonable progress in implementation of G-20 recommendations and would work towards taking the process forward

Emerging Issues: OTC Derivatives Market Reforms..2

Trade Reporting

- Banks and PDs have been mandated to report the inter-bank/PD IRS transactions since August 2007
- Phased roll-out of reporting of forex forwards, swaps and options since July 2012
- The last phase introduced on December 30, 2013 covered reporting of inter-bank and client transactions in Currency Swaps and FCY FRA/IRS; and client transactions in INR FRA/IRS
- Confidentiality protocols for reporting of client transactions introduced in consultation with FIMMDA and other market representative bodies
- The reporting platform for Credit Default Swaps (CDS) was put in place from the date of introduction of the instrument itself.
- Going forward the reported data will be used for strengthening RBI's surveillance of OTC derivative markets, financial stability assessments, micro-prudential supervision and for dissemination of price and volume information for enhancing transparency of OTC derivative markets.

Emerging Issues : OTC Derivatives Market Reforms..3

Standardisation

- Standardisation has been made mandatory for INR Mumbai Inter Bank Offer Rate (MIBOR)- Overnight Index Swap (OIS) contracts from April 1, 2013 and will be extended to other benchmarks in due course

- CDS contracts are standardised since inception

- Forex derivatives are currently non-standardised as they are mainly driven by customised client needs

- Given the volume & depth should we not move fast for standardisation ?

Emerging Issues: OTC Derivatives Market Reforms..4

Swap Execution Facility

- With regard to introduction of Swap Execution Facility (SEF), a trading system for IRS is expected to be operational in the second half of 2014.

SEF Vs. Stock Exchanges for IRS

- SEF for institutional investors (including dealers-brokers) for trading in specialized products and in large amounts and Exchanges focus on retail investors
- Exchange traded IRS may not cater to the needs of institutional traders who trade in large lots
- The long tenor of contract and management of cash-flows for extended periods of time (e.g. 5, 10, 20 years) is uncommon in exchange traded instruments which is possible in OTC trades
- Globally, attempts at exchange trading in the interest rate swap market met with little success (e.g. exchange trading of IRS in the CME)
- Validity of OTC derivatives under Indian laws depends on the fact that one of the counterparties to the transaction shall always be a Reserve Bank of India regulated entity which is extremely difficult to ensure in an exchange-traded environment

Emerging Issues: OTC Derivatives Market Reforms..5

Migration to Central Clearing & CCPs

- Migration to Central Clearing depends on standardization, lack of complexity, market liquidity and price information availability
- Guaranteed clearing exists for USD/INR forward transactions.
- Rupee IRS and forward rate agreements (FRA) currently being centrally cleared in a non-guaranteed mode.
- "In principle" decision to bring IRS and FRA transactions in the Indian rupee within the ambit of guaranteed settlement has been taken.
- Recently, Reserve Bank has issued guidelines on "capital requirements for bank exposures to central counterparties".
- CCPs would increase concentration risks; a large number of legal/operational issues such as inter-operability across different CCPs, legal complexity, regulatory uncertainties and inconsistencies, applicability of insolvency regimes and of the default management processes of CCPs and potential increase in collateral requirements are engaging regulators' attention
  - Hence, RBI benchmarking CCP with international best practices - PFMIs

Emerging Issues: OTC Derivatives Market Reforms..6

Margining

- Global initiatives on margining being put in place
- India would follow global best practice
- Non-centrally cleared IRS margining would be mandated

Bilateral netting

- Reserve Bank is examining the issue and would explore all the possible options including changing the legal framework to resolve the issue

Emerging Issues: Extraterritorial Application of Laws

- Despite efforts at regulatory harmonization, laws enacted in the wake of financial crisis such as Dodd-Frank Act, EMIR etc. have certain provisions that have extraterritorial implications as they impose registration/recognition, reporting requirements, etc.

- This potentially could increase complexity, introduce uncertainty through overlapping and conflicting rules and impose large costs on global OTC derivatives markets

- Way forward is through substituted compliance based the individual jurisdiction's compliance with applicable global standards

- Reserve Bank, other regulators, such as, SEBI and CCPs are now actively engaged with regulators in developed and emerging markets on these issues

Emerging Issues: Regulator - Market Body Interactions

- The development of any market needs a great deal of collaboration and consultations

- Need for high frequency quality interactions with market bodies, such as, FIMMDA/PDAI

- FIMMDA's role has increased substantially - price valuations for G-Sec and non-G-Sec, accrediting brokers in the OTC interest rate derivatives market, publishing daily CDS curve for valuation of open position, constitution and working of the Determination Committee, etc.

- PDAI has also been playing a very important role in making our G-Sec market more liquid and in the successful completion of the Government's market borrowing programme
  - Must move ahead on market making
  - Increase in turnover requirement?

Emerging Issues: Regulator - Market Body Interactions..2

- Market bodies have greater responsibility to shepherd the new products, such as, CDS, Corporate Bond Repo, Interest Rate Futures (IRF), etc.
  - Need for greater understanding and build-up of interest in market participants for wider acceptance.

- FIMMDA and PDAI to continuously engage with the regulator in a proactive manner and make constructive suggestions for improvement of the markets and also appreciate the concerns of regulators and communicate them to their members appropriately

- Need for FIMMDA & PDAI interfacing closely with the Indian Banks' Association (IBA) for providing more useful inputs to the regulators/policy-makers.

- FIMMDA as Quasi-SRO to full-fledged SRO?

Concluding Thoughts

- Our regulatory approach is cautious & calibrated with focus on financial stability and market development – focus on responsible financial innovation
- Our endeavour has been to promote market transparency, financial soundness of institutions by prudential regulation and orderly market conduct.
- The global financial reform initiatives have become more onerous and intrusive. The G-20 reform agenda which we have committed to implement has significant implications for domestic markets
- FIMMDA and PDAI have been playing a pivotal role in this endeavour by providing valuable support and inputs.
- No country can be an "island" and we need to comply with international best practice in regulation
- We will adopt the regulations in a calibrated manner keeping in view domestic circumstances and market dynamics.

All the best to
the delegates of FIMMDA & PDAI Conference
for
exciting business with serious fun!

Thank You.