

**REGULATION
OF
G-SEC & INTEREST RATE DERIVATIVES MARKET:
RECENT DEVELOPMENTS
&
EMERGING ISSUES**



Harun R Khan
Deputy Governor
Reserve Bank of India

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SCHEME OF PRESENTATION

- Importance of regulation for markets
- Global initiatives on regulation
- Regulation of G-Sec, Money and OTC derivatives market– the Indian context
- Interaction between regulator and the regulated
- Recent developments in regulation in India
- Some emerging issues



IMPORTANCE OF REGULATION

- Regulation is about changing the behaviour of regulated institutions
 - Through rules
 - Through incentives
- Three core objectives of financial market regulation
 - to sustain systemic stability
 - to maintain the safety and soundness of financial institutions and
 - to protect the consumer's interest



GLOBAL INITIATIVES ON REGULATION

- “Free markets paradigm” found to be inadequate
- Lack of robust regulation cited as a major reason for global financial crisis
- Policy makers determined to introduce new financial regulations to prevent similar crisis
 - Focused on strengthening micro-prudential and market-conduct regulation supplemented with an effective macro-prudential framework
- Greater emphasis on a system-wide approach
- Coordinated regulatory action through international agencies due to the complexity of financial system with entities straddling across national jurisdictions necessitated



GLOBAL INITIATIVES ON REGULATION..2

- New regulatory initiatives more intrusive in their impact than the “light touch” approach to regulation that prevailed
- The G-20 regulatory reform initiatives
 - compensation practices that promote prudent risk taking
 - greater standardization of derivatives contracts
 - use of risk-proofed central counterparties (CCPs)
- Comprehensive regulatory reforms in advanced economies
 - US (e.g. Dodd-Frank Act in US)
 - UK (e.g. Vickers review of banking system)
 - Euro Zone ([e.g. Markets in Financial Instruments Directive (MiFID-II), Markets in Financial Instruments Regulation (MiFIR), European Market Infrastructure Regulation (EMIR)].
- Regulatory initiatives at the global level
 - New rules on capital, liquidity and leverage (Basel III)



GLOBAL INITIATIVES ON REGULATION..3

- New regulatory initiatives exemplified by Regulation (EU) No. 236/2012
 - Restrictions on short selling and CDS
 - Market participants cannot buy EU sovereign CDS unless they serve to hedge a long position in that country's debt or assets or obligations that are highly correlated to it
 - Investors cannot short sell an EU sovereign bond unless they can reasonably prove that they have cover



REGULATION OF G-SEC, MONEY & OTC DERIVATIVES MARKET: INDIAN CONTEXT

- Reserve Bank - regulator of G-sec, money market, repo and OTC derivatives by statute (Reserve Bank of India Act, 1934)
- India's approach to regulation
 - Calibrated and gradual approach with focus on financial stability
 - Attaining standards of international best practice
 - keeping in view the underlying structural, institutional and operational issues specific to Indian market.
- Approach has served Indian financial markets well
 - India relatively unscathed from the contagion effects of global financial crisis.

THE INDIAN CONTEXT...2

- Regulatory measures
 - Requirements for registration and reporting
 - To ensure safe and financially strong entities have access to the financial system
 - Reporting for transparency
 - OTC derivatives reporting so that information requirement of the regulators and market participants are fully met in a dynamic sense
 - Requirements for capital and collateral
 - Migration to Basel III to strengthen the banks' capital base and improve their ability to withstand systemic shocks.
 - Margin requirements to deal with counterparty credit risks
- Orderly market rules
 - Market making
 - Short selling
 - Price Bands



THE INDIAN CONTEXT...3

Gandhi Committee: Major Recommendations on Regulatory Initiatives

G-sec market

- Review of regulations/guidelines by regulators like IRDA, PFRDA, etc. from the perspective of facilitating a more dynamic management of the G-sec portfolio held by the regulated entities
- RBI to draw a roadmap to gradually lower the upper-limit on HTM portfolio
 - keeping in view possible impact on the balance sheet of banks/PDs



THE INDIAN CONTEXT...4

Retail participation

- Make efforts to put in place a suitable mechanism for market-making by PDs in the odd-lot segment of NDS-OM.
- Examine the possibility of having a centralized market-maker for retail participants in G-sec in the long-term who would quote two-way prices of G-Sec for retail/individual investors.

Interest Rate Derivatives market

- Consider an electronic Swap Execution Facility (electronic trading platform) for the IRS market
- Consider introducing a CCP for providing guaranteed settlement of trades executed through the electronic platform.
- Standardize IRS contracts to facilitate centralized clearing and settlement of these contracts.

INTERACTIONS BETWEEN REGULATOR AND THE REGULATED

Need for effective communication

- Pre- monetary policy meetings
- Bi-monthly meetings with FIMMDA
- Monthly meetings with primary dealers
- Consultative process

Regulators and the market bodies

- FIMMDA is responsible for ensuring the new products, such as, CDS, Corporate bond repo, Interest Rate Futures (IRF), etc. are understood well and building up interest in market participants to enable the products to gain wider acceptance

RECENT DEVELOPMENTS IN REGULATION

- Period of Short Sale extended from the existing five days to a maximum period of three months.
- FIMMDA Code of Conduct for usage of NDS-OM & OTC market
- To enhance participation of PDs in corporate bond market
 - PDs allowed a sub-limit of 50 per cent of net owned funds for investment in corporate bonds within overall permitted average fortnightly limit of 225 per cent of NOF for call /notice money market borrowing,
 - PDs permitted to invest in Tier II bonds issued by other PDs, banks and financial institutions to the extent of 10 per cent of the investing PD's total capital funds
 - PDs allowed to borrow to the extent of 150 per cent of NOF through Inter Corporate Deposits
- Repo in corporate debt
 - eligible category of collateral expanded to include short term instruments like CP, CD and NCD; and
 - minimum haircut requirement has been further reduced
- Progress in signing Global Market Repo Agreement is slow and needs to be expedited – if needed RBI would mandate



RECENT DEVELOPMENTS IN REGULATION..2

Credit Default Swaps

- Eligible participant base increased
 - all India financial institutions like SIDBI, NABARD, NHB and Exim bank added as users in CDS
 - Insurance companies and mutual funds permitted to participate as users
- CDS permitted on
 - unlisted but rated corporate bonds
 - securities with original maturity up to one year like CPs, CDs and NCDs as reference/deliverable obligations
 - Users can unwind their CDS bought position with original protection seller at
 - mutually agreeable or FIMMDA price
 - in absence of an agreement, unwinding at FIMMDA price

RECENT DEVELOPMENTS IN REGULATION..3

Enhancing foreign investment limits in G-sec and corporate bonds

- Limit for investment in G-sec enhanced from US\$ 20 billion to US\$ 25 billion.
 - sub-limit of US\$ 10 billion for investment by FIIs and the long term investors in dated G-sec enhanced by US\$ 5 billion
 - condition of three year residual maturity of G-sec at the time of first purchase for the above sub-limit not applicable.
 - investments not be allowed in short term papers like T-Bills
- The limit for FII investment in corporate debt (other than infrastructure sector) enhanced by US\$ 5 billion to US\$ 25 billion
 - Investments not allowed in CPs/CDs

GROWTH, STABILITY AND INTEGRATION IN FIXED INCOME DEBT & MONEY MARKETS IN INDIA

- Fixed income markets made rapid strides
- Turnover increased significantly
 - In call money - 38% in 2011-12
 - In outright G-Sec- 21% in 2011-12
- Volatility moderated considerably
 - CPs- SD declined from 2.03 in 1st half of 2000 to 0.31 in 2010-13
 - CDs- SD declined from 1.94 to 1.31
 - 10 year G-Sec yield- SD declined from 2.09 to 0.31
- Correlation among interest rate in various segments improved significantly
- Increased turnover, moderation in volatility and augmented correlation indicate improvement in growth, stability and integration.
- This could be partly attributed to robust and conducive regulatory environment created by Reserve Bank of India



INTEREST RATE VOLATILITY IN FIXED INCOME & MONEY MARKETS

(standard deviation)

Period	Call	91 DTB	CP	CD	1 yr YLD	5 yr YLD	10 yr YLD
2000-05	1.91	1.78	2.03	1.94	1.93	1.93	2.09
2005-10	2.26	1.62	2.13	1.77	1.36	0.75	0.65
2010-13	1.44	1.43	1.65	1.31	1.00	0.39	0.31



SOME EMERGING ISSUES

Sectoral vs. Unified Regulator

- Unified regulator suggested in the FSLRC Approach Paper
- Different focus of securities market regulator – customer protection
- Banks are the primary participants in the money, G-sec and forex markets
 - entity regulator being market regulator has synergy
- Critical economic pricing variables like money market interest rates, medium to long term interest rates and exchange rates have a bearing on monetary policy function

SOME EMERGING ISSUES...2

Benchmarks (polled or traded)

- LIBOR manipulation scandal shocked financial markets
 - public confidence has been shaken
- Independent review by Martin Wheatley
 - LIBOR should be reformed rather than replaced
 - submissions used for fixing LIBOR be supported by transactional evidence rather than by estimates
- MIBOR and other benchmarks under review by FIMMDA
- Merit in basing the benchmark on some transactional evidence

SOME EMERGING ISSUES...3

G-20 OTC Derivatives Market Reform Agenda

- Reasonable progress made by India in implementation of G-20 recommendations
- Standardised product design for CDS
 - Interbank IRS-MIBOR-OIS standardised w.e.f April 1, 2013.
 - Other benchmarks to follow
- Swap Execution Facility – RBI examining legal and technological issues
- Non guaranteed clearing for IRS
- Trade Repository – in place for CDS, IRS



SOME EMERGING ISSUES...4

Migration to Central Clearing/Use of CCP

- Products meeting certain conditions, such as, standardisation, relative lack of complexity in contract terms, sufficient market liquidity and readily available pricing information can migrate to central clearing.
- Regulators mandating / incentivising migration
- Centrally cleared trades will attract lower risk weights
 - [RBI draft guidelines on capital requirements on exposure to CCP]
- CCP may engender concentration risk
- Safeguards for strong and efficient clearing system – fair and open access based on transparent criteria, robust regulatory oversight, effective resolution and recovery mechanism and adequate liquidity
- Indian CCP evaluated continuously with regard to compliance to international best practice – Principles for Financial Market Infrastructure (PFMI)

SOME EMERGING ISSUES...5

Margining non centrally cleared derivatives

- BCBS and IOSCO developing consistent global standards for these margin requirements for non-centrally cleared derivatives
- Greater collateralisation of such transactions may lead to new credit and liquidity risks
 - Systemic implications of increased asset encumbrance and possible shortage of safe assets
- In India margins are not posted for IRS
 - This may pose systemic risks
 - Reserve Bank would initiate steps shortly to mandate margin requirements for IRS
- The mandatory requirements to be introduced after consultations with market participants and implemented in phased manner

SOME EMERGING ISSUES...6

Bilateral Netting

- Improves efficiency
- Legal position not clear
 - Similar dispensation in most Asian Countries such as China, Malaysia and also countries like Australia
 - Reserve Bank examining the issues

Review of HTM

- One view: HTM not conducive to liquid G-Sec market
- On the other hand: HTM reduction has implications for bank balance sheets and Government market borrowing programme
- Issue needs further deliberation and consultation
- Any transition would be carried out in a non-disruptive manner

CONCLUSION

- No country can be an "island"
- We need to comply with international best practice in regulation adapted in a calibrated manner keeping in view domestic circumstances and market dynamics
- This is for the good of both the financial & real sectors
- Markets should be well-prepared for the transition
- Responsible financial innovation should be guiding principle
- Market bodies like FIMMDA & PDAI have important role to play

THANK YOU

