Chapter 1:

Introduction

1.1 The developed markets have witnessed a sea change in use of repurchase agreements (repos) as a money market instrument during the last decade. Repo is recognised as a very useful money market instrument enabling smooth adjustment of short-term liquidity among varied categories of market participants like banks, financial institutions and securities and investment firms. In all advanced financial markets, repo remains the most versatile and popular instrument, the repo market transactions accounting for the lion's share in securities transactions. Compared with the pure call/notice/term money and inter-corporate deposit markets which are non-collateralised , repo is a much safer instrument since it is backed up by securities and fully collateralised. Thus, the counterparty risks are minimal. Central banks around the world use the repo as a very powerful and flexible instrument for absorbing or infusing liquidity. Since it is a market based instrument, it serves the purpose of an indirect instrument of monetary control in a liberalised financial market environment.

1.2 Presently, Repo market is well developed both in the USA and Europe. In the U.S. repos are an alternative to traditional money market instruments. In Germany, from January 1, 1997, Deutsche Bundesbank has exempted banks from maintaining minimum reserves on repos with a maturity period up to one year and it has brought about a boom in the repo market. The repo market in France has become, over the past few years, the second largest, after the U.S. market, in size and liquidity. In the U.K., Bank of England has been using gilt repo market as a daily intervention tool in management of monetary policy.

1.3 The Indian experience is quite different when compared with the rest of the world. In India, the policy in regard to repos swung between two extremes. Institutionwise, both banks and nonbanks were allowed in the market and instrumentwise all Government Securities and Public Sector Units (PSU) bonds were eligible for repos till April 1988. Between April 1988 and mid-June 1992, only interbank repos were allowed but in all Government securities. Double ready forward (1) transactions were part of the repos market throughout the period. Subsequent to the irregularities in securities transactions that surfaced in April 1992, as part of the new guidelines on investment management by banks and institutions, repos were banned in all securities except Treasury Bills. Presently repos are permitted in all Central Government Securities amongst banks, primary dealers and satellite dealers with the objective of smoothening interbank adjustments in liquidity. The controls are being relaxed in a phased manner with a view to expanding the market in terms of participants and instruments.

1.4 There has been continuing demand from the market participants to widen scope of repo transactions with a view to increasing the depth and liquidity in the debt market in general and in Government securities market, in particular. While it is a very useful instrument in the money market, it is necessary to evaluate the immediate implications of expansion of the market in terms of participants and instruments against the background of the irregularities in securities transactions surfaced in April 1992 and the need for the availability of such a versatile instrument in the context of demand from the market participants. It is against this background that the Technical Advisory Committee on Government Securities Market suggested the need for preparation of a Technical Paper covering all aspects of repos comprising legal status, regulatory framework, standardisation of accounting, risks and its implications for reserve requirements laid down as part of monetary or prudential policy.

1.5 Sub Group was accordingly constituted with Dr.Ajay Shah, Assistant Professor of Indira Gandhi Institute of Development Research (IGIDR), Shri C.B.Bhave, Managing Director, National Securities Depository Ltd. (NSDL), Shri K.Venkatappa, General Manager, Department of Government and Bank Accounts , Reserve Bank of India (RBI), Shri K.D.Zacharias, Jt.Legal Adviser, Legal Department, RBI, Shri Vishnu Deuskar, Managing Director, ABN Amro Bank Securities (India) Pvt. Ltd. and Ms.Chitra Ramakrishna, Senior Vice President, National Stock Exchange as members and Dr. T.C.Nair, General Manager, Internal Debt Management Cell as Convenor of the Group. The Group held its discussions under the guidance of Mrs. Usha Thorat, Chief General Manager, IDM Cell. The Group benefited from discussions with Shri G.Shiva Head, Fixed Income and Money Market Group, Citi Bank and Shri Srinivasan, Fixed Income Group Head, ISEC Securities Ltd.

METHODOLOGY

1.6 The Group had three rounds of discussions on various aspects of expansion of the Repo market. It separately met representatives of a cross section of public sector banks to seek their views on widening of the repo market in terms of participation and larger number of instruments apart from the need to put in place appropriate clearing and settlement systems, evolving uniform accounting standards, documentation etc. Officials of foreign banks, private sector banks and financial institutions were also consulted on issues involved.

1.7 The Group gratefully acknowledges its appreciation to officers of various institutions with whom it had discussions and the unstinted support they extended in giving shape to this Report. The members of the Group also place on record their appreciation of the guidance received from Mrs.Usha Thorat, Chief General Manager, Internal Debt Management Cell, at various stages of discussions held and the support given in finalising the Report. Shri Anand Sinha, General Manager, Department of Banking Operations and Development immensely contributed in giving shape to the proposed accounting treatment of repos and the Sub-Group has all appreciation for the work done. Further, the Group also wishes to place on record its sincere thanks to Shri E.Madhavan and Shri Gurumurthy, Asst. General Managers of Internal Debt Management who rendered their assistance in finalising the Report.

STRUCTURE OF THE REPORT

1.8 After Chapter 1, the Introduction, Chapter 2 deals with Concept, Mechanics and Uses of Repos while Chapter 3 covers the Problems and the Present Status of Repo Market in India. Chapter 4 provides A Plan for Expansion of Repo Market. Chapter 5 gives Summary of Recommendations. While the focus of this report is on inter-institutional repo maket, the experiences with the instrument as a monetary tool is dealt with in Annexure I.

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(1) Under a double ready forward transaction an entity sells a security to another entity on ready forward basis and simultaneously purchases some other security from the same entity on ready forward basis