

## **Chapter 3:**

### **Development of Repos Market in India: Problems and Present Status**

3.1. The Group had discussions on the development of repo market in India, the problems faced by the market in the wake of the irregularities surfaced in the Government securities market in 1992, developments thereafter and the present status of repos. The Chapter is divided into three parts comprising the pre-1992 developments in the repo market, its present status and aspects concerning the need for expanding the market, over the next few years.

#### **PRE-1992 DEVELOPMENTS**

3.2. The Government notification dated June 27, 1969 under Section 16 of the Securities Contract (Regulation) Act, 1956 declared that:

"In the territory to which the Act extends, no person can except with the permission of the Central Government enter into any contract for the sale or purchase of securities other than such spot delivery contract or contract for cash or hand delivery or special delivery in any security as is permissible under the Act and the Rules and bye-laws and the regulations of the recognised stock exchange".

3.3 In terms of Section 28, the provisions of the Act do not apply to the Government, Reserve Bank and any local authority or any corporation set up by a special law or any person who has effected any transaction with or through the agency of any of these authorities. Even the permitted institutions could undertake repo transactions only in certain specified securities.

3.4. Repos being short term money market instrument, are necessarily being used for smoothening volatility in money market rates by central banks through injection of short term liquidity into the market as well as absorbing excess liquidity from the system. Regulation of the repo market thus becomes a direct responsibility of RBI. Accordingly, RBI has been concerned with use of repo as an instrument by banks or nonbank entities and issues relating to type of eligible instruments for undertaking repo, eligibility of participants to undertake such transactions etc. and it has been issuing instructions in this regard in consultation with the Central Government.

3.5. In the Indian context, the Group is aware of the fact that banks often entered into buy back arrangements in respect of Government other approved securities and PSU bonds among themselves and with their large public sector and corporate clients till April 15, 1987 when RBI put out certain guidelines to be followed in this regard.

3.6. The guidelines issued by RBI imposed prohibition against buy back arrangements in respect of corporate securities and bonds issued by public sector undertakings as they did not satisfy the preconditions for orderly and transparent conduct of repo transactions. Instructions issued by RBI insisted that the buy back deals undertaken by banks should be exclusively confined to Government and other approved securities and the repurchase dates should be fixed after a minimum period of 30 days from the date of sale of the securities in question. Also, the purchase/sale prices under the arrangements needed to be in alignment with the

proximate market rates prevalent on the date of the original transaction for the relevant Government and other approved securities.

3.7. Further vide its circular dated December 1, 1987 RBI clarified that units of Unit Trust of India are not approved security for entering into repo transactions.

3.8. As far as accounting is concerned the RBI Circular dated April 15, 1987 insisted that no sales of Government and other approved securities under the arrangement should be effected by banks unless the same are actually held by them on their own investment portfolio either in the form of actual scrips or in SGL account maintained with Reserve Bank. The banks also required to deduct the securities sold from the investment account of the bank and its SLR assets for the entire period of holding by the purchaser/counterparty. Further, the transaction could not be allowed to yield a return higher than the prevailing call money rate as it is a collateralised transaction involving no risk.

### **MISUSE OF REPO TRANSACTIONS**

3.9. The alarmingly large scale growth in repos made RBI cautious and in order to ward off any undesirable developments as a result of the large scale misuse of repos detected, with effect from April 4, 1988 it prohibited the banks from entering into buy back arrangements in Government and other approved securities with nonbank clients. In fact, the large commitments made by investors and their sudden unwinding could result otherwise in a serious liquidity bind. However, banks were permitted to enter into buy-back arrangements with other banks (inter-bank) in Government and other approved securities subject to strict adherence to guidelines issued.

3.10. In this context it is pertinent to point out that the Joint Parliamentary Committee, on surfacing of the irregularities committed in the Government securities market observed that the main factors responsible were the fraudulent manipulation of the investment portfolio of some banks to divert funds to certain brokers to fuel the unprecedented rise in share prices, existence of imperfect documents and contracts, violations of guidelines issued by RBI and inadequate internal control systems.

3.11. The Janakiraman Committee, set up in the wake of the securities market irregularities of 1992 reported that there existed a thriving market for repos and virtually all wholesale participants of the money market and not only banks, used repo transactions widely despite there being an explicit prohibition on them. In the case of repos where the transactions were permitted with restrictions, the irregularities revealed that some banks used repos to understate their actual liabilities, by advising nonbank customers to lend them money by way of repos rather than place the same in the form of deposits. Some other players went to the extent of first committing to borrow repo funds and only then investing the same in securities, such that the position in securities would not have been there but for the commitment of these repo funds.

3.12. Irregularities in the Government securities market also brought to the fore the imperfections in the delivery and payment systems for Government securities and the abuses they gave rise to. In several cases, commitments to repurchase or resell the securities were not documented. On the detection of the irregularities committed in the securities market, RBI imposed a ban on ready forward deals and banks were prohibited with effect from June 22, 1992 from undertaking repos in dated Government securities and approved /trustee

securities. Repos in Treasury Bills were, however exempted from the prohibition. Double ready forward deals including those in Treasury bills were also strictly prohibited and the ban was extended to financial institutions as well. In fact, RBI banned repos in Government securities excluding Treasury Bills in 1992.

3.13. Justice Variava's judgement immediately after the irregularities in securities surfaced in 1992, however, was of great significance in the context of the development of the repo market in India as it held the view that all repo transactions undertaken by banks and other institutions were illegal and void as they were prohibited under Section 16 of the SCRA 1956 and vide Government's notification dated June 27th, 1969.

## **PRESENT STATUS**

3.14. It was unfortunate that repos which acquired depth and liquidity as a money market instrument faced a ban in the wake of its unprecedented growth in volume in an environment where an appropriate delivery and settlement system was not available to take care of the development. This could be gathered from Government's stance on repos articulated in the Action Taken Report on Joint Parliamentary Committee.

The Report reads as under:

" The Government has revived this matter and it is felt that for ensuring adequate liquidity in the market it would be necessary to allow ready forward transactions in an appropriately regulated way or in a transparent manner. To ensure that ready forward transactions are conducted in a transparent manner, such transactions amongst banks in Government securities have been restricted to Treasury bills issued by Government and in such dated securities of Government approved by RBI subject to the condition that such transactions are put through the Subsidiary General Ledger Account with RBI. RBI have also banned ready forward transactions in all other securities including PSU Bonds and units of UTI"

3.15. As is evident from the foregoing discussion even before the recent ban on ready forwards, the repo transactions by banks were subject to certain regulatory guidelines by the RBI. The spirit of these instructions by RBI was in consonance with the implementation of liquidity management policies pursued by the RBI. As banks violated these guidelines, RBI had no alternative but to impose a ban on such arrangements in respect of dated securities although inter-bank ready forwards, were permitted in respect of Treasury Bills.

3.16 The stance taken by RBI is also explicit from its views on the recommendations of the Nadkarni Committee in its "Report on Trading in Public Sector Bonds and Units of Mutual Funds" published in 1992. The Nadkarni Committee suggested that ready forward transactions should be restored to provide liquidity to the market in bonds/units. On examination of the Report, RBI had felt that in order to restore ready forward transactions in bonds/units there is need to ensure transparency in transactions and prohibit dummy deals where no transactions take place but are stated to. There has to be simultaneous recording of the nature and quantum of the ready forward transactions, the pricing and the counterparties and this needed an electronic clearance, settlement and depository system as a precursor to reintroduction of the ready forward transactions facility. It was also then felt that in so far as the market in Public Sector Undertakings' bonds is concerned a similar facility could be provided by the Stock Holding Corporation of India Ltd. It also felt that with a view to

making a larger market for PSU bonds, transactions on the Stock Exchanges on a cash basis needed to be encouraged and PSUs whose bonds were not listed needed to be listed.

3.17. Consequently, in order to legally facilitate the repos transactions RBI had to take up the issue with the Government to exempt banks etc. from this prohibition. As long as the June 1969 Notification is operative, RBI would have to continue to take up with the Government to issue necessary notification exempting, such of those entities as deemed necessary by the Bank, from the prohibition contained in the Notification.

3.18 Amending the Notification dated June 27, 1969 which prohibited forward transactions in securities, Government issued notifications by virtue of which banking companies, co-operative banks, Primary Dealers (by name) and Satellite Dealers (by name) were permitted to undertake ready forward transactions in specified securities provided the transactions are settled through SGL Accounts maintained at Public Debt Office, Mumbai. Further, non-bank entities as notified by the Central Government were permitted to undertake Reverse Repos only. It may thus be seen that the entry into the Repo Market is regulated and some parties, viz., non-bank entities have been permitted only limited entry into the repo market as they were allowed to undertake reverse repos only.

3.19. An efficient and transparent clearing and settlement system contribute towards effective and riskless functioning of the securities markets . RBI has evolved such a system and it is obligatory for all the SGL account holders with Public Accounts Department (for Treasury Bills) as well as Public Debt Office ( for dated Government Securities) to maintain current accounts with Deposit Accounts Department (DAD) of the Bank. As per RBI's policy only select categories of institutions viz. banks, financial institutions etc. are allowed to maintain current account with DAD. The Delivery versus Payments System available provides for transfers of securities and funds on gross basis at the end of the processing cycle and under the system a transaction in SGL Account is matched with the transaction in the Current Account. If the transaction cannot go through for want of sufficient securities or funds, it is automatically kept on hold in queue for reprocessing at day end with the hope that the securities/funds position will improve by that time. If, however even after all the transfer forms have been processed there are no accruals either to SGL account or the current account and the negative balance position persists, the SGL transfer form bounces.

3.20. Keeping the usefulness of repos in view as an instrument for the development of the money market in the Monetary Policy for the first half of 1997-98 it was decided to allow repos in such of the PSU bonds and private corporate debt securities which are held in dematerialised form in a depository and the transactions done in recognised stock exchanges and make all Government securities including Treasury Bills eligible for ready forward transactions.

3.21. Since repos transactions were used for as short a period as one day merely as a change in nomenclature from call money and with a view to ensuring that banks resort to ready forward transactions in accordance with the spirit of this facility it was decided that effective from September 30, 1995 the minimum period for repo transactions should be three days. Effective from October 31, 1998 when the interbank liabilities were exempted from the requirements of maintenance of CRR except for the statutory minimum requirement of 3 per cent and with a view to enabling banks and other participants in the repo market to adjust their liquidity in a more flexible manner, it was decided to withdraw the restriction of the minimum period for repo transactions in Treasury Bills of all maturities and notified

Government of India dated securities. No other major procedural changes have been permitted in inter bank repo transactions since June 20, 1992 when the guidelines for undertaking repo transactions were issued for the first time since the initiation of financial reforms.

3.22. The stock of instruments comprising central government dated securities and treasury bills presently account for Rs.3,25,000 crore. and as per information available the major players in the repo market are select public sector banks, private sector banks and foreign banks apart from financial institutions as lenders. However, except the benchmark government securities others are not being used in repo transactions for want of liquidity.

## **OBSERVATIONS**

3.23. An examination of the present status of the repo market in India reveals that:

3.23.1 Since ready forward transactions are banned by the Government to facilitate undertaking the repos transactions legally RBI has to take up the issue with the Government in regard to eligible participants and instruments. As long as the June 1969 Notification is operative, RBI would have to continue to take up with the Government to issue necessary notifications from time to time exempting, such of those entities as deemed necessary by the Bank, from the prohibition contained in the Notification and to include such instruments as should be made eligible for undertaking repos.

3.23.2 Participation in repos market is restricted to banks, Primary Dealers and Satellite Dealers. This eliminates a large number of potential users like financial institutions, corporates and pension funds from the market thus stunting its growth.

3.23.3 Repos are permitted only in Government dated securities and Treasury Bills and in the market there is a demand for their extension to include bonds issued by All India Financial Institutions and Public Sector Units. It is felt that inclusion of these instruments would provide cheaper financing option for nongovernment securities and financing flexibility would be available to all participants.

3.23.4 There is an efficient and transparent delivery versus payments system which takes care of present limited volumes of transactions in Government securities. But it would require upgradation of technology to take enhanced volumes with the expansion of repo market.

3.23.5 There is no standardised accounting of repo transactions and the systems followed vary from bank to bank. Some banks account for repo as an outright sale and then outright investment on repurchases in their books at a different rate. Some banks account for the repo as a lending/borrowing transaction and treat earnings/costs as interest income/expense.

3.23.6 There is no standard legal documentation covering areas like margin requirements and additional collaterals to be provided either in the form of cash or equivalent securities to make up for the short fall. For, repo market participants in India do not follow any safeguards to take care of market /price risks as Government of India securities are usually less volatile than corporate bonds, for which monitoring of the value of collateral would be a vital area of concern. There is no system of applying hair cuts or margins.

3.23.7 Under the present arrangement of repos, protection for the parties involved is available

only to the extent of the realisable value of the collateral equals or exceeds the exposure. In the event of a default by the counterparty, the lender of cash should be in position to liquidate the securities received as collateral, thus offsetting any loss. Similarly, the seller /lender of bonds will hold cash against nonreturn of lent securities. There is no standard documentation /master agreement governing a repo transaction. Although repos are secured transactions , they are not riskless. Hence the law and procedures should provide safeguards against risks associated with repos.

3.23.7 There are procedural hassles in the form of safety measures which hamper the smooth operations of the repo market. These include restrictions on roll over of repos, lack of provisions for substitution and nonavailability of clear cut operative guidelines for constituents' SGL accounts with PDOs of RBI.

3.23.8 Further, there is lack of clarity over contract, deal and settlement dates as the market conventions do not provide any guidelines in this regard.

3.23.9 The scheme to permit such of the PSU bonds and private corporate debt securities which are held in dematerialised form in a depository and the transactions are done in recognised stock exchanges has not yet been operationalised due to levy of stamp duty on transfer of certain debt securities.

3.23.10 In spite of there being a strong case of some amount of expansion of the repo market there is always the lingering fear that reintroduction of repos could still result in temptation on the part of institutions to exploit any systemic weakness to their advantage which would severely impair further freeing of the debt market. It is therefore imperative on the part of both the Government and RBI to tread carefully as far as expansion of the repo market is concerned.

3. 24. From the foregoing discussion the Group has gathered the view that there is the need for development of the repos market in India in a phased manner enhancing participation and variety of eligible instruments with provisions for appropriate dealing and settlement system and standardised accounting and documentation.