Mr Reddy discusses issues in fixed income markets

Inaugural address by Dr Y V Reddy, a Deputy Governor of the Reserve Bank of India, at the seminar on fixed income markets, organised by the National Stock Exchange and ISMA in Mumbai on 11/02/99. (Dr Reddy expresses his gratitude to Dr A Prasad for his valuable assistance.)

I am happy to be with you today at this seminar organised by the National Stock Exchange (NSE) and the International Securities Market Association (ISMA). The NSE needs no introduction to this audience. Mr Patil has been, at our request, working closely with the Reserve Bank of India (RBI) on various issues and we value his advice. The NSE also has representatives on a number of committees looking into different aspects of the market.

ISMA has been performing the role of an effective self regulatory organisation (SRO) and the rules framed by ISMA have become a benchmark for the fixed income securities market. Hence, the expertise and experience that ISMA has gained over the years would be valuable to us in RBI also as we continue to develop our markets.

The objective of this seminar is to assess recent changes in the Indian fixed income market, review the international experience in the development of this segment of financial markets and flag the agenda for future action.

Major reform measures in the financial sector have been undertaken by the Reserve Bank of India since the beginning of the 1990s. Reform in the government securities market is important in view of its role in setting benchmarks in the rest of the financial markets. It is also crucial for bringing about an effective and reliable transmission channel for the use of indirect instruments of monetary control. A notable change was the switch from administered low coupon government borrowings to auctions in government securities at market related rates. Introduction of primary dealers has to some extent improved the liquidity in the secondary market. Innovative financial instruments were introduced, such as zero coupon bonds, floating rate bonds, capital indexed bonds, securities on which payment is made in instalments, etc. In addition, 14, 91 and 364-day T-bills presented investment avenues for deployment of short-term funds to investors. Counterparty risk in securities settlement has been eliminated with the introduction of Delivery versus Payment system (DVP).

I had, in an earlier speech a couple of months ago on debt markets, presented an agenda for further action, which covered, among others, technology, regulatory and legal issues, and the need for standardisation of practices in the debt markets. In fact, only a couple of weeks ago, I spoke at length on reforms in the money market also. So, perhaps there is no need to go into the details of either reform measures or agenda for action in these markets today.

I observe that today's seminar is structured in three sessions: transparency in fixed income markets, regulation in repo markets and regulation issues in an integrated market environment. These issues are of critical importance in the development of the debt markets and it may be useful to quickly review what we have achieved so far and what needs to be done. I will therefore address only those issues that are receiving specific attention in the seminar today.

Transparency in fixed income markets

It is widely recognised that weaknesses in the provision and use of information played a major part in the development and spread of recent international financial crises. A number of international groups have since been examining issues relating to the stability of the financial system. One such working group of The Willard Group examined transparency and accountability issues. This group has defined transparency as a process by which information about existing conditions, decisions and actions is made accessible, visible and understandable. Undeniably, transparency contributes to the efficient allocation of resources by ensuring that market participants have sufficient information.

This information is meant to enable them to identify risks and to distinguish one firm's circumstances from another's. Moreover, transparency helps inform market expectations. In turn, this helps stabilise markets during periods of uncertainty and also contributes to the effectiveness of announced policies. However, admittedly, there are limits to transparency. Some categories of information are costly to compile. In such cases, infrequent disclosure may be justified. Further, confidentiality may be warranted in some circumstances.

In determining the appropriate degree of transparency, the benefits must be balanced against costs. Transparency should not mean that there will be a one-size-fits-all code on this. Of course, in the final analysis, transparency will be with reference to factors considered relevant, which itself depends on the model for analysis that is considered useful. Also, transparency gives facts, but inference is a different matter and a judgment based on such inference is yet another matter. Personally, I believe that transparency is primarily the best test of our good intentions.

Hence, the Reserve Bank of India is disseminating exhaustive information relating to activities, both in the primary and secondary markets, especially the government securities market. For instance, detailed results of auctions of T-bills and dated governments securities including weighted average price, devolvement on primary dealers and RBI, and information on fixed rate repos are issued through regular press statements. The RBI also issues a daily press release giving details of secondary market transactions in the government securities markets. In addition to information on T-bills and dated government securities, the monthly RBI Bulletin and the Weekly Statistical Supplement to the RBI Bulletin contain information relating to open market operations and repo transactions of the RBI. The RBI website, which has been appreciated by many, as emulating international standards in excellence, also contains up-to-date information on financial markets.

Until 1994, the debt market was purely a telephone market meaning that all trades were negotiated and concluded directly by investors. The NSE introduced a screen-based trading system with the objective of increasing transparency in the market. But the general experience is that while actual trade is still negotiated over the counter, mere reporting is done through such a system. However, greater use of the online trading system is required rather than a mere reporting of trades in order to enhance transparency. Success will depend mainly on an increase in the number of transactions. A large number of transactions would result in a successful continuous order book for matching the trades. If the negotiated telephone deals are moved to a screen-based system, full information about volume and price of transacted security would be available online. This would result in better price discovery and promote transparency and efficiency in the market.

Currently, the daily available information to the market regarding secondary market trades is based on actual settlement through Subsidiary General Ledger on a particular date. This may not necessarily reflect a deal concluded on the same date as the SGL transfer form has to be lodged within 24 hours of the contract but not necessarily on the date of actual deal. Thus, an information gap exists between the deal date, contract date and actual settlement date. Screen-based trading would obviate this shortcoming.

The RBI is actively coordinating with the Primary Dealers Association in developing an Electronic Dealing System to facilitate dealing in money market, government securities and other debt instruments. This will lend transparency and efficiency to market operations. It will also enable the RBI to monitor developments in the market online.

The RBI has embarked on computerisation of its Public Debt Offices. This would link Public Debt Offices in the RBI with banks' treasury offices. Hopefully, primary dealers/satellite dealers, other SGL account holders and stock exchanges will also be linked.

There is enormous advantage in providing member terminals to SGL account holders as this will enable them to view RBI announcements regarding fresh auction, floatation of issue, conversion of loans, repo auctions, interest rate resets for floating bonds and other such information. Market participants will also be able to tender bids in auctions of dated government securities, T-bills and repos from all centres. The entire auction process, including allotment, determining and communicating payment amount, and advising successful and rejected bids to bidders, will be online. The list of successful bidders and the consideration amount payable would form the input to the settlement and servicing system.

While the link-up has advantages, it can be made operational only through electronic SGL forms. Early enactment of the new Government Securities Act replacing the Public Debt Act 1944 is essential since it will provide the RBI with substantive powers to design and introduce electronic SGL transfer forms.

Regulation in the repo market

In our market, interbank repos are permitted under regulated conditions. After the irregularities in securities transactions in 1992, eligible participants and instruments have generally been restricted but subsequently liberalised in a gradual manner. Now, all government securities have been made eligible for repo. Besides banks, primary dealers are allowed to undertake repo/reverse repo transactions. Nonbank participants have also recently been allowed to lend money through reverse repo to other eligible participants. In terms of instruments, repos have also been permitted in PSU bonds and private and corporate debt securities, provided they are held in dematerialised form in a depository and the transactions are done through a recognised stock exchange. However, this can be operationalised after the government issues a clarification regarding applicability of stamp duties on transactions in dematerialised instruments.

Admittedly, the interbank repo market in India needs to be made more transparent and better standardised. I have, time and again, been encouraging market participants to evolve code of best practices in the repo market through the Primary Dealers Association or FIMMDAI. The RBI has also been actively pursuing this issue in the Advisory Committee on Government Securities market and the Standing Committee on Money Market. Issues relating to evolving a code of best practice such as eligibility of participants and their requirements, eligibility of instruments for repo, general standards, systems and documentation, legal agreement, margin, deal confirmations, and default scenario were discussed in the recent meeting of the Standing Committee on Money Market held on February 3, 1999. In fact, pursuant to the discussions on the same subject in the meeting of Technical Advisory Committee on Government Securities Market held in November 1998, an internal subgroup of that committee is already looking into various aspects of repo market expansion, including issues comprising legal status, regulatory framework, standardisation of repo contracts and accounting system and introduction of tripartite repos. The subgroup is expected to complete its report by mid-March 1999. We expect that a standard repo agreement will emerge very soon from the subgroup’s recommendations. We also expect the participants to adopt them once it is considered appropriate by the RBI.

In this connection, I wish to recall that the RBI announced in the October 1998 review of monetary policy that call/notice/term money market should purely be an interbank market with additional access only to primary dealers. This implies that nonbank players have to be encouraged to deploy their short-term surpluses in other money market instruments. For instance, they can be allowed to borrow and lend freely through repos in both government and non-government securities. Thus, development of repo market assumes increased significance in the interest of further reforms in the financial markets.

Issues in regulation under an integrated market environment

In an integrated market, the regulatory framework should ensure that there are no regulatory overlaps or regulatory gaps in the financial system. The Deshpande Committee highlighted these gaps and overlaps and recommended amendment to Section 29A of the Securities Contract (Regulation) Act 1956 to enable the government to provide jurisdiction to the RBI also in regulation over money and debt markets. With this, the respective regulatory roles of the RBI and SEBI in the debt market will be formalised. The proposed change in the SCRA is bound to pave way for a much more active repo market.

In the PSU and corporate bond market, an important issue relates to large resources raised through private placement. No doubt, private placements offer a number of advantages. However, this market remains largely unregulated. Healthy development of the private placement market calls for more transparency, better disclosure and protection of investor interests.

A liberalised and integrated market environment also means that risks get transmitted from one segment of the market to another more rapidly. Market participants have to ensure that proper risk management systems are in place. In India, banks are the major players in the financial markets. The RBI has already circulated draft guidelines for ALM for banks, which indicate prudential limits for call borrowings. These guidelines will be operative from April 1, 1999.

Conclusion

As I mentioned at the beginning, I have flagged some issues that are currently engaging our attention in the fixed income market. I trust that these and other issues would be deliberated upon later during the day. I would be happy to have feedback from the organisers about the outcome of the seminar.

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