Role of Banks in Capital Market Development

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The development of local capital markets has long been a key area of discussion between the regulators and market participants.

A well-developed capital market can boost economic growth by ensuring efficient allocation of capital to the real economy with better sharing of risk.

This compliments the banking sector that has remained central to India's growth story since the program of economic reforms introduced in the nineties.

Banks mobilized small and scattered savings of the community and made it available for the credit needs of an emerging economy. They also helped shape the financial infrastructure of the country that has largely remained unscathed from the impact of the global economic crisis.

Today, India is the best performing large economy and is estimated to grow at over 7 percent in FY17. On the other hand, the developed world is struggling to come out of their sluggishness. This only strengthens the case for further reforms in capital markets and the onus to achieve it largely lies on the banking sector.

A story of reforms

The wheels of banking sector reforms were set in motion by the program of economic reforms of the nineties. It was nothing short of a revolution for billions of Indians as the country broke away from the shackles of low growth and catapulted itself into the fast lane of liberalization.

Though the reform push was preceded by the precarious economic situation of 1991, the process itself was calibrated and well thought-out.

A notable feature of the financial sector reforms in India has been the stress on financial stability. Our financial markets opened to overseas investments, became deep and liquid but also emerged resilient in the face of challenging domestic and global events.

Development of the local bond market allowed the government to finance its large fiscal deficits without having to resort to foreign borrowing.

The Reserve Bank of India is now committed to gradually increase the foreign participation in the local debt market to help provide more breadth to the market. It is also working on a proposal to cap bank lending to large companies.

The proposed changes will not only reduce a bank's risk with regards to exposure to large companies, it will also force firms to seek alternative sources of funding to finance their growth and strengthen the balance sheets of investors and issuers.

Need for vibrant capital markets

A well-developed local capital market improves the availability of long term financing and allows investors to better manage risk by avoiding the asset-liability mismatch – a big concern for bank lending to long-term projects.

Local currency bond markets allows domestic investors to better manage inflation risk. It also makes the country less vulnerable to sudden start and stop of foreign capital inflows. It helps deepen the financial market and thereby improves the efficiency of capital allocation in the economy. Allowing foreign investments into the local markets helps provide liquidity and breadth to the market and helps risk sharing across countries.

Last but not the least, the development of local capital markets can further improve financial stability by enhancing the ability of financial institutions to manage risk. Products like interest rate derivatives and credit derivatives provide a better assessment and protection against risk. Moreover, a more diverse financial system that includes capital markets alongside banking markets tends to be more stable and better able to absorb shocks.

Role of banks

The development of capital markets is primarily a regulator-driven process where banks are the catalyst that help in achieving the objectives. Banks have been the main drivers of innovation and providers of liquidity in developing markets. It is also important to understand that incentivizing banks alone is not enough. For the market to develop, there needs to be a level playing field for all participants.

Channel for origination: Given that most of the lending in India is still done by banks in the form of loans, the lenders are uniquely placed to introduce new names to the bond markets. The introduction of guidelines which made borrower rating essential for raising capital resulted in a number of companies getting themselves rated. From there, bringing them to the bond markets and making investors understand the credit risk more widely is a role which banks can play effectively.

Liquidity support: Banks can provide liquidity options to the market, either in the form of providing buying support when markets are dislocated, or by entering into repo transactions / other funding mechanisms, especially for new borrowers to enhance the buying power of other market participants.

Understanding risk: Given multiple product engagement with borrowers, banks have a better understanding of their credit strength. With due respect to the client confidentiality and regulatory requirements, a mechanism can be put in place to share information between the banks and non-bank participants.

Product support: Banks are best placed to encourage complementary products to further enhance the width and penetration of bond markets – such as securitization products, credit default swaps, and so on.

Regulatory support

Credit Risk: Banks should treat credit exposure via loans and bonds as the same. Currently, they are happy to lend to lower-rated credits in the form of loans but won't invest in their bonds. There should be guidelines and encouragement for banks to take on more lower-rated credit risk in bonds.

Information flow: Regulators should allow information flow on credit risk between bank and non-bank markets for a better judgement on risk.

Market makers: Banks can be incentivised by regulators to do market making. This can happen through liquidity support via repos from RBI as an example, or by providing some capital relief on the amount of market-making a bank does on an exchange.

Exposure norms: Capital market exposure norms should be more relaxed (for both direct and indirect expsoure) and more sophisticated models should be followed which would compute permissible exposure linked to type of expsoure, volatility / VaR / stop loss limits, capital availability , and so on. Basically banks who can demonstrate greater sophistication in understanding and monitoring risk should be given more limits, other things remaining the same.

Quasi equity instruments: A separate limit for investment by banks in quasi-equity instruments like preference shares, compulsorily convertible debentures etc. should be allowed. These instruments should get listed

Coordination between regulators: Different regulators like Reserve Bank of India, Securities and Exchange Board of India and others, have different criteria of risks and guidance for investment for the same instrument or same level of risk. A greater coordination among regulators will help in uniform assessment of risk for the markets. Also, any pending tax issues for both debt and equity capital markets should be speedily resolved

Role in equity market development: The regulator should look at enhancing the banks' equity market limits from the current level of 20% of their net worth. Here the equity includes IPO, secondary market purchases, convertible instruments and venture capital funding. They should also be allowed to participate in projects through partially convertible structure.

Increasing limits: Under the current regulation, the banks cannot invest more than 30 percent of the company's equity (including pledge of shares). This limit should be increased seeing current market scenario where companies are resorting to restructuring.

Apart from the above, the regulators should look at raising the limit of liquidity and margin funding provided by banks to brokers. Merchant bankers should be provided with underwriting limits and the infrastructure for application supported by blocked amount for initial public offers (IPO-ASBA).