Integrated Financial Market

Himanshu Kaji
Group Chief Operating Officer & Executive Director
Edelweiss Financial Services Ltd.

An "Integrated Financial Market", could be understood as interlinking of various constituents of the financial markets (domestic as well as international) which ensures continuous unconstrained access to finance and a market which is directed towards the convergence of risk-adjusted returns of a particular type of asset class across all the markets. Liberalization of Indian economy from 1991 onwards and continuous development and advancement of capital markets / money markets in India, has paved a path for India's financial services sector's development, both domestically as well as internationally. In past couple of decades, the Government of India, Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI) and other Regulatory authorities have proactively and cautiously contributed towards series of continuous reforms such as significant relaxation in the Foreign Investment policies, liberalization of Foreign Exchange regime in India , current account convertibility, market-driven interest and exchange rates, auction-based allocation of government securities, allocation of new banking licenses, creating a new class of payment / small finance banks etc.

In retrospect if one looks at, the consequence of these financial services sector reforms have emerged into an integrated financial market and reduction in the arbitrage opportunities across various asset classes. This also effectively leads to efficient allocation of financial resources amongst different constituents of the economy. Discussed herein below are some of the significant policy changes and other measures that have taken place in past couple of decades which has resulted in development of an integrated financial market in India.

· ***Money market / Government securities (G-Sec) market Reforms***

Monetary and Financial system reforms picked up a pace some 25 years ago, on constitution of certain key committees for suggesting financial sector reforms. These were the report of the Committee which reviewed the Working of the Monetary System - Chakravarty Committee, 1985, the Working Group on the Money Market - Vaghul Group, 1987 and Narasimham Committee in 1991 and 1998. The financial sector reforms initiated following the recommendations of these committees produced far-reaching changes in the financial sector, which have led to today's strengthened financial system. Several money market / G-Sec reforms were been initiated by the RBI taking the recommendations made by the aforesaid committees into consideration. Some of these key measures are discussed below:

Introduction of new Instruments: RBI introduced several initiatives and introduced new instruments like certificates of deposit, commercial papers, treasury bills of varying maturities (14, 91 and 364 days) and interbank participation certificates. The emergence of these new instruments has led to creation of a diversified market for short term instruments.

Interest Rate Deregulation: Post 90's, Government lifted the ceiling rates of the call money market, short-term deposits, bills rediscounting, etc. Commercial banks have been allocated the task of monitoring the interest rate changes to ensure that the changes are well within the limits. Currently interest rates are determined by the working of market forces but for a few regulations.

Mutual Funds / Money Market Mutual Fund (MMMFs): The first step towards the development of Mutual Fund industry was initiated by way of launch of Unit Trust of India (UTI) by the Government of India. Until 1987, UTI enjoyed a monopoly in the Indian mutual fund market. Subsequently, various other government-controlled Indian financial companies like State Bank of India, Canara Bank, and Punjab National Bank also entered into the Mutual Fund industry. The major boost came in the sector by introduction of the SEBI (Mutual Fund) Regulations in the year 1993, post which several players entered the Mutual Fund industry. The net resources mobilized by Private Sector mutual funds have increased from Rs. 87.09 billions to Rs. 549 billion[1] from financial year 2000-01 to 2013-14 respectively.

For creating additional short-term investment avenues, the RBI encouraged and established the Money Market Mutual Funds (MMMFs) in April 1992. Financial institutions / various mutual fund houses / UTI have set up such funds which mobilise resources and essentially make investment in the money market instruments.

Establishment of the CCIL: The Clearing Corporation of India limited (CCIL) was setup in 2001 and commenced its operations in 2003. The prime objective of CCIL was to bring efficiency in the transaction settlement process, insulate financial system from operational hazards, undertake other activities that would help to broaden and deepen the money, debt and forex markets in the country. CCIL provides exclusive clearing and settlement for transactions in money market, G-Sec and foreign exchange. The setting up of CCIL has significantly enhanced the efficiency and security of settlement system.

Establishment of the DFI / SBI DFHI: The Discount and Finance House of India (DFHI) was set up in April 1988 with an aim to develop money market in India and to

impart liquidity in the money market. Later in the year 2004, two leading players DFHI and SBI Gilts Ltd, a subsidiary of State Bank of India merged into a new company named SBI DFHI Ltd. SBI DFHI is one of the key players in the Primary Dealer segment of the domestic debt market. It has played an important role in stabilizing the Indian money market.

Liquidity Adjustment Facility (LAF): RBI remains in the money market on a continue basis through the LAF viz. the repo transaction. LAF adjusts liquidity in the market through absorption and or injection of financial resources. In 2004, RBI reviewed and revised the then existing LAF facility after considering the recommendation of Internal Group on Liquidity Adjustment Facility and suggestions from the market participants and experts.

Government securities / Corporate bond market

Major players in the Government securities market in India include commercial banks and primary dealers besides institutional investors like pension and provident fund, insurance companies, mutual funds, regional rural banks, co-op banks. Primary Dealers play critical role as market makers in Government securities market. Foreign Institutional Investors (FIIs) are allowed to participate in the Government securities market within the quantitative limits prescribed from time to time. Corporates also buy/ sell the government securities to manage their overall portfolio risk.

Several fundamental reforms took place in the government securities market including setting up a system of primary dealers (PDs) for dealing in government securities, introduction of delivery-versus-payment (DVP) system in respect of government securities settlement, introducing new instruments such as zero coupon bonds, partly paid stock and capital-indexed bonds, conducting auctions to impart greater transparency in operations, allowing repos in government dated securities etc. Government of India, in consultation with the Reserve Bank of India, also issued a new short-term instrument, known as Cash Management Bills (CMBs). First set of CMBs were issued in May 2010. CMBs have been issued with the objective of meeting the temporary mismatches in the cash flow of the Government.

As per the database on Indian economy by RBI, the total central and state government securities (aggregate issuances of Central and State Government securities which represent the face value of interest bearing outstanding rupee securities excluding Treasury Bills, Saving Prize Bonds, expired loans and interest-free non-negotiable securities of Government of India) has increased from INR 860 billion (in the year 1991) to INR 47,769 Billion (in the year 2014).

· ***Banking Sector Reforms***

In February 2013, the Reserve Bank of India (RBI) released the new set of guidelines for licensing of new banks in the private sector. This followed by the RBI granting license to two applicants namely IDFC and Bandhan Financial Services in April 2014. For furtherance of the Banking System reforms in India, RBI in November 2014, laid down the Guidelines for Licensing of Small Finance Banks in the private sector with an objective to further financial inclusion by (a) provision of savings vehicles, and (b) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high technology-low cost operations. As per the information available on RBI's website, more than 100 applications have been received by the RBI for obtaining license which is currently under consideration at RBI's end.

Further, as a part of financial inclusion, the current Prime Minister of India, Shri Narendra Modi also launched the "Pradhan Mantri Jan-Dhan Yojana (PMJDY)" which is aimed at ensuring access to various financial services like availability of basic savings bank account, access to need based credit, remittances facility, insurance and pension to the excluded sections i.e. weaker sections and low income groups. The scheme is run by Department of Financial Services, Ministry of Finance. As on 17 January, 2015[2], Banks have opened 11.50 crore accounts, against the estimated target of 7.5 crore households in the country.

Separately, with an aim to provide a structured platform to the Banking sector for managing NPAs, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was put in place in the year 2002, to allow banks and FIs to take possession of securities and sell them.

Capital Markets reforms

The Ministry of Finance houses the Capital Market Division within the Department of Economic Affairs. The division is responsible for formulating policies related to the orderly growth and development of the securities markets (i.e. share, debt and derivatives) as well as protecting the interest of the investors. The Division administers legislations and rules made under the Depositories Act, 1996, Securities Contracts (Regulation) Act, 1956 and Securities and Exchange Board of India Act, 1992.

The SEBI was established in 1988 which later received a legal status in 1992. Key objective of the SEBI was to protect the interests of investors in securities, promoting the development of the securities market, and regulating the securities market. SEBI is proactively engaged in regulating the activities in the capital markets, regulating activities of the intermediaries and persons associated with the securities market, merchant banking activities, regulating mutual funds, to promote stock exchange activities and act as regulator to the securities issues. Effective introduction of various regulations and rules by SEBI has led to increase in merchant banking activities, rising electronic transactions, growing mutual fund Industry, growing stock exchanges, growth of derivative transactions etc. The SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of various market intermediaries, for prevention of unfair trade practices,

and insider trading. Introduction of various Regulations have given variety of securities / instruments for investments leading to the expansion of the capital market in India.

SEBI also appointed several committees for creating efficiencies in the Regulatory framework from time to time. Some of the key committee recommendations were included in the Report of Shri K.B. Chandrasekhar Committee on Venture Capital in 2000, Report of the reconvened committee on substantial acquisitions of shares and takeovers under the chairmanship of Justice P. N. Bhagwati in 2002, Report of SEBI Advisory Committee on Derivative on the Development and Regulation of Derivative Markets in India in 2002, The Report of Shri N R Narayana Murthy Committee on Corporate Governance in , Report of SEBI Advisory Committee on Derivative on the Development and Regulation of Derivative Markets in India, Report of the RBI-SEBI Standing Technical Committee on Interest Rate Futures in 2009 etc.

With a view to create efficiency, SEBI regularly reviews the existing regulatory framework and comes up with several regulatory changes from time to time. Some of the recent substantive changes brought in by the SEBI include for eg. replacing the erstwhile Venture Capital Regulations with the Alternative Investment Fund (AIF) Regulations, replacement of the erstwhile SEBI (Disclosure and Investor Protection) Guidelines with SEBI (Issue of Capital and Disclosure Requirements) Regulations in the year 2009 to enhance the enforceability of the regulatory provisions contained in the DIP Guidelines, replacement of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 with SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Replacing the erstwhile SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 with the SEBI (Share Based Employee Benefits) Regulations, 2014, Replacement of SEBI (Prohibition of Insider Trading) Regulations, 1992 with the SEBI (Prohibition of Insider Trading) Regulations, 2015.

SEBI has done immense contribution to India's financial system and the capital market of today, by creating various regulations for governance of the entire securities / capital market in the country. One of the major shifts in the Indian financial sector was introduction of FII regime, which has led to substantial increase in foreign participation in the Indian equities / debt market and in the activities on the stock exchanges.

- ***Forward Market Commission[3]***

As per the information available on the website of the Forward Market Commission, Hon'ble Finance Minister in the Budget Speech for 2002-2003 indicated the Government's resolve to put in place a mechanism of futures trade/market. Government issued notifications on 1 April 2013 permitting futures trading in all the commodities. Options' trading in commodity is currently prohibited.

Currently 6 national exchanges, regulate forward trading in 113 commodities. Besides, there are 11 Commodity specific exchanges recognized for regulating trading in various commodities approved by the Commission under the Forward Contracts (Regulation) Act, 1952. Out of 17 recognized Exchanges, Multi Commodity Exchange (MCX) National Commodity and Derivatives Exchange (NCDEX), National Multi Commodity Exchange (NMCE), ACE Derivatives and Commodity Exchange (ACE), Universal Commodity Exchange Ltd. (UCX) and Indian Commodity Exchange Ltd (ICEX), contributed 99% of the total value of the commodities traded during the year 2013-14.

Further, FMC also continuously takes various initiatives such as awareness programmes, capacity building programmes, internships and other activities for raising awareness about the commodity futures market. FMC is also an associate member of IOSCO, an international organization of Security and Commodities Market Regulators. Further, in order to have collaborations with international Regulators, FMC has also signed Memorandum of Understanding with the United States Commodity Futures Trading Commission (USCFTC) in October 2006, the China Securities Regulatory Commission (CSRC) in November 2006 and the Commissao de Valores Mobiliarios – CVM (Securities and Exchange Commission of Brazil), in January 2010.

In order to strengthen regulation of commodity forward markets and reduce wild speculations, the current Finance Minister Shri Arun Jaitley, in his speech of Union Budget, 2015, proposed to merge the Forward Markets Commission with SEBI.

- ***Forex reforms***

India switched over to a market-determined exchange rate system in March 1993 and current account convertibility was instituted in August 1994. For effecting the integration of Indian financial market with international markets, RBI / SEBI and the Government of India have taken several steps. These include liberalization of capital flows (transition from controlled FERA regime to much liberalized FEMA regime in 1999-2000), introduction of FII regime in 1993, significant relaxation on sectoral caps for various sectors for foreign investment, introduction of regime for investment in listed privately placed debentures, gradual increase in investment limits for Foreign Institutional Investors (FIIs) in government and corporate debt market, introduction of Qualified Foreign Investor (QFIs) as an investor class (which all now converge into one single Foreign Portfolio Investment (FPI) regime), permitting select sectors to raise External Commercial Borrowings etc.

It may be pertinent to note that the steps taken by the Government and RBI have translated into the increased mobilisation of foreign investment in to the country. As per the RBI website, net foreign investment in India has increased from USD 5.86 billion (2000-01) to USD 26.38 billion (2013-14)[4] .

• *Exchange Traded and OTC Derivative Market*

In 1999, the provisions of Securities Contract Regulation Act, 1956, were amended to permit derivative trading in equities upon recommendations of two separate committees headed by Shri L C Gupta Committee report on derivatives and Shri J R Varma Risk Containment in the Derivative Market. As regards, foreign exchange markets, OTC derivatives in the form of forward and swap contracts have been in existence for a long time. Post deregulation of interest, in the year 1999, RBI, as a part of the financial sector liberalisation process permitted the banks, primary dealers and financial institutions to undertake interest rate swaps and forward rate agreements.

In the aftermath of the global financial crisis, improving transparency of the OTC derivatives market has been a principal theme of discussion concerning the steps to be taken to prevent the recurrence of such a crisis in future. Two major steps in this direction are (a) clearing and settlement of OTC derivative transactions through Central Counterparties (CCP) and (b) incentivising or mandating reporting of OTC derivatives trades to designated trade repositories (TRs). The report also noted the need for comprehensive reporting mechanism with unrestricted access to the regulators responsible for financial stability, post-trade processing services to market participants, and dissemination of aggregate volume and price data to the market and public at large[5]. In 2012, trade repository has been operationalised after RBI advised that the trades in OTC foreign exchange and interest rate derivatives between the banks/primary dealers and their clients should be reported on the CCIL platform.

• *Technology, payment, and settlement infrastructure*[6]

Recognising that payment and settlement systems should conform to international standards, the RBI has taken several measures to ramp up the payment and settlement infrastructure, leading to advancement in the past couple of decades. RBI introduced electronic funds transfer system and electronic clearing services (ECS Credit and Debit) in the 1990s, implemented the National Electronic Fund Transfer (NEFT) system in November 2005 and the real-time gross settlement (RTGS) system in March 2004. Also, recently, mobile banking / payment banks / internet banking etc. have also gained RBIs focus. To facilitate faster settlement of trades in government securities in dematerialised form, an electronic negotiation-based trading and reporting platform called the Negotiated Dealing System (NDS) was introduced by RBI in February 2002. The RBI acts as the central security depository (CSD) for government securities. For other securities, equities and corporate bonds, the two central depositories are the National Securities Depository Limited (NSDL) and the Central Depository Services Limited (CDSL), which hold the securities issued and traded through the stock exchanges in dematerialised form.

Accordingly, it is quite evident that the authorities are proactively and continuously making effort to ensure that the payment and settlement system at all point of time meets the international standards.

Recent Events

As the economic environment evolves, various changes are required for the country's financial system and regulatory landscape. Towards this end a continuous effort is made by the Government through formation of various research & recommendation committees which have engaged in proposing the key reforms that are necessary for the industry. This included the Committee on Financial Sector Reforms formed with a view to outlining a comprehensive agenda for the evolution of the financial sector under the chairmanship of Shri Raghuram Rajan, which submitted its comprehensive report in 2008, Report of the Working Group on Foreign Investment was formed in 2010 under the chairmanship of Shri U. K. Sinha.

• *Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments*

SEBI constituted a committee for Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments under the Chairmanship of Shri. K.M. Chandrasekhar. The committee submitted its report in June 2013. One of the key committee recommendation was merging of the then existing FIIs, sub-account, Qualified Financial Investors (QFI) under one investor class namely FPI (which has already been implemented in 2014 by way of replacing the old FII Regulations with the new FPI Regulations).

• *Financial Sector Legislative Reforms Commission*

The Ministry of Finance, Government of India, constituted the Financial Sector Legislative Reforms Commission (FSLRC/the Commission) in March 2011 with a view to rewriting and cleaning up the financial sector laws to bring them in line with the current requirements. The Commission submitted its report in March 2013. The Commission proposed a financial regulatory architecture featuring seven agencies (retaining some of the existing agencies within the overall framework) with modest set of changes and functionalities:

- RBI;
- SEBI, FMC, IRDA and PFRDA to merge into a new unified agency;
- Securities Appellate Tribunal (SAT) to subsume into the FSAT;
- The existing Deposit Insurance and Credit Guarantee Corporation of India (DICGC) to subsume into the Resolution Corporation;
- A new Financial Redress Agency (FRA) to be created;
- A new Debt Management Office to be created;
- The existing Financial Stability and Development Council (FSDC) to continue to exist with modified functions and a statutory framework.

The Commission also laid down a draft framework, namely, 'Indian Financial Code' proposing to replace the

bulk of the existing financial law. Various steps are being taken in this direction for eg. the government is already working towards merger of FMC with SEBI, which was also announced in the Union Budget 2015, Government has created a task force for creation of Financial Redress Agency in June 2015. The merger of FMC with SEBI is one of the very significant steps which will create an opportunity for integrated exchanges in near future where equities, debt instruments, commodity derivatives and currencies would trade under one platform. This will create opportunities for the depositories and clearing corporations, who could also cater to the commodity traders going forward. Integration could also offer arbitrage opportunities across segments in an exchange and make margin money fungible for trading across various asset classes like commodities, currencies and equities. These are some of the many benefits of the FMC merger with SEBI and this is a very positive step of moving towards an integrated platform.

Further, the current Finance Minister in the Union Budget 2015 also emphasized the need for deepening of the Indian Bond market, to bring it at levels of Indian equity market. The Finance Minster also indicated to begin the process by setting up a Public Debt Management Agency (PDMA) which will bring both India's external borrowings and domestic debt under one roof. The Finance Minister also announced that the Indian Financial Code will be introduced in Parliament after the Justice Srikrishna Committee report.

Way Forward:

Financial markets in India have witnessed considerable development due to the financial sector reforms that have taken place in past couple of decades. A gradual and calculative approach has led to an efficient development of the Indian economy and also helped overcome the financial crisis of 2008. Government securities, money market instruments, foreign exchange, and equity markets have effectively resulted in a matured financial services sector in the Indian economy. It is imperative that the Government / SEBI / RBI and all the market participants continue to play proactive and complementary role for the sustained development of the sector, contribute towards economic growth and meet the large investment requirement of the growing economy like ours. While financial market reforms require its due importance, there are risk of the same having a spill-over effect on the other segments of financial spectrum, it is necessary that the authorities are cautious and evaluate various nuances around the reforms while their introduction in the interest of financial stability and for a more matured development. Going forward, it may be imperative for the stakeholders to also focus on widening the participation base in various segments of capital markets, expanding the coverage of bond market, focus on the advanced risk management techniques to manage the market risk and ensuring the appropriate regulations are in place. Research and development should also be the focus area by which the stakeholders could achieve more advanced payment and settlement infrastructure in sync with the global best practices.

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[1] Database on Indian economy – RBI's data warehouse http://dbie.rbi.org.in/
[2] Press note for the Press Briefing of Finance Minister, Shri Arun Jaitley on Pradhan Mantri Jan-Dhan Yojana dated 20 January, 2015.
[3] www.fmc.gov.in
[4] Database on Indian economy – RBI's data warehouse http://dbie.rbi.org.in/
[5] Report of the Working Group on Reporting of OTC Interest Rate and Forex Derivatives dated 25 May 2011
[6] Payment, clearing and settlement systems in India – CPSS - Red Book 2011