

*20th FIMMDA - PDAI Annual Conference**

B.P Kanungo

I am happy to be here today amidst you and I must thank Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) for this privilege. The annual conference of FIMMDA and PDAI has of late been known as much for the content of the deliberations as for the choice of the venues, and the present one, its twentieth edition, is no exception. These occasions bring together the best minds in the financial market, particularly the fixed income segment, under one roof and provide excellent platform for deliberating on contemporary issues facing the markets. It is an important platform for us in the Reserve Bank to share our views on topics of current relevance with the market participants who have a vital role in, and responsibility for, driving growth and development.

FIMMDA is a representative body of participants in the fixed income market in India. I am happy to note that unlike many such organisations around the world, FIMMDA is much less an interest group, and has over the years played a key role in developments of the markets. It has ably contributed to our efforts towards building deep and liquid fixed income markets including derivative markets. But for the role it has played in the spheres of valuation, price dissemination, product evolution, benchmark development, assimilation of best practices and market education, we would be well short of being one of the most evolved of fixed income markets among the emerging economies that we are today. Similarly, PDAI has played a seminal role in development of the primary market in government debt over the last two

* B.P Kanungo, Deputy Governor, Reserve Bank of India, Speech Delivered in Moscow on August 31, 2019.

decades, and the successive successful issuances of government debt owes a great deal to the community of primary dealers.

The importance of the fixed income markets cannot be over emphasised. Apart from the fact that these markets meet the funds requirement of the sovereign and sub-sovereign bodies across the globe, they also substantially meet the external funds requirements of financial as well as non-financial firms. Further, these markets are also intimately linked with the funding requirement of individuals- education finance, home finance, consumption finance and so on- in several ways from providing pricing benchmark to providing funding for the institutions that provide primary funding. Quite obviously, the aggregate value of outstanding fixed income instruments is estimated to be in excess of USD 100 trillion in contrast with the value of the global stock market around USD 70 trillion. The daily trading volume of the fixed income instruments also exceeds that in the stock market by a factor of three. Though US continues to account for a large part of the global fixed income market, the fact that the global market size has trebled during the last fifteen years seems to indicate that the other jurisdictions are catching up.

Of the two non-equity sources of external funding for the corporate sector, *viz.*, bank finance and market-based finance, the literature seems to find the latter the preferred mode from a systemic viewpoint. Without going into this debate, we can perhaps say that the two play a complementary role. The Indian financial sector which mostly has been a bank-based one needs to develop a robust fixed income market to bring in market discipline, to augment bank finance and indeed free up bank finance for uses that cannot access the market directly. Development of the fixed income market has been an important objective of the Reserve Bank, the Government, the Security and Exchange Board of India (SEBI) and other regulators these many years. Significant progress has been made, yet a lot remains to be achieved.

What are the attributes of the market we aspire to have? There are many ways to describe an efficient and robust market; but we can underscore four aspects.

Firstly, there must be wide range of products available. It is nowhere more pronounced as in the financial markets because it is well recognised that a wide array of securities enable the economic agents to better deal with the uncertainty of the future.

Secondly, there must be transparency. The financial market is characterised by information asymmetry, both pre- and post transaction. The borrower or investee always knows more about itself than the lender or the investor. The markets use various mechanisms to address this problem. Financial disclosures and ratings are two most common means, the integrity of which is critical to a well-functioning financial market.

Thirdly, there must be liquidity. A market without liquidity serves no purpose. A liquid market spurs production and consumption; in financial markets, liquidity facilitates savings and investment. Liquidity is often seen as synonymous with trading volumes, but as has been pointed out since the times of Keynes, volumes brought on by transient investors driven by speculative short-term gains may not necessarily bring efficiency to the market. Liquidity essentially means easy and frictionless entry into and exit out of investment positions without loss of value. Several prerequisites underpin this: large number of participants, fewer barriers to entry, large volume of transactions, pricing efficiency, absence of risk-free arbitrage and so on.

Lastly, there must be efficient risk management. As the financial crisis has demonstrated, a market without adequate risk management measures is prone to failure with enormous economic and social cost. I had mentioned earlier about the range of financial products, the caveat is that the complexity of these should not run ahead of the understanding of their risk implications. Measures like move to

exchange traded products, central counterparty clearing, bilateral margining and reporting positions to trade repositories are aimed at improving the risk management practices.

How do our fixed income markets perform against these standards? Let me list some stylized facts.

Government securities, that constitute the largest segment of the fixed income market, stand at about ₹58 trillion, treasury bills accounting for another about ₹6 trillion. Though the primary issuances have been quite seamless, only the 10 year benchmark security accounts for bulk of the trading volumes. Indeed, liquidity in this benchmark security as represented by the bid-ask spread is impressive, and according to a recent Bank for International Settlement (BIS) study, among the best amongst emerging markets. Liquidity, however, almost completely dries off in other off-benchmark securities, which does not reflect well on the market.

The corporate debt market has registered impressive growth. In the five years between June 2014 and June 2019, the market size has grown from ₹14.43 trillion to ₹30.63 trillion. Out of this, the size of structured notes market has grown from ₹8.78 billion to ₹230 billion¹. These figures underscore the growing maturity of the market. We must however note that there are in excess of 24000 instruments outstanding, reducing the average outstanding per instrument to a small figure. On the other hand, the issuances in recent times have been predominantly (upto 75 per cent) by the financial firms. Besides, most of the issuances have been through private placement. The secondary market in corporate debt is so illiquid that we can very well say there is no such market. The rating transition of some corporate debt, particularly those issued by financial firms, has been phenomenal – from sound credit to junk.

¹ SEBI Data.

The evolution of the money market continues to be stunted. Most of the activity is concentrated in the overnight segment and a robust term money market continues to elude us. There is some trading in the treasury bills, but activity in the Commercial Papers (CPs) and Certificate of Deposits (CDs) is confined to primary issuances.

The interest rate derivatives market also continues to be lacklustre. There is reasonable liquidity in overnight interest swaps, but there is no appetite, and hence not much trading in other derivatives including interest rate futures. The Credit Default Swap (CDS) market, introduced in 2012 is moribund. It is ironical that while some participants used to write little understood products like quanto swaps a decade and a half back, there is little effort to provide simple products like caps or collars on bonds today.

Despite allowing full access to non-resident investors to the domestic interest rate derivatives market, anecdotal evidence seems to suggest that an offshore market in this segment might be developing, much like the Non-deliverable Forward (NDF) market.

I now come to the important question of what needs to be done? We must understand that development of markets is a complex process. An economy aspiring for faster development, does have financing needs. There is domestic savings augmented by the foreign savings to fulfill the financing needs. It is for the market to perform an efficient role in allocation. Development of markets is not driven by altruism; it requires alignment of incentives of all stakeholders – the investor, the investee as well as the regulator. The incentives of the first two are well appreciated, but the regulator is often seen as a spoilsport in the process of development of markets. It must be appreciated that the regulator's objective is financial stability, avoidance of market failures and consumer protection, and the financial crisis has underscored the importance of these objectives. Even as the regulatory framework keeps evolving, are there other aspects to look at?

One of the most important prerequisites of a liquid and robust market is wide participation by agents with large volumes of merchandise. In this respect, banks constitute the single largest set of entities followed by insurance companies, pension funds, and now alternative investment funds. It has been generally observed that such of these entities as have large balance sheet, large holding of government securities are not very active either in markets or in innovation. There is perhaps a need to go beyond the comfort of 6-9-3 banking in search of unexploited market and unharvested returns. We would also work towards enhancing the overall liquidity in Government securities market in terms of availability of two-way quotes in less liquid maturities through targeted market making schemes. Further, measures towards activation of a securities lending and borrowing programme, inter-operability of depositories for smooth transfer of ownership in securities will receive our attention. We are also engaging Government for active consolidation of Government debt through frequent buyback/switch operation.

It is recognised that non-resident investors bring volume and liquidity to the financial markets for the simple reason that there is a large corpus of savings available overseas, forever in search of yields. There has been a gradual effort to remove the barriers to entry for non-resident investors in the debt segment. The gradual process is motivated by the possibility of sudden reversals causing turbulence in the interest rates. Even though there has been a great deal of interest from foreign investors in Rupee debt securities in recent times which protects the Indian borrower from foreign exchange risk in contrast with foreign currency debts, the threat to stability in the interest rate market and some residual threat to stability in the forex market remains. Be that as it may, greater access to foreign investors to the rupee debt market – cash as well as derivative will gradually be considered.

It is estimated that five years down the line, the demand for bonds will significantly outstrip the

supply. It is a paradoxical situation. Is the market barring borrowers from the market? The issues relating to CDS comes to mind. The basic purpose of CDS was to enable lower rated borrowers to access the market while the investor is protected against default by buying a CDS. But in a market, where only highly rated entities issue bonds, there will be no need for a CDS or rather, a CDS will leave nothing on the table for the investors, in comparison with a government security. Bringing liquidity into this and other derivative product needs introspection.

The risk management at market level is pretty robust, with central counterparty settlement, exchange traded products, trade repositories, legal entity identifier, *etc.* But there is scope of improvement at entity level as far as financial institutions are concerned, which will be tested with introduction of new accounting standards. Some other aspects of regulation – *e.g.*, treatment of cash margins as deposits, payment of interest on such margins, posting of collateral abroad – are all under examination to enable participants to move to global margining standards.

Insurance Regulatory and Development Authority (IRDA), SEBI and Pension Fund Regulatory and Development Authority (PFRDA) too could help development of interest rate markets. For instance, short selling activity could benefit if a wider pool of securities lenders can be developed. Insurance companies, pension funds and mutual funds have significant holdings of Government securities that could be used to lend to short sellers. This would avoid short-squeeze incident we saw a couple of years back, apart from generating income for these entities. We are working with regulators to develop a securities lending product that could enable these entities to participate in securities lending.

On a more general note, one of FIMMDA's important function has been to organize market feedback on policy initiatives. This is a great help for regulators to assess the impact of regulations, especially at the proposal stage. While this should

continue, I would be really happy if FIMMDA and its members make efforts to identify market development initiatives and bring it to the notice of the regulators. On a lighter vein, market is known to run ahead of regulators while the latter try to catch up. While this is not what I can encourage you to do, I do appreciate that market alone can foster innovative ideas and shall expect you to engage with regulators in regard to the steps that we can jointly take.

Ordinarily, in so far as the trades are between informed participants who are capable of comprehending and defending their interests, the regulator should not be concerned about the fairness of pricing. Nevertheless, fair pricing is a sound principle in any market, often threatened by the fact that there are few sellers. I expect FIMMDA, with its expertise in valuation and role as a market developer will keep a close eye on this.

There have been discussions about market timings of various segments of financial markets. Taking into account the representations received from the market, we are examining current market timings with respect to trading, clearing and settlement cycles of financial markets regulated by the Reserve Bank to improve market efficiency.

Financial Market Infrastructures play a critical role in the financial system and the broader economy. These infrastructures facilitate the clearing and settlement of monetary and other financial transactions, such as payments, securities, and derivative contracts (including derivatives contracts for commodities). The central bank of any country is usually the driving force in the development of national payment systems. The Reserve Bank has been playing this developmental role and has taken several initiatives for Safe, Secure, Sound, Efficient, Accessible and Authorised payment systems in the country. In this context, I would briefly outline the developments taking place in this space.

At the heart of Payment Market Infrastructures (PMIs) is the one owned by central banks which the world over is a Real-time Gross Settlement (RTGS)

system. As the world moves closer to real time, in everything, including payments and the inflection on innovation, better governance and wider access, the role of the RTGS system is evolving. This places new demands on the business and technology architectures of PMIs and RTGS systems in particular. To move closer to providing access to the RTGS for longer durations, the customer timings have been recently extended. There has been a growing demand for providing wider access to the RTGS system and allow participation of non-banks. The High-Level Committee on Deepening of Digital Payments (CDDP) recommended that non-banking entities should be included as associate members of payment systems and become an active player in enhancing acceptance infrastructure in the country. The recommendations are under examination.

Another development in the markets is related to implementation of Legal Entity Identifier (LEI). In view of the financial crises across the world, LEI has provided a way to identify financial connections so that regulators and firms can better understand the true nature of risk exposures across the financial system. In India, LEI has been mandated across various sectors in the financial markets including

derivatives and non-derivatives market and also for large corporate borrowers. This is being implemented in a phased manner. Since it has been made mandatory for large corporate borrowers to obtain LEI, banks should, apart from advising such borrowers to obtain LEI, encourage such borrowers to obtain LEI for their parent entity as well as all subsidiaries and associates. Implementation of LEI for large borrowers may help banks in better monitoring of transactions and hence, exposure of such borrowers across nations.

Let me now conclude. The role of financial sector in a growing economy cannot be overemphasised. As the most important segment, the fixed income market in India has to grow to cater to the investment needs of an economy that aspires to become a USD 5 trillion economy in near future. While the Reserve Bank and other sister regulators will continue to draw the contours of growth with financial stability in mind, the market needs more activity, innovation and enterprise from the community of participants in this market.

I hope that you will keep this refrain in mind when you discuss the markets in this conference. I wish your deliberations all success.