

Indian Financial Markets : New Initiatives by Dr. Y.V. Reddy Deputy Governor Reserve Bank of India, Mumbai at Indian Institute of Foreign Trade at Delhi on November 5, 1997

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Indian Financial Markets: New Initiatives

It gives me great pleasure to be in this institute today. I have many friends here since I had the privilege of being the Director General of this esteemed institution in 1995. However, the main reason for my being here today is the insistence of my dear and esteemed friend Dr. P.L. Sanjeev Reddy. His contribution to this Institute is not merely outstanding but unprecedented, and history will record it to be so. I have been asked by him to speak on Globalisation of Indian Financial Markets: New Initiatives. But, I have taken the liberty of slightly enlarging the scope of this special lecture as the title now indicates. I would like to take this opportunity to highlight the measures taken by the Reserve Bank of India (RBI) recently to widen and deepen the financial markets, integrate the various markets domestically and integrate our markets with the global financial markets.

In our country, there is a large informal financial sector coexisting with the organised one. Nationalisation of banks, establishment of Regional Rural Banks and cooperative credit movement, provided impetus to expand the organised market. More recently, non-governmental organisations are being encouraged to lend through self-help groups. Local Area Banks have also been permitted which may expand the scope of the organised market. Yet, significant segments of our economy are outside the organised sector. For example, financing of film industry, acquisition of gold ornaments, vegetable vending in urban areas, or artisans' needs in rural areas are mostly outside organised financial markets. There is an urgent need to analyse the participants, magnitudes, nature and characteristics of the unorganised and informal financial markets. We have to explore ways of either bringing them directly into the mainstream or establish suitable linkages with the organised financial markets. However, I will confine today's discussion to the organised markets only.

The main segments of the organised financial markets are: (i) money market, (ii) credit market, (iii) capital market, (iv) Government securities market, and (v) foreign exchange market. I am classifying Government securities market separately in view of its importance in the Indian financial system though it is part of debt-market and thus of capital market. Each market is unique in terms of the nature of participants and the instruments in the market. The process of financial sector reforms has aimed at widening and deepening each market and moved towards integrating these markets domestically as also with global markets.

Money Market

The central bank is an important constituent of the money market due to its role as a lender of last resort to banks which form a sizable segment of the money market. By regulating the cost and quantum of lendable resources of banks, central banks transmit monetary policy signals to the economy through the money market. Hitherto, Cash Reserve Ratio (CRR) and Open Market Operations (OMO) have been used by the RBI as important instruments for monetary management. In April 1997, the Bank Rate has been activated and operationalised as a signal for money market interest rates. Incidentally, it has also been accepted as a reference rate by State Bank of India, which has linked its long-term prime lending rate to Bank Rate.

Money market performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity. It also facilitates the conduct of monetary policy. The money market instruments comprise call money (overnight), notice money (up to fourteen days), Treasury Bills (of various maturities), Commercial Paper, (CP) Certificate of Deposits (CD), inter-bank repos, Government dated securities with balance maturity of less than one year, commercial bills and inter-corporate deposits.

The participants in the money market are banks, primary dealers, financial institutions, mutual funds, non-bank financial companies, manufacturing companies, State Governments, provident funds, non-resident Indians, overseas corporate bodies, foreign institutional investors and trusts. However, participants do not have a uniform status in dealing in different instruments. For instance, financial institutions and mutual funds are allowed only as lenders in the call money market but are permitted to buy and sell CP. Similarly, in respect of repos, banks and Primary Dealers (PDs) in Government securities are allowed to borrow and lend while others are allowed only to enter into reverse repos (i.e., as lenders). The RBI and Securities and Exchange Board of India (SEBI) regulate the participants and use of instruments in the money market depending among others, on their respective roles in the financial system and the potential systemic risks.

In an effort to broaden the money market, existing participants were provided with extended access, new participants were allowed to participate and new instruments were introduced, especially since April 1997. The major changes are:

- Permitting all PDs to participate in the call money and bills rediscounting market both as borrowers and lenders, and private sector mutual funds to participate as lenders.
- Extending the facility of routing call money transactions to all PDs and in order to provide more flexibility, reducing the minimum size of operation from Rs.10 crore to Rs.5 crore.
- In the CD market, reducing the minimum amount of issue progressively from Rs.25 lakh to Rs.5 lakh.
- In order to give more flexibility to the investment operations of money market mutual funds and an opportunity to raise their average yields, permitting investment in corporate debentures and bonds within prudential limits.
- Prescribing an umbrella limit (linked to net owned funds of the institution) for mobilisation of resources by way of term money borrowings, CDs, term deposits and inter-corporate deposits, to developmental financial and specialised financial institutions, such as IDBI, ICICI, EXIM Bank, in place of the erstwhile instrument-wise limits.
- Allowing repo transactions in such of the Public Sector Units' bonds and private corporate debt securities which are held in dematerialised form in a depository and traded through a recognised stock exchange.

Credit Market

The credit market can be classified by maturity of finance - short-term and long-term. The distinction between the short-term and long-term credit institutions is increasingly getting blurred, but it is still possible to classify them in terms of their traditional objectives. Short-term finance is

extended in the form of cash credit limits and term loans with maturity of less than one year. Institutions mainly extending such loans are commercial banks, cooperative banks and non-bank finance companies. Recently, development financial institutions have also entered into this foray.

Long-term finance is extended in the form of term loans technically for a period of over one year but substantively and in practice for a period of over three years. Institutions extending such loans are developmental financial institutions, specialised financial institutions and investment institutions. Recently, commercial banks are extending their operations in this area.

Sources of credit can be classified into internal (rupee credit) and external (foreign currency loans through external commercial borrowings and foreign currency denominated non-resident deposits under FCNR-B).

Significant changes have been brought about in credit markets, particularly since April 1997. Banks are easily the most critical players in this market. The RBI is moving away from microregulation to macromanagement of banks. All deposit rates are freed except for savings accounts and term deposits up to 30 days. Banks have been given the freedom to evolve their own methods of assessing working capital and also the freedom for credit dispensation without consortium obligations. Banks are now allowed to freely fix their lending rates beyond Rs. 2 lakh, and within a ceiling of 13.5 per cent for loans amounting to Rs. 25,000 - Rs. 2 lakh. Of course, some lending rates for export activity are also regulated. In order to impart transparency to their operations, banks are required to announce their prime lending rates (PLR) and the spread over PLR. Banks have also been given the freedom to prescribe a separate term prime lending rate for maturities of 3 years and above. Credit can now be extended against FCNRB deposits in foreign currency. Guidelines for External Commercial Borrowings (ECB) have also been liberalised from time to time on issues such as maturity, ultimate end-use, interim parking and strict application of ceilings.

It is important to note that credit markets have been liberated, in a dramatic fashion, both quantitatively and qualitatively. While qualitatively, the interest rate prescriptions have been removed and microregulation dispensed with, there has been a quantum jump in quantitative terms. Thus, for every rupee of deposit, while over one-third was available for lending to the commercial sector before the reform, two-thirds of the amount is now available since statutory prescriptions have been reduced from one-half (55 per cent) to one-third (33 per cent).

Capital Market

This market is regulated mainly by SEBI and to some extent by the Departments of Economic Affairs and Company Affairs of Government of India. SEBI has been proactive in regulating the capital market by introducing a number of measures aimed at safeguarding and stimulating the interest of investors. We will confine to the recent measures introduced by the RBI to widen and deepen the market.

Perhaps the most important measure in this area relates to the removal of the 5 per cent ceiling in respect of banks' investments in PSU and corporate bonds and debentures. After this liberalisation, banks have increased their investment in debt instruments in a big way. Banks are now allowed to lend against shares and debentures to individuals up to Rs.10 lakh. In the recent monetary policy, banks have also been permitted to extend bridge loans against expected equity flows/issues within the 5 per cent ceiling.

Government Securities Market

The Government Securities market constitutes the principal segment of the debt market. The participants in this market as issuers are the Central and State Governments. The main investors are the RBI, insurance companies, banks, State Governments, provident funds, individuals, corporates, NBFCs, financial institutions, and to a limited extent FIIs and NRIs. Reforms initiated in the recent period include, introduction of Treasury Bills of varying maturities, abolition of tax deduction at source on interest income from Government securities, and permitting FIIs to invest in debt instruments including dated Government securities as also allowing them to hedge their foreign currency risk in the forward markets. The monetary policy of October 1997 announced the introduction of uniform price auction in respect of 91-Day Treasury Bills as an experimental measure with a view to broadening the investor base and removing the winners curse; the introduction of pre-announced notified amounts for all auctions of Government securities, and the intention to accept non-competitive bids outside the notified amount in order to ensure more transparency in the primary auction process. FIIs with 30 per cent ceiling on investment in debt, are being allowed to invest in Government securities in addition to corporate debt.

Foreign Exchange Market

State Bank of India is the single-largest participant in the forex market, accounting for about 40 per cent of the value of total customer transactions. In the inter-bank segment of the market, SBI alongwith a few other banks constitute the market-makers, i.e., banks which are always ready to quote two-way price both in the spot and forward markets. Foreign banks are predominant among the other participants.

The customer segment is dominated by the Indian Oil Corporation and certain other large public sector giants like Oil and Natural Gas Commission, Bharath Heavy Electricals Ltd., Steel Authority of India Ltd., Maruti Udyog, etc. There is a perceptible presence of large private sector corporates like, Reliance Group, Tata Group, and Larsen and Tubro. Of late, foreign institutional investors have accounted for a large supply in the market. The RBI also buys and sells foreign exchange at its discretion to ensure orderly conditions in the market.

Till recently, the market was dominated by trade-related flows and was not driven by financial market expectations inasmuch as the arbitrage opportunities between the Indian and offshore money (financial asset) markets were highly restricted. Nevertheless, the market-makers are now better-placed to give quotes with narrower spreads than before. Let me list some major initiatives taken recently to broaden this market :

Corporates are now allowed to sell and buy in the forward market beyond six months on a presumptive basis, subject to certain conditions. This has resulted in extending the forward market beyond six months. In fact, forward quotes for periods of more than six months and up to 12 months are now available on a regular basis and at narrower spreads.

Authorised Dealers (ADs) are now allowed to run long-term rupee-forex swap books. This has resulted in better avenues of forex exposure management.

Forward cover for FIIs in debt instruments and for NRI depositors in respect of deposits held in NRI and FCNRR schemes has been allowed enabling these participants to hedge their exposures.

Integration and Globalisation of Financial Markets

Since the introduction of the reform measures, broad segments of the market, viz., money market, Government securities market and foreign exchange market have responded favourably

and become increasingly integrated. Each market is interlinked since most participants can move freely from one market to another. For instance, the Treasury Bills and repo rates are intimately linked to call money rates. Expectations on domestic interest rates have an influence on the forward forex rates. The CP rates are linked to call money rates and lending rates apart from the overall liquidity situation in the money market. The rates at which CDs are issued and traded depend on the call money rates, the liquidity needed for extending credit and the return on other assets in the financial markets.

Interest rates on advances (in the credit market) depend on deposit rates, lending rates of competitors, CD rates, interest rates on other money market instruments and access to capital market. The interest rates on capital market instruments (debt instruments) are linked to interest rates in the money market, credit market, Government Securities market and interest rates abroad.

We, in the RBI, have taken significant steps to integrate the domestic markets and also the Indian forex market with the global financial system. Let me list them here.

First, with a view to facilitating the development of a more realistic rupee yield curve and term money market which would enable pricing of other securities, banks have been exempted from maintaining cash reserves on liabilities to the banking system.

Second, the list of participants who can enter into reverse repos have been extended and guarded permission has been given for entering into repos in non-Government debt.

Third, banks are allowed to freely invest in PSU and corporate bonds and debentures without any ceiling but within prudential exposure norms.

Fourth, banks are permitted to fix their own position limits and aggregate gap limits in foreign exchange.

Fifth, banks are now allowed to borrow from overseas markets up to a maximum extent of 15 per cent of their unimpaired tier-I capital.

Sixth, banks are also allowed to invest in overseas money markets up to a maximum extent of 15 per cent of tier-I capital.

Seventh, banks can now provide foreign currency denominated loans to their customers out of their pool of FCNR-B deposits.

Eighth, FIIs to the extent of their permissible debt component, can invest in Government securities.

Ninth, banks will be allowed to provide credit/non-credit facilities to Indian joint ventures/wholly owned subsidiaries abroad.

Tenth, SEBI registered Indian fund managers, including mutual funds will be allowed to invest in overseas markets subject to ceilings.

The proposals for deepening and widening the forex market such as allowing forward cover based on business projections, allowing FII debt funds, FCNRB and NRE depositors to take forward cover and the development of rupee-forex swap markets have strengthened the market participants with additional instruments to hedge risks and help reduce exchange rate volatility.

Deregulation and liberalisation of the financial markets have strong influences on the developments in the financial markets and its stability, as the various segments of the markets get increasingly integrated. It is in this context, that the Reserve Bank has been emphasising the importance of liquidity and risk management by the market participants. The recent resource management discussions with banks emphasised these aspects. The monetary and credit policy of October 1997-98 announced the intention of the RBI to issue broad guidelines to banks for managing liquidity and interest rate risks. Asset liability management would, undoubtedly be the most challenging task for the future.

Agenda for Future

The report of the Committee on Capital Account Convertibility has identified a number of areas for future reforms in the financial sector. The Governor, Dr. C. Rangarajan, in his inaugural address at the Bank Economists' conference had identified the new challenges and opportunities that may dominate the future course of banking development in India. The Conference helped to identify specific areas that need attention in the future. Further, some issues relating specifically to the financial market have been raised from time to time. While we cannot take a view on such issues without a detailed examination, let me list them here for record. I will classify them under three broad areas, viz., money market, Government securities market and foreign exchange market.

Money Market

- Reduction of minimum period of term deposits.
- Reduction of the lock-in period of MMMF units from the present 30 days.
- Enlarging the scope of participation in the repo market.
- Removal of inter-bank liabilities completely from minimum prescription for SLR of 25 per cent and CRR of 3 per cent.
- Introduction of intermediaries in money market.
- Creation of level playing field for all banks/FIs/NBFCs in the money market by prescribing liquidity reserve requirements and removing other elements of market segmentation.
- Introduction of screen based dealing systems for money market instruments and Government securities.

Government Securities Market

- Increasing the number of PDs and enhancing their underwriting capability to 100 per cent.
- Introduction of when-issued market.
- Providing access to FIs in Treasury Bills.
- Introduction of interest rate Futures in Treasury Bills/dated Government securities.
- Automating the DVP system fully.

Foreign Exchange Market

- Issuance of foreign currency denominated bonds to residents.
- Allowing FIs with equity exposure to cover in the forward market.
- Allowing FIs to participate as full fledged Authorised Dealers.
- Allowing all derivatives including rupee based derivatives.

Some of the reforms suggested require legislative changes. I have stated this elsewhere, and I reiterate - a comprehensive exercise on legislative changes is required to put our financial sector on par with global standards. Further, there are issues of regulation and supervision which need to be addressed. The viability of further reforms is also critically dependent on improvements in the area of payments and settlement systems. Issues relating to Technology, Human Resources Development and Industrial Relations are other areas that require urgent attention. I would also like to flag the role of market participants in the evolution of standard market practices and accounting procedures. We cannot afford to be in a hurry to bring about reforms. Integration and globalisation of financial markets are not ends by themselves, nor are they risk-free. Every step that we take recognises this basic tenet and takes into account the uniqueness of our own circumstances and requirements.

Thank you.