



A study of financial markets and regulatory framework of RBI in India

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Abstract

This study aims to provide an assessment of the financial markets and role of RBI in India. Financial markets bring borrowers and lenders together in efficient ways and help channel resources to create a healthy national and global economy. Financial markets allow traders to buy and sell stocks and bonds, and enable businesses to raise financial capital to grow. They provide essential funding that affects people's lives in many ways, from starting a business to expanding a current one, or providing investment opportunities for people planning for their future. Businesses also have reduced risk and expenses in acquiring financial capital because they have reliable markets where they can obtain funding. Financial markets are there to match them with the best funding source. Financial markets also reduce the cost of doing business by providing the global economy with a reliable source of cash or liquidity. Reserve Bank has statutory powers to form the regulatory framework for the interest rate markets, including the Government Securities market; money markets.

Keywords: financial markets, economy, securities, financial instruments, funds mobilization

Introduction

Financial markets play an important role in the growth and development of an economy by facilitating efficient allocation of resources and sharing of risks. Financial markets have a significant impact on our daily lives in many ways; it's not just about how we directly engage with markets as traders and investors.

Financial markets are markets of short-term, long-term, or undated financial assets or securities. The financial market refers to the market where the sale and purchase of financial products occurs. Financial Markets include any place or system that provides buyers and sellers the means to trade financial instruments, including bonds, equities, the various international currencies, and derivatives. It acts as a platform for sellers and buyers to connect and deal in their desired financial assets at a price determined by market forces. Financial markets facilitate the interaction between those who need capital with those who have capital to invest. In addition to making it possible to raise capital, financial markets allow participants to transfer risk and promote commerce.

Furthermore, efficient financial markets and institutions tend to lower search and transactions costs in the economy. By providing a large array of financial products, with varying risk and pricing structures as well as maturity, a well-developed financial system offers products to participants that provide borrowers and lenders with a close match for their needs. Individuals, businesses, and governments in need of funds can easily discover which financial institutions or which financial markets may provide funding and what the cost will be for the borrower. This allows investors to compare the cost of financing to their expected return on investment, thus making the investment choice that best suits their needs. In this way, financial markets direct the allocation of credit throughout the economy—and facilitate the production of goods and services.

Accordingly, the Reserve Bank has been undertaking policy reforms and regulatory policies in active coordination with Government and other stakeholders to develop safe and

stable financial markets which facilitate efficient price discovery through increasing the depth and width of financial markets and provide appropriate products for trading and risk management. Given its significance, the development of financial markets has always remained one of the key priorities of the Reserve Bank. As part of this approach, it seeks to broad base markets by easing access, enhancing participation, facilitating innovation, protecting users and promoting fair conduct.

1. The Reserve Bank is also responsible for the regulation of financial market infrastructure, including financial market benchmarks, for these markets. The Reserve Bank has a legislative mandate to regulate the interest rate and foreign exchange markets which are critical for the resilient functioning of the financial system and the broader economy, and for ensuring financial stability. The Reserve Bank is tasked with the regulation, development and oversight of the interest rate markets, including the Government Securities market; money markets including the market for repo in Government securities and corporate bonds; foreign exchange markets; derivatives on interest rates/prices, foreign exchange rates and credit.
2. The Reserve Bank authorises Electronic Trading Platforms (ETPs) under the Electronic Trading Platforms (Reserve Bank) Directions, 2018. ETPs are any electronic system, other than a recognised stock exchange, on which transactions in eligible instruments like securities, money market instruments, foreign exchange instruments, derivatives, etc. are contracted. No entity shall operate an ETP without obtaining prior authorisation of RBI.
3. The robustness and reliability of financial benchmarks are critical for efficient pricing and valuation of financial instruments. To improve the governance of the benchmark processes in markets regulated by the RBI, the Financial Benchmark Administrators (Reserve Bank) Directions, 2019, were issued in June 2019. The Financial Benchmarks India Private Limited is

authorised under these Directions to act as an administrator for significant benchmarks notified by RBI.

4. To promote a robust, fair, liquid, open and appropriately transparent markets, underpinned by high ethical standards and to prevent abuse in markets regulated by the Reserve Bank, the Reserve Bank of India (Prevention of Market Abuse) Directions, 2019 have been put in place, in line with the best global practices.
5. To promote the highest standards of governance and conduct in Over-The-Counter (OTC) interest rate, foreign exchange and credit derivatives markets, the Master Direction – Reserve Bank of India (Market-makers in OTC Derivatives) Directions, 2021 set out the regulatory framework for product suitability and user appropriateness, governance arrangements and risk management for OTC derivative transactions.

1. The financial markets and their roles

There are three principal financial markets we'll refer to, money markets, capital markets and forex markets. All three underpin most financial markets' roles. We'll then get more granular as we spotlight the bond, commodities, and derivatives markets.

1. Money markets provide short term loan finance for businesses and households, including inter-bank lending; commercial banks providing liquidity to each other
2. Capital markets are where securities like shares and bonds are issued to raise medium to long-term finance for businesses and governments.
3. Foreign exchange markets are where currencies get exchanged and traded to allow the smooth transaction of international commerce

These three markets are interlinked, and how their efficiency helps support the global economic ecosystem is a fascinating subject.

- a. Financial markets create liquidity allowing businesses to grow and entrepreneurs to raise money for their ventures.
- b. They reduce risk by having information readily available to investors and traders.
- c. Financial markets smooth economies by creating investor confidence.
- d. Investor confidence helps to stabilise economies.

2. Functions of Financial Markets

1. Price Determination
2. Funds Mobilization of Savings
3. Capital Formation
4. Providing Liquidity to Financial Assets
5. Risk sharing
6. Easy Access
7. Reduction in transaction costs.

3. Regulatory Framework and Instruments of RBI

The Reserve Bank has statutory powers to form the regulatory framework for the interest rate markets, including the Government Securities market; money markets, including the market for repo in Government securities and corporate bonds; foreign exchange markets; derivatives on interest rates/prices, foreign exchange rates and credit.

3.1 Government securities market

The Government securities market, which trades securities issued by Central and State Governments, has seen significant growth in the last two decades. It has a sizeable primary and an active secondary segment. Trading predominantly takes place on the Negotiated Dealing System-Order Matching (NDS-OM), an anonymous order-matching trading platform. All the secondary market transactions in Government Securities are settled through a central counterparty mechanism under Delivery Versus Payment (DVP-III) mode operated by the Clearing Corporation of India Limited (CCIL). Multilateral netting is achieved with a single funds' settlement obligation for each member for a particular settlement date. The settlement is achieved in the RTGS (Real Time Gross Settlement) Settlement/Current Account maintained by the member in the Reserve Bank. Individuals can access the Government securities market through the RBI Retail Direct in addition to through stock exchanges or through gilt accounts with commercial banks.

A primer on the Government securities market are as under:-

3.2 Money Markets: The money markets include:

- a. The uncollateralised segment - which can be accessed by banks and primary dealers, subject to prudential limits;
- b. The collateralised segment - which are accessed by banks, primary dealers, mutual funds, insurance companies and corporates;
- c. Commercial Paper (CP) and Non-Convertible Debenture (original maturity up to one year) – instruments with original maturity up to one year which can be issued by companies, including Non-Banking Finance Companies (NBFCs) and financial institutions; and
- d. Certificate of Deposit (CD) – a negotiable, unsecured money market instrument with original maturity up to one year which are issued by banks.

3.3 Foreign exchange market

The Foreign Exchange Management Act, 1999, better known as FEMA, 1999, provides the statutory framework for the regulation of Foreign Exchange derivative contracts. Persons resident in India and persons resident outside India can hedge their valid foreign exchange exposures, including anticipated exposures, through OTC and exchange traded currency derivatives. Persons resident in India are also permitted to hedge their commodity price risk and freight risk in overseas markets (except gold, gems and precious stones).

3.4 Interest Rate Derivatives

Retail users are permitted to participate in the IRD market for the purposes of hedging. Non-retail users can take part in the IRD market for the purposes of hedging or otherwise Interest rate swaps (IRS), forward rate agreements (FRA) and European Interest Rate Options are permitted on various benchmarks for all users /clients. Market-makers are also permitted to offer structured derivatives and swaptions to non-retail users / clients (i.e., entities with a net-worth of Rs.500 crore and above). Market-participants can also undertake transactions in exchange traded IRD products such as interest rate futures (IRF). Non-residents can utilise Rupee IRD products for the purpose of hedging and can also

access the Rupee Overnight Indexed Swap (OIS) market for the purpose of hedging and otherwise. Banks having Authorised Dealer Category-I (AD Cat-I) license under FEMA, 1999 and Stand-alone Primary Dealers (SPDs), authorized under to undertake transactions in the Foreign Currency Settled OIS (FCS-OIS) market with non-residents and other such market-makers. FPIs can also undertake transactions in IRF.

Credit derivatives

Market participants are permitted to utilise single-name Credit Default Swap (CDS) contracts in the OTC segment and the stock exchanges. In the OTC markets, retail users are permitted to buy protection only for the purpose of hedging while non-retail users are permitted to buy protection for hedging. Non-retail users such as regulated financial entities and FPIs are also permitted to sell protection.

3.5 Non-resident Investment in Debt

The investment regime for non-residents in debt has evolved to facilitate foreign investment with calibrated macro-prudential controls. Foreign Portfolio Investors (FPIs) have three routes to invest in debt:

a. Medium Term Framework (MTF)

Introduced in October 2015, this route enables FPIs to invest in all government securities, including treasury bills, and corporate bonds within an overall limit, fixed as a percentage of the total outstanding stock of government securities and corporate bonds. Investments under this route are subject to certain macroprudential limits.

b. Voluntary Retention Route (VRR)

Introduced in March 2019, the VRR offers a combined investment limit to FPIs through which they can either invest in government or corporate debt. Investments under VRR are broadly free of macro-prudential controls but are subject to a minimum retention period of three years

c. Fully Accessible Route (FAR)

Introduced in April 2020, this route enables non-residents to invest in certain specified government securities without any limit or macro-prudential control.

4. Market Infrastructure

A well-designed and reliable market infrastructure contributes to both financial stability and operational efficiency in the system. RBI has taken several steps to put in place an effective and efficient market infrastructure.

4.1 Electronic Trading Platforms

Electronic Trading Platforms (ETPs) are available for trading in instruments like securities, money market instruments, foreign exchange instruments, OTC derivatives in RBI regulated markets. ETPs are any electronic system, other than a recognised stock exchange, on which transactions in eligible instruments are contracted. No entity shall operate an ETP without obtaining prior authorisation of RBI under.

4.2 NDS-OM

Negotiated Dealing System – Order Matching (NDS-OM) is an anonymous screen-based order matching electronic

system which facilitates participants to trade anonymously in Government securities. NDS-OM is operated by the CCIL on behalf of the RBI and is authorised as an ETP under the Electronic Trading Platforms (Reserve Bank) Directions, 2018.

4.3 Legal Entity Identifier

The Legal Entity Identifier (LEI) code is conceived as a key measure to improve the quality and accuracy of financial data systems for better risk management post the Global Financial Crisis. LEI is a 20-digit unique code to identify parties to financial transactions worldwide. LEI system has been implemented in OTC markets for Rupee Interest Rate derivatives, foreign currency derivatives and credit derivatives in India, in a phased manner. Globally, the use of LEI has expanded beyond derivative reporting and it is being used in areas relating to banking, securities market, credit rating, market supervision, etc. In line with the global trend, the Reserve Bank has mandated implementation of the LEI system for non-derivative financial markets regulated by the Bank as well.

4.4 Trade Repositories

Trade repositories (TR) are one of the most important market infrastructures on account of their ability to make the opaque OTC derivative market transparent. Based on the recommendations of the Working Group, the Clearing Corporation of India (CCIL) was designated as a Trade repository for interest rate and forex derivative transactions.

4.5 Financial Benchmark Administrators

The robustness and reliability of financial benchmarks are critical for efficient pricing and valuation of financial instruments. In recognition of the key role played by financial benchmarks in the financial system, a Committee on Financial Benchmarks (Chairman: Shri P Vijay Bhaskar, ED, RBI) was constituted in June 2013 by the Reserve Bank of India with a mandate to study the various issues relating to financial benchmarks in India. The Committee had recommended, among other things, regulatory oversight of benchmark administrators. The International Organization of Securities Commissions (IOSCO) has also issued Principles for Financial Benchmarks in July 2013 to create an overarching framework of principles for benchmarks used in financial markets. Accordingly, to improve the governance of the benchmark processes, Financial Benchmark Administrators (Reserve Bank) Directions, 2019, were issued in June 2019. The Directions are based on the practices recommended by IOSCO in their report on Principles for Financial Benchmarks as well as in the Report of the Committee on Financial Benchmarks set up by the Reserve Bank.

5. Growth of financial markets in India

5.1 As per the report published in Mint on 12 Mar 2023, that India recently crossed the UK to become the 5th largest economy in the world with a per capita income of \$2000. The IMF expects the per-capita income to grow at 6% till March 2025 (FY25). At \$2,000 levels, income crosses the minimum expenditure level & incremental income is used for spending & investments.

5.2 As per the report published by Morgan Stanley on 08 November 2022 that India is already the fastest-growing economy in the world, having clocked 5.5% average gross

domestic product growth over the past decade. India is on track to become the world's third largest economy by 2027, surpassing Japan and Germany, and have the third largest stock market by 2030. India's GDP could more than double from \$3.5 trillion today to surpass \$7.5 trillion by 2031. Its share of global exports could also double over that period, while the Bombay Stock Exchange could deliver 11% annual growth, reaching a market capitalization of \$10 trillion in the coming decade.

5.3 As per the report published in Statista that:

- Total revenue in the Finance market is projected to reach US\$8.77m in 2022.
- Total revenue is expected to show an annual growth rate (CAGR 2022-2027) of 14.97%, resulting in a projected market volume of US\$18.75m by 2027.
- Advertising revenue in the Finance market is projected to reach US\$7.03m in 2022.
- The number of downloads in the Finance market is projected to reach 313.60m downloads in 2022.
- In-app purchase (IAP) revenue in the Finance market is projected to reach US\$1.32m in 2022.
- Paid app revenue in the Finance market is projected to reach US\$0.42m in 2022.
- The average revenue per download currently is expected to amount to US\$0.03.
- A global comparison reveals that most revenue is generated in the United States (US\$537.60m in 2022).

Conclusion

The core objective of the Reserve Bank's regulations for financial markets is to develop safe and stable markets which provides appropriate products for trading and risk management. As part of this approach, it is sought to progressively address structural rigidities for enabling better price discovery and increasing both the depth and width of the financial markets. Efforts are on to develop and strengthen inter-linkages between market segments, increase the participation base and foster competition, increase the menu of choices through innovations in products and ensure resilience through robust market practices and conduct. With a view to foster market innovation, regulations are being framed, providing broad principles for the activities that can be undertaken in the financial markets. Regulatory, legal, institutional and technological infrastructure is also being strengthened for orderly market activity.

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