An update on international competitiveness
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1 Summary

This international competitiveness update has four parts:

- The Securities Market Report Card (SMRC) for currency derivatives and equity index derivatives updated till Q1, 2015.
- An update on the implementation status of policy proposals for the commodity derivatives market.
- An update on the international competitiveness linked proposals proposed in Budget 2015.
- An analysis of the opportunities and challenges arising out of the merger of Forward Market Commission (FMC) with SEBI.

2 Updated SMRC

2.1 International competitiveness of currency derivatives

Table 1 International competition in exchange traded currency derivatives

(USD Billion)

	Traded Volumes					Open Interest				
	Q1-14	Q2-14	Q3-14	Q4-14	Q1-15	Q1-14	Q2-14	Q3-14	Q4-14	Q1-15
Exchange										
India	2.12	2.45	2.79	2.45	2.87	1.33	2.48	4.19	4.62	4.47
Intl.	1.38	1.20	1.35	1.31	1.51	1.05	1.19	2.08	1.99	2.01
OTC										
India	18.43	21.33	18.29	17.93	16.14	-	-	-	-	-
Intl.	-	-	-	-	-	-	-	-	-	-

Notes: Q1 denotes January-March, Q2 denotes April-June, Q3 denotes July-September and Q4 denotes October-December.
Source: Indian exchanges include NSE and BSE. International exchange values are for the Dubai DGCX and Singapore SGX.

Table 1 shows that:

- Traded volume in Indian exchanges has remained flat over the past year, with some improvement observed in Q1-15. International exchanges have seen the same positive trend.
- Open interest in Indian exchanges increased in Q3-14 and has remained flat since then. A similar trend is seen in international exchanges as well.

  The Q3-14 increase could be due to **?** allowing banks to re-enter the market, and FPIs to participate for the first time.

- The growth in the international exchanges has taken place simultaneously and without any policy impetus. It is, therefore, cause for concern.

Summary: the international competitiveness of Indian currency derivatives markets *has not changed significantly* in the previous quarter.

2.2 International competitiveness of equity derivatives

Table 2 International competitiveness of equity derivatives

(USD Billion)

	Traded Volumes					Open Interest				
	Q1-14	Q2-14	Q3-14	Q4-14	Q1-15	Q1-14	Q2-14	Q3-14	Q4-14	Q1-15
Futures										
India	1.29	1.84	1.80	2.61	2.08	3.37	3.36	3.04	4.40	4.92
Intl.	0.60	0.82	0.85	0.95	0.36	7.54	8.27	8.76	9.78	7.95
Options										
India	18.11	24.41	42.86	62.04	36.28	17.14	22.01	22.08	22.33	22.38
Intl.	0.003	0.003	0.003	0.002	0.006	0.25	0.27	0.33	0.25	0.27
PNs	-	-	-	-	-	31.95	35.37	32.16	33.57	39.11

Notes: Q1 denotes January-March, Q2 denotes April-June, Q3 denotes July-September and Q4 denotes October-December.
Source: Indian exchanges include NSE and BSE. International traded data is from the Nifty futures market at the Singapore SGX.
Blank fields indicate that data is currently not available.

Table 2 shows that:

- There is a decline in *traded volumes* on equity index futures at both the international and Indian exchanges in Q1-15 compared to Q4-14.
- There is an increase in the *open interest* at Indian exchanges compared to a decrease at the international exchanges in Q1-15 compared to Q4-14.

  As a consequence, the ratio between the OI on Indian vs. international exchanges has some improvement in favour of the Indian markets.
- India retains the dominant status on equity index options. However, there is a drop in traded volume in Q1-15 compared to Q4-14.
- There is no change observed in open interest on equity index options in this period.
- Open interest for participatory notes (PNs) has increased by in Q1-15 compared to Q4-14. However, it remains at 10-11% of the assets under custody (AUC) of FPIs during the period.

Key observation, the international competitiveness of Indian equity futures market *has not changed* in the previous quarter. India continues to be the dominant market for *equity options*. But Indian exchanges continue to have a lower open interest in *equity futures* compared to international exchanges, even though there is a slight improvement in relative numbers in the latest quarter.

3 Update on commodity derivatives market

Table 3 lists the current status of implementation of the short and medium term policy recommendations for the commodity derivatives market.

Table 3 Status of short and medium term policy recommendations

Proposals	Implementing agency
Not implemented	
• Remove regulatory constraints on banks and MFs to participate in commodity derivatives.	**RBI, SEBI, DEA, FMC**
• Extend non-speculative status on direct taxes for all exchange traded commodity derivatives contracts.	**DEA, CBDT**
• Devolve contract design, product innovation and trading time related decisions to exchanges with monitoring by FMC.	**FMC**
• Set up an expert committee to rationalize margins and position limits taking into account (a) the diverse nature of the underlying commodities; and (b) position limits and margins on competitor offshore exchanges.	**DEA, FMC**
• Devolve position limit and margin setting to exchanges with monitoring by FMC.	**FMC**
• Implement **?** procedures for setting position limits and margins.	**FMC**
• Rationalise stamp duty through the India Stamp (Amendment) Bill, 2014.	**Central/State governments**
In progress	
• Create a high level committee to create of (a) A robust warehousing system to strengthen delivery against contracts; and (b) A well-functioning market for warehouse receipt finance.	**FMC, WDRA, RBI**
• Implement **?** process for governance of regulation making at FMC.	**FMC**
Proposed in Budget 2015	
SEBI-FMC merger	
• Allow foreign entities with commodity exposure to participate in Indian commodity derivatives: (a) Create a mechanism for registering commodity specific participants with FMC. (b) Ensure co-ordination between FMC, RBI and SEBI to avoid multiple registration and compliance requirements.	**DEA, FMC, SEBI, RBI**
• Implement the following key proposals of the FCRA Amendment Bill, 2010: (a) Provide statutory powers to FMC to become an independent regulator. (b) Widen FMCs powers on investigation, enforcement and imposition of penalties. (c) Make SAT the appellate body for FMC orders. (d) Widen definition of commodity derivatives to include goods, services, activities and events. (e) Permit options. (f) Permit cash-settlement of index like products. (g) Demutualisation and corporatisation of all recognised associations.	**DEA**
• Enhance regulatory capacity and resources at FMC.	**DEA**
• Remove Central government's power to ban commodity derivatives trading.	**DEA**
GST implementation by April 2016	
• Focus on implementing GST.	**Central/State governments**

4 Budget 2015: impact on factors of international competitiveness

Table 4 reports the list of budget announcements that have an impact on the factors of international competitiveness. They are: (1) capital controls, (2) tax policy, (3) regulatory certainty (4) frictions (5) market microstructure, and (6) a vibrant domestic market. The budget has specific measures with regards to (1), (2) and (6).

On capital controls: The measures announced are mainly in the equity market segment where capital controls are relatively low and these measures may have a limited positive impact.

Several short term measures to improve competitiveness did not appear in the budget. For example, (1) procedural bottlenecks faced by FPIs under the Foreign Portfolio Investors (FPI) Regulation, 2014, implemented from June, 2014, (2) the government bond foreign investment limit of USD 30 billion, which is already full, deters any new investors in the fixed income market from entering.

On tax policy: Several measures have been announced in the budget with the intent of providing tax incentives and clarity to foreign investors. However, in their legislative implementation, they add to tax uncertainty. Since the effective date for these measures is from FY 16-17, there is no impact in the current year.

On a vibrant domestic market: Several measures have been announced which may improve the quality of domestic debt and commodity derivatives markets in the long run.

Factors	Segment	Measures	Impact	Effect	Legislation
Capital controls	Equity	• Proposal to amend to Section 6, FEMA.	Positive	Single window clearance	Finance Bill, 2015
		• Proposal to merge FPI and FDI schemes.	Positive	Single window clearance	SEBI FPI regulations, 2013; FDI regulation
	Fund management	• Proposal to allow foreign investment in AIFs.	Positive	Widen available funds	SEBI AIF regulation; RBI regulation under FEMA, 2000
Tax policy	Equity	• Amendment to definition of GDR in Section 115ACA of the Income Tax Act.	Weakly positive	Tax benefit to two types of DRs	Finance Bill, 2015
		• Amendment to indirect transfer tax rules.	Negative	Retrospective taxation not addressed	Finance Bill, 2015
		• Proposal to amend tax rules for offshore structures based on place of effective management (PoEM)	Negative	May result in double taxation	Finance Bill, 2015
	Debt	• Amendment of Section 194LD of Income Tax Act	Weakly positive	Extension of two years, no policy direction	Finance Bill, 2015
	Commodity derivatives	• Proposed GST implementation by April, 2016.	Positive	Rationalised indirect tax framework	GST Bill, 2014
	Fund management	• Proposed tax pass-through status to Category I and Category II AIFs.	Positive	Single point taxation of unit holders	Finance Bill, 2015
		• Proposed rationalisation of tax for REITs and InvITs.	Weakly positive	All capital gains & MAT issues not addressed	Finance Bill, 2015
		• Modification of Permanent Establishment (PE) norms for fund managers	No impact	-	Finance Bill, 2015
		• Tax neutrality on merger of similar schemes of MFs	Positive	Anomaly removed	Finance Bill, 2015
	All segments	• Deferment of GAAR.	Weakly positive	Extension of two years, no policy direction	Finance Bill, 2015
		• Exemption from MAT for FPIs.	Negative	Increases ambiguity	Finance Bill, 2015
Vibrant domestic market	Debt	• Proposal to set up PDMA.	Weakly positive	Consolidation of debt market under SEBI. Capital controls still with RBI.	Finance Bill, 2015
		• Proposal to bring a comprehensive Bankruptcy Code in FY 16-17.	Positive	Effective corporate bankruptcy framework	New Bankruptcy Code; Companies Act, 2013; SICA, 1985
		• Proposal to extend SARFAESI, 2002 to NBFCs.	Positive	Better secured debt recovery by NBFCs	SARFAESI, 2002
	Commodity derivatives	Proposed merger of FMC with SEBI.	Positive	SEBI as unified securities market regulator	Finance Bill, 2015
	All segments	• Update on implementation of IFC and proposal to set up a task force for a FRA.	Positive	-	IFC
	Within GIFT	• Proposal to announce GIFT regulations by March, 2015.	Positive	-	SEZ Act, 2005

Table 4: Impact of budget announcements on international competitiveness

5 Merger of Forward Market Commission with SEBI: opportunities and challenges

The merger of FMC with SEBI has been proposed in Budget 2015. This will create a unified securities markets regulator in SEBI. In this note we evaluate the potential impact of this merger on the commodity derivatives market.

Impact on international competitiveness and challenges:

The merger of FMC with SEBI has several positive implications for international competitiveness:

- The consolidation of commodity derivatives trading along with secondary trading in debt securities under SEBI, will empower SEBI as a one-stop-shop regulator for all secondary trading.

  It provides an opportunity to create a consolidated market with common clearing corporation for multiple assets. There are several advantages to this for the regulator as well for the market participants. A common clearing house would result in a robust risk management system since it would facilitate a complete risk profile for a client/member across assets/exchanges and help detect market risks by pooling information from a wide range of products simultaneously. It would also reduce cost for clearing members by enabling cross-margining for offsetting positions across assets/exchange. The other benefits to clearing members result from reduced paperwork, rationalisation of processes, netting efficiency, collateral efficiency and default fund efficiency.
- FMC was not an independent regulator like SEBI. It was a department of the Central Government and had limited powers of surveillance, investigation and enforcement. SEBI, enabled through the SEBI Act, has better regulatory infrastructure and resources and the same will now become available to the commodity derivatives segment.
- Several legal and regulatory hurdles that existed in the commodity derivatives market may now be considered for easing. This includes: (1) allowing foreign participants, (2) allowing products such as options of commodities and derivatives on underlying such as indexes, weather and freight.

The implementation of this merger will be the key challenge:

- Commodity derivatives, while being financial instruments, are different due to the physical settlement element associated. With a unified regulator, there could be pitfalls of securities market norms and regulations being applied to commodity derivatives without appropriate consideration. Example of this could be contract specifications of commodity derivatives which may vary from other securities.
- Foreign participants in commodity derivatives include financial institutions that have commodity trading desks as well as large commodities trading firms (example: Agrico, ADM, Cargill, Glencore etc.). In allowing foreign participation in Indian commodity derivatives, the registration mechanism will also need to address the requirements of all types of participants.
- For these derivatives, SEBI will need to set up formal mechanisms to coordinate with the Warehousing Development and Regulatory Authority (WDRA), which is the regulator involved in the delivery against commodity contracts.

- The organisation structure of FMC merged into SEBI will be critical to ensure that both the elements (1) the unique features of commodity derivatives; and (2) the advantages of a consolidated portfolio and unified regulator, are appropriately addressed in this merger.