International competitiveness quarterly update
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1 Executive Summary

This update presents how Indian derivatives markets have fared compared to their international competitors in January-February 2016. The update has two parts: the first presents a comparison of the performance of the market segments in terms of growth in market size, and the second highlights which policy recommendations were implemented in the recent period.

We summarise the international competitiveness update as follows:

1. Commodity derivatives market: In agricultural commodities (wheat, sugar, cotton, soya oil), Indian markets have been steadily shrinking compared to their global counterparts. This is not a healthy sign for a country that is significantly dependent, economically and politically, on agriculture. In the recent quarter, there was an intervention by an exchange to shut down trading in castorseed futures in response to suspected market manipulation.

   In non-agricultural commodities, India remains the larger market for gold and silver. But for crude oil and natural gas, the Indian market remains significantly smaller than world markets. There were no significant policy implementations in this quarter.

2. Currency derivatives: There has been a marginal, relative improvement in both volumes and open interest of INR futures and options traded in India, as well as their international counterparts. Indian exchanges remain the larger market, but we do not include the growth of the Non-Deliverable Forwards (NDF) market here for lack of access to data.

   There has not been any change in the microstructure or policy recommendation of note in this quarter. Cross currency options were introduced but these do not impact the the rupee linked derivative market.

3. Equity derivatives market: Trading in index futures and options have remained steady in India, but are dropping in competing markets. The overall size of these markets remain significantly *smaller* compared to the previous year.

   The policy intervention of note in the intervening period was the *increase* in trading size from Rs.200,000 to Rs.500,000.

2 Commodity derivatives market

Tables 1 and 2 show that:

- The size of the commodity derivatives market in India is small compared to off-shore markets.
- This is despite the fact that India is one of the largest producers of agricultural commodities such as wheat, cotton and sugar.
- India's exposure to non-agricultural commodities such as petroleum and linked products and bullion is also significant.

Table 3 lists the current status of policy recommendations for commodity derivatives market.

Table 1 The report card for agri-commodity derivatives

		Size of participation: Traded Value (USD Billion)				Open Interest (USD Billion)			
		Q1-15	Q2-15	Q3-15	Q4-15	Q1-15	Q2-15	Q3-15	Q4-15
India									
Wheat	NCDEX	0.002	0.007	0.0004	0.0001	0.010	0.031	0.002	0.0007
Sugar	NCDEX	0.014	0.030	0.004	0.006	0.095	0.134	0.012	0.021
Cotton	MCX	0.007	0.010	0.003	0.004	0.024	0.034	0.015	0.013
Soyabean	NCDEX	0.130	0.374	0.031	0.031	0.293	0.286	0.024	0.027
Soya Oil	NCDEX	0.138	0.167	0.043	0.026	0.264	0.358	0.093	0.036
Intl.									
Wheat	CME/ZCE	1.318	1.562	1.084	1.344	3.762	2.958	3.080	3.705
Sugar	ICE/ZCE	1.178	0.858	0.956	3.037	5.578	4.090	4.970	8.320
Cotton	ICE/ZCE	0.506	0.432	0.052	0.470	2.805	1.843	0.263	3.320
Soyabean	CME/DCE	3.925	4.349	1.483	4.486	8.643	8.993	3.957	7.653
Soya Oil	CME/DCE	0.875	1.075	0.261	0.665	2.565	2.335	0.459	1.292

Table 2 The report card for non-agri commodity derivatives

		Size of participation: Traded Value (USD Billion)				Open Interest (USD Billion)			
		Q1-15	Q2-15	Q3-15	Q4-15	Q1-15	Q2-15	Q3-15	Q4-15
India									
Gold	MCX	0.640	0.477	0.599	0.485	0.316	0.271	0.274	0.225
Silver	MCX	0.400	0.375	0.338	0.303	0.162	0.171	0.193	0.194
Crude Oil	MCX	0.831	0.877	0.843	0.778	0.135	0.072	0.089	0.114
Natural Gas	MCX	0.205	0.149	0.126	0.152	0.029	0.027	0.021	0.031
Intl.									
Gold	CME/SHFE	0.267	0.375	0.132	0.508	0.086	0.558	0.143	0.589
Silver	CME/SHFE	0.003	0.249	0.002	0.286	0.014	0.159	0.009	0.261
Crude Oil	ICE	2.834	2.591	2.130	1.868	2.995	3.846	2.730	3.348
Natural Gas	CME	3.067	3.025	3.100	2.513	37.639	40.221	37.860	35.699

Notes:
Only the most liquid near month futures contracts have been reported.
For international exchanges, sum of the daily average numbers for two exchanges has been reported.
Total traded value and open interest are average daily values for each quarter.
Q1 – Jan-Mar, Q2 – Apr-Jun, Q3 – Jul-Sept, Q4 – Oct-Dec
Source: Thomson Reuters Eikon database.
NCDEX - National Commodities Derivatives Exchange, MCX - Multi Commodity Exchange,
CME - Chicago Mercantile Exchange, SHFE - Shanghai Futures Exchange,
ZCE - Zhengzhou Commodity Exchange, ICE - Intercontinental Exchange

Table 3 Policy recommendations for the commodity derivatives market

Proposals	Implementing agency	Implementation status
Short term actions		
• Remove regulatory constraints on banks and MFs to participate in commodity derivatives.	**RBI, SEBI, DEA**	RBI May 2015 circular – banks to *encourage* large agri borrowers to hedge using domestic commodity derivatives.
• Implement Handbook (2013) procedures for setting position limits and margins.	**SEBI**	In progress.
• Create a high level committee to establish (a) A robust warehousing system to strengthen delivery against contracts; and (b) A well-functioning market for warehouse receipt finance.	**SEBI, WDRA, RBI**	In progress.
• Extend non-speculative status on direct taxes for all exchange traded commodity derivatives contracts.	**DEA, CBDT**	
Medium term actions		
• Allow foreign entities with commodity exposure to participate in Indian commodity derivatives: (a) Create a mechanism for registering commodity specific participants. (b) Ensure co-ordination between RBI and SEBI to avoid multiple registration and compliance requirements.	**DEA, 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 FMC's 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**	(a), (b), (c) and (g)under implementation as part of SEBI-FMC merger.
• Enhance regulatory capacity and resources at FMC.	**DEA**	
• Devolve contract design, product innovation and trading time related decisions to exchanges with monitoring by FMC.	**SEBI**	
• Set up an expert committee to rationalise 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, SEBI**	
• Devolve position limit and margin setting to exchanges with monitoring by FMC.	**SEBI**	
• Implement Handbook (2013) process for governance of regulation making at FMC.	**SEBI**	In progress.
• Remove Central government's power to ban commodity derivatives trading.	**DEA**	
• Focus on implementing GST.	**Central and state governments**	In progress. GST Bill in parliament.
• Rationalise stamp duty through the India Stamp (Amendment) Bill, 2014.	**Central and state governments**	
Long term goals		
• Rationalise and reduce legislative contradictions around the interaction of derivatives and spot market for commodities.	**Central and state governments**	In progress.
• Set up an expert committee to evaluate setting up of a full fledged OTC commodity derivatives market. Amend FCRA to enable an OTC market.	**DEA**	Partially implemented through FCRA Amendment 2015 and SCRA Amendment 2015.

3 Currency derivatives market

Table 4 shows that:

- In the exchange market:
  - For futures, in the onshore market, the Q4-15 traded volume (TV) and OI have both declined (by around 10%) relative to the previous quarter.

    On offshore exchanges, relative to the previous quarter, futures TV has remained flat but OI has declined (by 32.9%).
  - In the onshore options market, in Q4-15 relative to the previous quarter, the TV and OI have remained flat.

    However, there is an improvement in the market relative to Q4-14. The TV has increased by 77.6% and the OI by 50.5%.
  - The TV in the over-the-counter (OTC) market has declined marginally relative to the previous quarter (by 3.7%). However, the decline is larger when compared to the same quarter in the previous year (by 20%).

Summary: There has been a sustained improvement in the options market onshore.

Table 5 shows the status of implementation of the policy recommendations.

Table 4 The report card for currency derivatives

	Size of Participation										Cost				
	Traded Volumes (USD Billion/day)					Open Interest (USD Billion)					Impact Cost (%)				
	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15
Futures															
India	2.45	2.87	2.80	2.83	2.56	4.62	4.47	4.92	5.65	5.08	0.105	0.099	0.093	0.084	0.069
Intl.	1.31	1.51	1.36	1.74	1.70	1.99	2.01	2.59	6.56	4.40	-	-	-	-	-
Options															
India	0.85	1.93	1.55	1.5	1.52	2.53	2.73	2.84	3.75	3.81	4.05	3.39	2.90	2.86	2.19
Intl.	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
OTC															
India	17.93	16.14	18.25	14.89	14.33	-	-	-	-	-	-	-	-	-	-
Intl.	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Notes:
Q1 – Jan-Mar, Q2 – Apr-Jun, Q3 – Jul-Sept, Q4 – Oct-Dec The traded volume for India OTC market is computed from RBI weekly statistical supplement. Open interest is calculated using NSE bhavcopy data.
Impact cost are for a transaction of Rs. 1 million for futures, from snapshots of the NSE limit order book costs for India.
Impact cost are for a transaction of Rs. 50,000 for options, from snapshots of the NSE limit order book costs for India.
Blank fields indicate that data is currently not available.

Table 5 Policy recommendations for the currency derivatives market

Proposals	Implementing agency	Implementation status
Short term actions		
• Clarify ambiguities in direct tax treatment of ETCD transactions for domestic firms.	**CBDT, DEA**	
• For foreign participants, eliminate the regulatory uncertainty regarding the Singapore and Mauritius tax treaties.	**CBDT, DEA**	
• Rationalise KYC and compliance requirements for non-resident participants in line with CDD requirements under FATF.	**SEBI, RBI**	Partially implemented.
• Remove documentation requirements for taking positions in the ETCD market that were introduced in the RBI Circular: June (2014).	**RBI**	
• Remove restrictions on cancelling and re-booking OTC contracts.	**RBI**	
• Remove restrictions on participation by domestic financial institutions.	**RBI, SEBI, IRDA**	
• Devolve trading time linked decisions to exchanges and AD I Banks.	**SEBI, RBI**	
• Devolve product innovation decisions from regulators to exchanges.	**SEBI**	
• Avoid banning market segments, participants or products. All regulatory intervention should be as per Handbook (2013) procedures.	**DEA, RBI, SEBI**	
Medium term actions		
• Sign tax treaties similar to the Mauritius and Singapore treaty with other FATF-compliant countries.	**DEA**	
• Implement Handbook (2013) process for governance of the regulation making process at RBI and SEBI.	**DEA, RBI, SEBI**	In progress at SEBI.
• Set up an expert committee to rationalise position limits and margins and design a framework within which the power to set position limits and margins is devolved to exchanges.	**DEA, SEBI**	
Long term goals		
• Move to a residence-based taxation regime over the longer term.	**DEA, CBDT**	
• Consider a time-bound plan for the internationalisation of the INR, in line with the plans of the Chinese government for the internationalisation of the Renminbi.	**DEA**	

4 Equity derivatives market

Table 6 shows that:

- For equity index futures, in Q4-15, relative to the previous quarter:
  - Traded volumes (TV) onshore has declined (by 22.5%) while TV offshore has increased (by 219.2%).
  - Onshore Open interest (OI) has declined (by 8.2%) while offshore OI has increased (by 29.4%).
- India retains the dominant status on equity index options, but:
  - TV has declined relative to the previous quarter (by 17.6%) and so has OI (by 4.6%).
- There is a marginal decline in OI for participatory notes (PNs) relative to the previous quarter (by 5.1%).

Summary: onshore futures market has seen a decline. In the same period offshore futures markets have seen an improvement.

The onshore options market continues to be in a dominant position.

There has been an overall decline in the index derivatives market onshore as well as in PNs.

Table 7 lists the current status of policy recommendations for equity derivatives market.

Table 6 The quarterly report card for equity derivatives

	Size of Participation										Cost				
	Traded Volumes (USD Billion/day)					Open Interest (USD Billion)					Impact Cost (%)				
	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15
Futures															
India	2.61	2.08	1.97	1.95	1.51	4.40	4.92	3.78	3.89	3.57	0.004	0.005	0.005	0.005	0.005
Intl.	0.95	0.36	0.31	0.26	0.83	9.78	7.95	6.47	5.68	7.35	0.018	0.014	0.011	0.016	0.017
Options															
India	62.04	36.28	32.49	26.24	21.77	22.33	22.38	22.19	22.58	21.52	0.429	0.506	0.533	0.409	0.413
Intl.	0.002	0.006	0.002	0.001	0.001	0.25	0.27	0.36	0.17	0.26	-	-	-	-	-
PNs															
	-	-	-	-	-	33.57	39.11	38.62	35.02	33.23	-	-	-	-	-

Notes:
Q1 denotes January-March, Q2 denotes April-June, Q3 denotes July-September and Q4 denotes October-December.
Example: Q2-13 denotes April-June, 2013; Q1-14 denotes January-March, 2014.

Traded volumes and open interest for India are calculated using daily NSE bhavcopy data, daily BSE bhavcopy data, and Thomson Reuters trades for SGX. Impact cost are for a transaction of Rs.1 million for Nifty futures and at-the-money Nifty options, from market-by-price data from NSE, and Thomson Reuters quotes for SGX.
Blank fields indicate that data is currently not available.

Table 7 Policy recommendations for the equity derivatives market

Proposals	Implementing agency	Implementation status
Short term actions		
• Rationalise KYC and compliance requirements for non-resident participants in line with CDD requirements under FATF.	**SEBI, DEA**	Partially implemented.
• Allow access to all foreign participants that meet the FATF CDD requirements.	**SEBI, RBI**	
• Eliminate the regulatory uncertainty about availing treaty benefits under the proposed GAAR.	**DEA, CBDT**	GAAR implementation date extended to 2017.
• Remove STT but without the adverse impact of higher capital gains tax.	**SEBI, DEA, CBDT**	
• Remove stamp duty as index derivatives are cash settled and no delivery of the underlying takes place.	**SEBI, DEA, CBDT**	
• Make trading and clearing rules nationality and participant neutral: (a) Allow FPIs and MFs the same list of permissible securities that are allowed to domestic participants as collateral; and (b) Allow FPIs access to ETCD market.	**SEBI, RBI**	(b) Implemented by RBI in June 2014.
• Clarify the regulatory position on PNs.	**SEBI**	Partially implemented.
• Move towards FATF compliant CDD disclosures for PNs.	**SEBI**	
• Devolve market timing decisions from regulator to exchanges.	**SEBI**	
Medium term actions		
• Create a working group for common clearing among exchange traded products, equity, equity derivatives and currency derivatives, in phases. Phase I for multiple segments within a single exchange and in Phase II across exchanges, with multiple competing clearing corporations.	**SEBI, RBI**	
• Implement Handbook (2013) processes for governance of the regulation making process at SEBI.	**SEBI, DEA**	In progress at SEBI.
• Remove regulatory restrictions on domestic FIs participation in equity derivatives.	**SEBI, RBI, IRDA**	
• Set up an expert committee to rationalise position limits and margins. This committee should: (a) Rationalise position limits across all market segments; (b) Create single margin system across market segments in two phases; and (c) Rationalise margins vis-a-vis competitor markets like SGX.	**SEBI, RBI**	
• Devolve margins, position limits, trading time, product innovation etc. linked decisions to exchanges, with suitable monitoring by SEBI.	**SEBI**	In August, 2015 SEBI increased the lot size of index derivatives contracts from Rs. 2 lakh to Rs. 5 lakh.
Long term goals		
• Move to a residence-based taxation regime over the longer term.	**DEA, CBDT**	
• Set up an expert committee for creating an onshore OTC market for equity derivatives. Amend SCRA suitably for this to happen.	**DEA, SEBI**	

5 Securities lending and borrowing market: a missing link for equity derivatives markets

In order to develop better pricing and liquidity on derivatives markets, participants must have the ability to borrow and lend securities. For example, when index futures prices drop below the index spot price, the markets take a much longer time to correct this difference and bring the futures price back above the index price. Arbigrageurs, who trade to correct such mispricing, find it more difficult to borrow securities when they sell or short-sell the index.

In this note, we assess the SLB market in India and compare it with its counterparts in the US, Brazil and South Korea, in terms of size and market structure. We highlight the issues and challenges in the Indian market and identify policy actions that are required to improve this market.

5.1 Market size

Globally, SLB is mostly an over-the-counter (OTC market). As a result, there is limited data available on the scale of the activity. Market estimates suggest that the value of securities lent is at around USD 1 trillion[1]

Prior to the global financial crisis (GFC) in 2007–2008, the SLB was a large market with the value of securities on loan at USD 2.3 trillion. During the GFC, the Securities and Exchange Commission (SEC) tightened requirements for lending and borrowing of shares of large financial firms. After 2007, SLB for all securities (not just equity shares) declined. The value of loaned assets currently stands at approximately USD 1 trillion, less than half of pre-GFC levels. In the US, equities account for 30% of the securities on loan, treasuries and agency bonds are 31%, and foreign equities are 17% of the SLB market.[2]

In India, SLB trading is small. The average daily traded value was Rs.17 lakhs. The average daily number of trades was 423 between January – April, 2016. The weighted average yield is around 10 – 12%.[3]

5.2 Market structure

In India, securities lending is an exchange traded market. It was introduced by the National Securities Clearing Corporation Ltd (NSCCL) in April, 2008. The market design has an automated screen based system that matches orders to lend and borrow securities, electronically and based on price-time priority. There is a limited settlement guarantee scheme where NSCCL acts as the Central Clearing Counterparty (CCCP). Put together, these features reduce the counterparty credit risk and the collateral risk.

OTC trading in SLB is prohibited.[4] The use of only an exchange platform limits

[1]Source: Markit Group Ltd. (Federal Reserve Bank of New York: Reference guide to U.S. repo and securities lending markets, December 2015)

[2]Source: Office of Financial Research (OFR) Analysis

[3]Source: National Stock Exchange data

[4]SEBI Circular: 20th December 2007

the scope of transactions as well as reduces contracting flexibility available to participants in the OTC market.

The only other country with an exchange traded SLB market is South Korea. Brazil allows trading to take place both on exchange and in OTC. The U.S. market, which is the largest for SLB, is an OTC market. Table 8 provides a comparison of the market structure between various jurisdictions.

Table 8 Comparison of securities lending markets across jurisdictions

	India	U.S.	Brazil	South Korea
Market	Exchange	OTC	Exchange and OTC	Exchange
Clearing	Mandated central clearing	Mutual settlement	Mandated central clearing	Mandated central clearing
Settlement guarantee by CCCP	On best effort basis in case of early recall	NA	On best effort basis in case of early recall	Guaranteed settlement in case of early recall; guarantee fee charged
Average yield	12.5%	0.4%	-	-
Utilisation of lendable securities (% of total)	Miniscule	7 – 8%	-	-
Securities traded	Equities traded in F&O segment	Domestic and foreign equities, US treasuries, municipal bonds, corporate bonds, Eurobonds, asset backed/mortgage backed securities	Equities, corporate bonds	KRX listed equities, corporate bonds, government bonds, municipal bonds, ETFs, warrants
Permitted collateral	Bank guarantees, fixed deposit receipts, cash	Equity, bonds, cash	Listed and unlisted equity, bonds, ETF quotas, bank LCs, foreign securities, equity dividends, other financial instruments	Equity, bonds, cash, ETFs
Collateral and margin requirements	100% cash or equivalent collateral + margin	Collateral with haircut + no margin	Collateral with haircut + margin (on exchange)	Collateral with haircut + no margin
Profile of lenders	Retail and HNIs (90%), MFs can only lend, Pension funds and Insurance companies not allowed	Diverse. Spread across Pension funds, MFs, Endowment funds, Sovereign Wealth funds, Insurance companies, Banks and other asset managers	Retail (26%), foreign investors (37%), MFs (28%)	Foreign investors (86%). Retail not allowed
Profile of borrowers	Brokers and proprietary traders (close to 100%)	Diverse. Spread across hedge funds, asset managers, dealers, brokers and banks	Funds (68%), foreign investors (24%)	Foreign investors (90%), securities companies (8%)

Source: G. Suvanam and M. Jalan, 2010, Developing the securities lending and borrowing market in India

5.3 Indian SLB market: issues and challenges

Market structure design flaws

Excessively small position limits: The client level position limit of 1% of market wide position limit (MPWL) is too small especially for institutional investors. The presence of extremely low limits on trading ETFs may be a reason for their failure in improving liquidity. For example, position limit in NIFTYBEES for June 2014 was 5486 units.

Restrictions on participation

Missing lenders: Pension funds, who are large lenders globally, do not participate in the Indian SLB market, because of restrictions in the the investment guidelines under the Investment Management Agreement between the NPS trust and pension funds.

Promoters, whose shareholding is generally high, do not participate even without explicit restrictions. Partly, this is because there is no clarity on disclosure guidelines on how shareholding pattern of promoters and insider trading norms need to be reported when they lend in the SLB market.

Limited participation by FIIs: FIIs are likely to be rapid entrants into this market, except for regulatory constraints they face.

- RBI's rules for FII participation in the SLBM prescribe that shares may be borrowed *only* for short selling. However, there is no clarity on what happens if the FII sells short and is unable to procure stock in the SLB market (RBI Circular: December, 2007).
- RBI Circular: December (2007) restricts collateral from FIIs to be in the form of cash only, while domestic institutional investors have a wider range of choice of collateral.[5]
- RBI Master Circular (2014) prohibits NRIs from participating in this market.

Lender's risk perception: The securities loan is made on the exchange platform and covered by the clearing house, which implies no counterparty risk that the lender will not receive the lending fee. But there remains the risk that the lender may not receive the security on an early recall.

Absence of OTC markets: Over-The-Counter (OTC) markets provide greater contract flexibility and implicitly wider position limits, which in turn, may encourage greater participation. The low volumes in India may partly be because the Indian regulator has limited the SLB segment to the exchange, unlike (say) Brazil which allows trading in SLB on both the exchange and OTC (Suvanam and Jalan, 2012)

5.4 Policy recommendations

1. **Short-term actions**
   (a) *Increase position limits*: SEBI and the exchanges should reconsider the client level positions. They should seek market consultation and set position limits accordingly. (**SEBI, NSE, BSE**)
   (b) *Increase FPI participation:* RBI Circular: December (2007) permits only cash collaterals for margins for FPIs. This increases their cost of participation. RBI already allows FPIs to maintain a wider range of collaterals in the equity and F&O segment. These should be also extended to the SLB segment. (**RBI**)
   (c) *Promoters as lenders*: Clarify rules of participation for promoters. (**SEBI**)
2. **Medium-term goals**
   (a) *Permit pension funds to lend*: PFRDA ought to release guidelines similar to those released by IRDA for insurance firms to lend securities.

[5]Permitted collateral from domestic institutional investors include cash, fixed deposit receipt, bank guarantees and, most recently, Gsecs and T-bills.

(**PFRDA**)

(b) *Consider guarantee mechanisms to reduce lender risk*: The existing SLB framework does not provide a settlement guarantee in case of early recall by lenders (SEBI Circular: January, 2010). In contrast, the CCP in South Korea provides settlement guarantee for a fee. In Hong Kong, the CCP forces borrowers to return the securities to the lender in case of early recall. Indian exchanges may consider adopting similar approaches. (**Exchanges, SEBI**)

3. **Long-term goals**

(a) *Evaluate permitting parallel OTC markets:* The SEBI circular: Dec 20, 2007 prohibits an OTC market for SLB. Given the importance of the functions of lending and borrowing securities, the regulator ought to considerrisk management systems that are required to safely enable OTC markets for SLB. (**SEBI**)

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