Is it time to start an OTC derivatives market?

DEBATE

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Given how Participatory Notes are essentially an OTC market for Indian equity derivatives, moving them onshore should be an important objective.

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Longer-dated options are not viable because of low liquidity in exchanges ... in OTC markets, however, they are quite viable

Over-the-counter (OTC) derivatives and exchange-traded derivatives coexist in healthy competition in most developed markets. It is true that standardised and highly liquid contracts are best traded in organised exchanges because of the enhanced transparency and lower systemic risk. However, new contracts are often best incubated in OTC markets until they achieve a critical mass of liquidity and widespread participation at which point they can be moved to the exchange traded format. Competition between OTC markets and exchanges forces each market to lower costs and to adopt the best practices of the other market. The most important candidates for OTC equity derivatives are long-dated equity options. Exchange-traded options in India go out to a maturity of only three months and liquidity is concentrated in the near month. Longer-dated options are not viable at present because of the extremely low liquidity. However, in OTC markets, options with maturities of three to five years are quite viable because of the large ticket size (notional values of $10 mn are quite common).

Participatory Notes are essentially an OTC market in Indian equity derivatives. Indian regulations have driven this important market outside India and the result is a loss of liquidity, a loss of income for Indian financial services firms and a loss of access to OTC derivative markets for Indian securities and investment firms. Bringing this market back to India should be a significant regulatory priority. The SCRA should be amended quickly to allow OTC equity derivatives in India.

Internationally, exchanges have responded to the threat of OTC markets by introducing flexible options where market participants can choose parameters such as exercise prices, expiration date and type of expiration (American or European style) provided they trade the contracts in large blocks. These flexible options are listed, margined and cleared like standard options and, therefore, combine the flexibility of OTC options with the transparency and low systemic risk of exchange-traded options. Flexible options can be introduced in India without any statutory amendments and are, therefore, an attractive short-term solution until the legal groundwork for a full-fledged OTC market is established. To bring the PN market to India, we must also establish a tax system for portfolio investment similar to that in the US. The US does not tax “Portfolio Interest” income, capital gains on securities and income from derivative transactions (“Notional Principal Contract” income) earned by foreign investors. For too long, India has used the Mauritius double taxation agreement as an excuse for not doing something similar, but the Mauritius solution works only for investment in equities and not for investment through derivatives. The time has come to take Mauritius out of the loop altogether.

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OTC derivatives lack transparency and it is difficult for regulators to assess both the sytemic risk as well as that to individuals

Any measure to introduce a market for over-the-counter (OTC) derivatives in India must be implemented carefully. The exchange-traded derivative market in India is transparent in price discovery, has strict controls on marketwide open exposures and individual investor exposure, and has tight mechanisms in place to control margins of individual participants, with minimal counterparty exposure. However, it

operates within a rigid framework and is not suited for all types of contracts, especially within the credit and interest rate markets. An individual investor in India has very limited choice of product beyond equities. The fixed income market is illiquid, investors have limited avenues to invest in structured notes, or to invest conveniently in commodities. On the other hand, market participants have limited ability to either mitigate their risk or disperse risk in the credit markets. In such an environment, there is a case to be made for introducing OTC derivatives. Simultaneously, there is also a need to further develop the exchange-traded derivative market, with trading in contracts with longer maturities and contracts in other asset classes to be introduced.

OTC derivatives, however, lack transparency both from the perspective of the investor as well as the regulator. Given the infinite permutations and combinations possible in the creation of such instruments and the limited reporting requirements, it is difficult for the regulator to assess the systemic risk and the risk to individual participants from such exposure. OTC derivative transactions also result in the creation of bilateral counterparty exposures, with assessment of this exposure made increasingly complex given the variety of structures and asset classes available to a market participant. OTC derivatives can also be subject to higher levels of leverage, given limited regulatory oversight on transactions. The creation of a vibrant OTC derivative market can, therefore, expose the Indian financial system and the Indian investor to a fair amount of risk, and trading in such instruments must be permitted only with checks and balances that compensate for the relatively nascent stage of evolution of the Indian financial markets.

Developed markets operate with multiple levels of regulation. In addition to regulatory oversight by the regulator, firms regulate their own conduct through compliance officers, risk managers and financial controllers. With the exception of a few of the largest firms in India, our financial system is yet to attain this level of self-governance, risk management and financial control. So, while creating a market for OTC derivatives, it is important in the initial stages to permit only a small, manageable set of firms to carry on OTC derivative business for customers. Firms should also be required to report all OTC derivative exposures on a monthly basis, so that the regulator has a record of exposure levels of the financial system and of individual firms.