Presentation on:

**Implications of Capital Controls for Domestic Capital Markets**

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Impact of Capital Controls on Domestic Markets

Currency Markets

Equity Markets

Debt Markets
Currency Markets

- Foreigners don’t have access to onshore dollar rupee market unless they have genuine underlying
- Two markets: Onshore and NDF
- Proposed are currency futures
- Is offshore market the driving force??
- Well-diversified end-users onshore. Onshore market much deeper and well-diversified
- Comfort

**Conclusion:** Minimal impact of capital controls on domestic currencies market
Debt Market...
Players

- Structural issue is limited no. of players
- End-users in 5 categories but 80% of the market consists of < 20 players

<table>
<thead>
<tr>
<th>Investor Class</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>&lt; 10 banks consist of 90% of the market</td>
</tr>
<tr>
<td>Insurance Cos.</td>
<td>One insurance company is 85% of the market</td>
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<tr>
<td>PFs</td>
<td>1 PF is around 45% of the market</td>
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<tr>
<td>MFs</td>
<td>AUM in debt funds is miniscule</td>
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<tr>
<td>FII</td>
<td>Restricted (caps by regulators)</td>
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</tbody>
</table>

- Major segment viz. banks are often doing similar business in same area
- Therefore the investor base is not really diversified
- To have a vibrant capital market, we need multiple diverse end-users : which is missing
- Structurally not possible to change market quickly. Easier and faster way to develop markets is to allow offshore players
Debt Markets...
Products

- **Onshore**
  - Cash markets
  - Interest rate swaps
  - Credit derivatives (proposed)
  - Interest rate futures (proposed)

- **Offshore**
  - Cash Bond markets
  - Credit Derivatives (CDS, CLN etc.)
  - Non-deliverable interest rate futures

- ECB caps and restrictions (pricing cap of L+250 bps and permitted end-use to be outside the country beyond US$ 20 mm) have created significant funding constraints
  - Widening of rates in offshore markets make it impossible even for top rated Indian companies to raise funds offshore within the pricing cap

*Conclusion*: There is a huge impact of capital controls on Indian debt markets
Debt Market (Cont’d)

- Allowing foreigners in debt markets onshore creates flow volatility. Is it desirable??

- However, some measures can be taken without getting into debate of desirability of capital flows and volatility
  - CDS / Guarantee
  - Interest rate derivatives
Flows in CDS

Normal Scenario (no default)

- **offshore**
  - **Commission**

- **onshore**
  - **CDS / Guarantee**

**Offshore entity**

**Investor holding local bond**

- **Inflow**: Nil
- **Outflow**: Restricted to amount of CDS premia / guarantee commission
Flows in CDS (Cont’d)

**Default Scenario**

- **offshore**
  - Residual value
  - Offshore entity

- **onshore**
  - Notional
  - Investor holding local bond

**Conclusion**: Allowing CDS with offshore counterparties would not result in large net flows (inflow/outflow)
Interest Rate Swaps

Example

- **Offshore entity**
  - 5-yr OIS

- **Investor holding local bond**
  - 7%

- Net flow – Difference of OIS and 7%
  - If OIS is nil, max. inflow is 7%
  - If OIS is 17% (lets say), outflow is 10%

**Conclusion:** Over the tenor of swap and on a per annum basis, flows would not be large
Debt Market (Cont’d)

- The offshore market is also important given, interalia, the quantum of funds that can be raised
  - Domestic markets are limited in so far as amount of funds that can be raised is concerned, given limited no. of players

- Domestic banks should be allowed to remit money to their offshore branches to meet offshore funding requirement of Indian corporates
  - Will address lack of funding options for these branches given global credit scenario
Equity Markets

- Liberalized at regular intervals starting 1994 for offshore investors
  - Some restrictions, but wide enough to enable fund raising/investment

- P-Note/ODI ban in Oct 2007 first significant step towards controls
  - Has created a distortion in markets and impacted market sentiment negatively

- Offshore players can still meet their requirements through shifting exposure to India-based products in other exchanges (Nifty Futures on Singapore Exchange, soon to be launched USFE)

\[\textit{this shall result in “export” of Indian markets offshore}\]
Equity Markets (Cont’d)

- Anomaly of asset managers being able to hedge on Indian markets while brokerages cannot needs to be addressed.

- Onshore players should be allowed to exploit arbitrage with India-based products in offshore markets.

- Reverse fungibility should be made more efficient for ADR/GDR.
  - Will address the lack of liquidity/stagnancy of these markets post issuance.

- Onshore players should be allowed to exploit arbitrage of ADR/GDR and underlying prices to address the distortion because of lack of liquidity.

...these will address issue of price distortion and prevent export of onshore markets.