Interest Rates: Final Call for Sound Risk Measures

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It had to happen sooner or later!

As the interest rates end their dream run of over 7 years, the time has come to look hard at the systemic level environment prevailing in the markets. As the 10-year sovereign yield descended from its high of 14% in 1996 to a low of 4.97% in November 2003, a degree of complacency had unconsciously crept in. Of course, it wasn't a smooth ride during those seven odd years. Far from it! The East Asian Crises, the sharp and sudden hike in CRR in January 1998, the nuclear tests, the 9/11 catastrophe and last but not the least, the Iraq war, did keep the market on tenterhooks intermittently. But at the end of the day, the rally resumed its earlier momentum and all was happily forgotten as a bad nightmare. If you had sufficient temerity and patience to hold on to your outstanding positions long enough, you could come out of the tunnel. Or so it seemed!

The immense potential of profiting from the interest rate party induced hitherto dormant bank treasuries into reinforcing their staff. In the wake of the 1992 securities scam, the entire securities market had found itself in a 4-year long spell of investigations, audits, commissions, et al. But by the mid-90s, the whiff of liberalization had begun to cast positive effects on the market.

The birth of the NSE and the introduction of a new entity called the "Primary Dealer" heralded a new era for the debt markets. The increasing liquidity, mainly on account of strong FII inflows and a lucrative capital market, was able to meet the ever expanding government borrowing programs. The entry of private banks and PDs into the trading arena brought in newer skills and ideas which gave a fillip to market sentiments. The trading volumes which were a few hundred crores rose to as high as 7000-8000 crores on a single day.

As market sentiments improved, the government was gradually successful in being able to elongate the sovereign yield curve from 10 years to 30 years. The lure of big bucks at the long end sent many investors chasing these papers.

Constitution of SROs like FIMMDA and PDAI provided a structured forum for airing opinions and making representations to various regulators. A combined effort of such bodies along with a reformist approach by the regulators led to several landmark developments in the market such as introduction of LAF, online settlement through NDS, setting up of CCIL, introduction of CBLO etc.

To a large extent, the major pitfalls present in the erstwhile settlement systems were taken care of through progressive reforms. The regulators have demonstrated remarkable sense of purpose and vision in implementing these far reaching measures.

While there has been laudable progress in the field of settlement systems, not enough appears to have been done to address the interest rate risk that has the potential of sending the markets into a shock syndrome.

With the reversal in fortunes, many market players have clamped down on their respective activities, thereby reducing market volumes. With volumes drying up, the efficiency in price discovery has also been hit. In the year gone by, most trading portfolios have seen considerable depreciation. In this bleak scenario, a few tenacious traders continue to make efforts at generating market interest. However, the focus has shifted clearly to the credit department and the erstwhile blue-eyed boys of treasury have lost their sheen. The build up of credit portfolios on the rebound poses an inherent threat of a rise in NPAs in the future, but that is a topic for another day. The conscious change of tack is understandable in the given circumstances. Let us see the reasons for this.

As elaborated earlier, a broad downward trend in interest rate movement has the potential to lull concerns on fortifying the system to weather shocks. There appears to be some ambiguity about the possible methods of risk containment that would be able to protect institutions.

While many of the global players have their own set of imported mechanisms for this purpose, some of the domestic participants are perilously in the dark. One possible reason is the absence of a strong regulatory framework as far as risk management is concerned. On the one hand, while this approach may be seen as allowing for liberty to individual participants to adopt their own desired methodologies, the glaring knowledge gaps in this regard may not necessarily permit this to get translated into reality.

Another obvious lacuna in the markets is the inability to convert a bearish interest rate view into profits. This is something which is quite taken for granted in most other markets. The sole instrument available as on date is the interest rate swap. First introduced in 1999, the swaps market has not been able to make much headway in terms of development. While the paucity of required skills and their distribution among market players is certainly one of the reasons, the hesitation evident in regulatory ethos is a serious hamper to the growth of this market. The not so pleasant experience of newer players in the unregulated OTC derivatives market has also put many plans on hold. Efforts to install a more structured exchange traded futures segment have yielded no results, once again due to regulatory obstacles. Absence of a strong derivatives market severely hampers efforts at hedging positions in the cash markets, which further adds to the risk quotient.

But there is a silver lining behind the clouds. Plans to overhaul the trading environment by introducing far reaching measures like introduction of short selling, when-issued markets, interest rate futures, etc. are on the anvil. Once these proposals see the light of the day, there is hope that fortunes of treasuries will get de-linked from interest rate scenarios. This will also lead to increased volumes arising out of the trading element which would resultantly curb extreme price volatility that is often experienced in the current scenario.