How banks and funds are gaming money markets in India

Banks and mutual funds in India are earning abnormally high returns in money markets by breaching central bank rules forbidding forward trades, multiple people involved in the practice said, undermining the effectiveness of monetary policy in the process.

The widespread practice, known as "river crossing", involves three-way trades in certificates of deposit (CDs) between banks and mutual funds and typically takes place at the end of every financial year in March when cash conditions in the banking system are tight.

The trades, which artificially push up short-term interest rates for about two weeks before they return to normal, have made it harder for the central bank's most recent cut in policy interest rates to have an impact on borrowing rates and in turn stimulate credit as economic growth languishes at a decade low.

The Reserve Bank of India (RBI) is already hamstrung by sluggish monetary policy transmission, meaning its interest rate decisions take six to 12 months to have an impact on the real economy, given relatively low credit penetration.

RBI also struggles to get banks to change rates soon after its own moves, even though 75 per cent of the banking system is state-controlled. In the past year, RBI has cut policy rates by 100 basis points (bps), but banks have lowered their own base rates by just 25 bps despite central bank prodding.

"This is artificially keeping the deposit rates on the higher side when it is not warranted, and that is aggravating the problem of transmission," said Rupa Rege Nitsure, chief economist at Bank of Baroda, after being told about the market practice during a phone interview with Reuters. She said she previously had not been aware of such trading. The impact of the activity can be seen in three-month certificates of deposit maturing in June, which traded this week at around 8.70-8.90 per cent, with some above 10 per cent, according to data from the Fixed Income Money Markets and Derivative Association Trade Reporting and Confirmation System.

The actual market rate was 7.95-eight per cent.

Such covert agreements involved trades of as much as Rs 40,000 crore ($7.4 billion), out of about Rs 1,80,000 crore due for maturity in March, according to rough estimates of two banking and two fund sources who declined to be identified.

"This is a critical time for monetary policy transmission. The cost of funds as well as lending rates should come down," Nitsure said.

The trades have taken place as India considers forming a unified regulatory authority that would assume oversight of trading in currency, bond and derivatives markets from the central bank. The proposal does not address regulation of money markets, handled by RBI. It was unclear whether RBI is aware of the practices. A spokeswoman for the

central bank declined to comment after being provided detailed verbal and emailed queries from Reuters.

How to cross the river

The trades mostly take place at the end of the financial year, when companies make tax payments and government spending slows, creating a liquidity shortage that drives up rates. Also during March, banks aggressively look to raise deposits to bolster year-end balance sheets, sucking more cash out of the market.

While rates typically ease in April as cash conditions return to normal, mutual funds look to generate extra returns by locking in March-level returns through forward contracts unwinding in April, according to at least 20 market participants with direct knowledge of the practice.

None of the nearly two dozen market participants wanted to be identified discussing deals that could draw scrutiny from the central bank.

After a bank agrees to issue a CD to a mutual fund, the fund then approaches a second bank to pay for that CD on its behalf. The second bank holds the CD, earning holding period interest as high as 20 per cent on an annualised basis, but agrees to sell the CD to the fund at a higher pre-determined rate at a future date.

The mutual funds tap the second banks to hold the CDs on their behalf as they are cash-constrained due to year-end redemption pressure.

However, the last leg of the trade breaches rules forbidding CDs to be booked at a forward rate. In a legal trade, the second bank would have to sell the CD back to the fund at the prevailing market rate, instead of the higher agreed rate.

In a more recent means of breaching rules, mutual funds and banks are entering into banned forward contracts by breaking up CDs with maturities of two months or more in order to skirt a regulation that came in to effect late last year that they must mark-to-market investments of over 60 days. The deals between banks and funds are done verbally instead of the typical contracts involved in the sale and purchases of CDs, thus evading regulatory scrutiny, the sources said.

“This is an OTC market, and since there is no reporting platform for primary CD deals, many take advantage, citing market imperfection if there is any query on rates,” said a dealer in a bank involved in the trades.

RBI had previously expressed interest in starting a primary reporting platform for CD sales to improve transparency in this market, one official with direct knowledge said.

Some bankers said they saw no harm in the trades.

“It is like the difference between tax evasion and tax planning. If someone is trying to find an opportunity to maximize returns, then why not?” one banker said.

(Business Standard)