An Indian spot currency trading platform

The RBI proposal is both noble and overdue, but it must avoid the creation of early monopolies or slicing and dicing the platform

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On October 12, 2017, the Reserve Bank of India (RBI) issued a discussion paper that proposes to establish a spot currency trading platform and allow retail consumers access to it. Today, retail consumers are largely at the mercy of banks when dealing in foreign exchange. Banks often decide the buying and selling rates for foreign exchange at the opening of business hours and retain the same rate through the day. Resultantly, buyers and sellers of foreign exchange end up missing the benefits of intra-day price movements. Moreover, most banks do not transparently disclose their charges for currency dealings. Hence, allowing direct access to an exchange-like platform for currency trading is a welcome move. This essentially means when one goes to buy or sell foreign exchange from or to a bank, the buyer or seller dictates the price. The bank will place the order on the exchange platform for execution. This is a good thing, as it places more control in the hands of the consumer and will bring down the costs associated with the forex service. However, the scheme for setting up the platform is riddled with three problems.

First, the discussion paper proposes to segment the trading platforms for retail consumers on the one hand and banks, which are the institutional participants in a currency market, on the other. It states, "The retail market will be separate from the interbank market." The discussion paper does not clarify the reason for dicing the platform into retail and institutional segments. Bifurcating an exchange into retail and institutional segments dilutes the principle underlying an exchange platform, which is to aggregate, buy and sell orders of all sizes and kinds. This gives buyers and sellers of assets the benefits of liquidity and efficient price discovery.

Compare this to a regular equity exchange, where buy and sell orders of all types and sizes are thrown into the same pool, and then matched on a price/time priority basis. In a regular order matching system, each order is time-stamped and matched to an order with an exact opposite position. Such order matching maximises the possibility of order execution for all kinds of participants, retail and institutional. It is difficult to envisage a financial market where retail market participants would be deprived of the liquidity provided by institutional participants. The proposal must be revisited in favour of a single platform that pools all orders, retail and institutional.

Second, the discussion paper proposes to allow only one player, namely, the Clearing Corporation of India Limited (CCIL), to offer the spot currency trading platform. In its defence, the paper says that other vendors will be allowed to offer similar platforms in due course. The proposal to monopolise the platform through CCIL in the beginning will deprive other players from the first mover's advantage, which is crucial for offering a platform-like service that runs on network effects. It has long been recognised that

TRADING SNAPSHOT

Traded volumes and number of trades in G-secs on NDS-OM and NSE platforms

Date	Traded volume on NDS-OM in ₹cr	Traded volume on NSE in ₹cr	Number of trades on NDS-OM	Number of trades on NSE
Oct 23, '17	23,079	225	2,059	6
Oct 24, '17	27,456	431	2,591	10
Oct 25, '17	36,063	690	3,268	20
Oct 26, '17	17,046	865	1,422	17
Oct 27, '17	50,163	942.50	4,193	27

Source: CCIL and NSE

financial market exchanges have positive network externalities. In industries with positive network externalities, the first mover advantage is critical as the value of the service directly depends on the number of users. To migrate users from one exchange to another at a later stage is costly and difficult. Creating statutory or quasi-statutory monopolies, howsoever temporary, can have adverse effects on competition especially in such industries.

India has witnessed a similar experiment in the past where a statutory monopoly has been created for the settlement of trades in G-secs. The Government Securities Act, 2006, creates a monopoly in favour of the RBI for the settlement of trades in G-secs, by mandating that all trades in G-secs must be settled in the Subsidiary General Ledger Account, maintained by the RBI. Additionally, the CCIL has been given the exclusive mandate for clearing trades in G-secs. These two monopolies virtually ensured that the NDS-OM, which is the RBI-operated exchange for secondary market trading in G-secs, became the largest repository of volumes and trades in G-sec trading.

While other exchanges were allowed to offer platforms for G-sec trading, a seamless transaction involving trading, clearing and settlement was possible only on the NDS-OM. The table gives a comparative five-day snapshot of the traded volumes and number of trades executed in G-secs on the RBI-run NDS-OM and the debt segment on the NSE, both of which started trading operations at about the same time. The difference between these two exchanges, on both the parameters, is tellingly staggering.

How do we regulate exchanges which trade spot currency contracts? First, in a partially capital account economy the rules governing inflows and outflows are laid down in the regulatory framework that imposes capital controls. The regulator's job is to ensure people buy foreign currency and repatriate it abroad in compliance with these rules. In India this is done through authorised dealer banks which report the inflows and outflows of foreign exchange in the accounts held with them under the provisions of the Foreign Exchange Management Act, 1999. Hence, no specific intervention is warranted in the currency spot trading market from the perspective of India's rules on partial capital account convertibility.

Second, there are two possible market failures arising out of this platform. First, the systemic risk issues arising out of default in honouring matched trades. This can be taken care of through appropriately designed margining systems, as are applied for the membership of every central counterparty clearing platform. Second, consumer protection issues involved in the sale and advisory functions associated with buying and selling foreign exchange. This needs regulatory oversight akin to any other financial product that is sold or bought in India today. Finally, there is a risk of market abuse, that is price manipulation, which can similarly be dealt with by an appropriate market abuse regime.

Third, a review of international jurisdictions shows unlike the proposal in the RBI discussion paper, spot currency dealing platforms are offered by regular exchanges worldwide. In the European Union, a long-standing debate on whether currency contracts settled in the T+2 cycle should be regulated at all or not was settled in favour of not including spot currency contracts in the MiFID II (Markets in Financial Instruments Directive II). Similarly, spot currency contracts in the UK, US and Australia are regulated only from a consumer protection perspective.

To conclude, the proposal to finally allow the introduction of spot currency trading platforms where consumers get the benefit of the best price for currency bought and sold, is both noble and overdue. However, it is important that we get it right, by avoiding the creation of early monopolies or slicing and dicing the platform, to ensure that its benefits percolate to those for whom they are intended.

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