Jayanth R Varma: More noise, less effect

Jayanth R Varma / New Delhi October 19, 2007

It would be ironical if the proposal designed partly to lower capital inflows actually increases them.

Sebi's proposal to restrict the issuance of participatory notes by foreign institutional investors (FIIs) was widely commented upon in this newspaper yesterday. I agree with much of this discussion, particularly the suggestion that we should move away from the FII framework to a regime of direct access to various classes of foreign investors while also simultaneously developing a domestic OTC equity derivative market. Rather than repeat all this analysis, I would focus on the details of Sebi's proposal on participatory notes.

Sebi's first proposal is to ban participatory notes that have a derivative as the underlying. From all the discussion that one has seen on this proposal, the intention appears to be to ensure that a participatory note is backed by a cash market position and not a derivative position.

If Sebi does indeed wish to ban the use of derivatives to hedge participatory notes, it should say so in that many words. A financial regulator should respect the semantic integrity of well defined technical terms and not abuse the term "underlying" to mean what it does not and cannot mean. In this context, the use of the word "against" before the word "underlying" in regulation 15A of the FII regulation is also unfortunate as that word is perhaps the source of this confusion.

The term "underlying" is a technical term with a well-defined meaning in the world of finance. The underlying of a participatory note is the instrument from which the participatory note derives its value; it is the instrument which is delivered on the settlement of the participatory note or with reference to whose price the participatory note is cash settled. The "underlying" in this technical sense has nothing to do with the portfolio that the FII uses to hedge the participatory note. A participatory note that is cash settled using the Nifty index futures price has the future as the underlying even if the FII hedges it using cash equities. Similarly, if the participatory note is cash settled using the cash price of the Nifty index, its underlying is the cash index and not the index future even if the FII hedges the note using index futures.

Putting semantics aside, I now turn to the substance of the proposal. If Sebi bans the use of derivatives to hedge participatory notes, it would have three implications. First, since cash equities are less liquid than the futures, the hedging costs would increase. The hedging risks could also increase as the volatility risk of options cannot be hedged using only the cash market. The FII would, therefore, have to charge a wider spread to its clients. This "sand in the wheels" would impede the use of participatory notes but not eliminate it.

Second, Sebi's proposal would prevent participatory notes that involve a short position in Indian equities since short selling is not feasible in the cash market today. Since short selling is essential for a well-functioning market, this is clearly an undesirable consequence of the Sebi proposal.

Third, it would prevent the issuance of participatory notes that are essentially synthetic rupee money market instruments because these synthetics can be created only by offsetting positions in cash and futures markets.

The second major proposal of Sebi is to ban participatory notes issued by sub-accounts. In my view, this is largely an administrative measure which would not have a significant long-run impact.

Sebi's third proposal is to limit participatory notes' issuance by any FII to 40 per cent of the assets under custody of that FII. Today, the issuance of these notes is concentrated in the hands of a few FIIs partly because of their superior skills in running a derivative hedge book and partly because of the economies of scale in this business. Sebi's proposal would force buyers of participatory notes to buy from less efficient hedgers and, therefore, incur greater costs. This would amount to more "sand in the wheels" whose long-term impact would be modest.

I also believe that the 40 per cent limit can be circumvented by an FII buying cash equities and selling stock futures or index futures. This synthetic rupee money market position would not increase the FII's exposure to the Indian equity market but it would increase assets under custody and allow the FII to issue more participatory notes. In the context of a strong rupee and a positive interest rate differential, this synthetic money market position may also be a profitable low-risk investment for the FII. It would indeed be a delicious irony if a proposal designed partly to reduce capital inflows leads to more capital inflows.

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