G Padmanabhan: Changing contours of debt management

Address by Mr G Padmanabhan, Executive Director of the Bank of India, at the Annual Meeting of the Primary Dealers Association of India, Mumbai, 17 January 2015.

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1. Mr Sharan, Mr Sridharan, office bearers of Primary Dealers Association of India (PDAI) and other colleagues from banking fraternity. India, like other Emerging Market Economies (EMEs), has been impacted by the global financial crisis, European sovereign debt crisis and related developments. We were certainly bruised, but not battered. This led to increased volatility and uncertainty in the financial markets. Like other economies, we had also embarked on a program of fiscal stimulus to revitalise the economy resulting in accelerated borrowings. As a result, gross market borrowing of Government of India has increased by nearly 400 percent during last seven years. During 2008–10, we front loaded the borrowing, de-sequestered MSS balances and shortened average maturity of issuances to successfully complete the large borrowing programmes. Once the markets stabilized, we embarked on elongation of maturity. During these years, Reserve Bank has continued development of the G-sec markets by a series of measures such as, introducing new instruments, expanding the investor base, strengthening market infrastructure, etc. As a result, we have today, a world-class trading and settlement infrastructure, reasonably deep and liquid markets, a stable domestic investor base and keen foreign investor interest. On the sustainability front, the debt ratios are reasonable and there is political and administrative commitment for fiscal consolidation.

2. The present market conditions are guided by a host of varying factors, like change in monetary policy stance in India and commitment to inflation management, reasonable stability on currency front, current account deficit under control, fiscal consolidation path but at the same time a fast changing geo-political landscape. Weakening commodity prices including plummeting crude prices, weakening Euro Zone economy, signs of strengthening US economy, signs of growth slowdown in China and at the same time emergence of a stable government in India are shaping the contours of Indian financial markets.

3. We have been successful in running the huge government borrowing programme in a cost effective and risk efficient manner. This would not have been possible without the active participation of the primary dealers who are one of the most important stakeholders in the conduct of the government borrowing programme. To put this in perspective, PDs have subscribed to nearly half of the notified amount in the primary auctions of GoI dated securities during past two years. The share of PDs subscription in T-Bills auctions during last two years is impressive as they picked up nearly three fourths of the issuances. Share of Standalone PDs in secondary market volume in 2013–14 was around 15%.Thus the primary dealer system has grown and showed resilience even in challenging market conditions thereby ensuring non-disruptive borrowings.

4. However, we cannot rest on our laurels. We have to gear up for the future. The government is committed to fiscal correction path and fiscal consolidation but challenges abound for the bond traders and markets. Going forward, the gross bond supply would remain elevated even after fiscal consolidation as the government is likely to continue running fiscal deficits in the foreseeable future due to the accumulated debt stock that needs to be rolled over as also the country's growing GDP. The demand for bonds would be impacted among other factors, by the likely pickup in the private sector credit, scaling down of SLR and HTM, the policy stance on foreign portfolio investment in G-sec, etc.

5. With regard to foreign investment in domestic financial markets, our policy has been to increase access in a calibrated and gradual manner. Though we are sensitive to the

demand for opening markets to foreign investors, the advantages of widening and diversifying investor base which improves demand for government bonds need to be kept in view along with the considerations about financial stability arising from sudden-stop and reversal risks. These risks manifested during the taper tantrum. Our markets were liquid enough to enable large transactions in an orderly fashion and this is one of the factors that inspired confidence among global investors and influenced their return. However, the financial stability implication of "investment tourists" exiting at a whiff of trouble has always to be kept in mind as we progress along the path of liberalization.

6. In this context, it may be worthwhile to comprehensively debate on the issuance of sovereign bonds abroad either in INR or foreign currency vis-a-vis enhancing the limits domestically for international investors including the pros and cons of joining various emerging market indices.

7. In this regard, as you may be aware, there are proposals for allowing international settlements of Indian government bonds through global securities settlements systems like Euroclear. Such settlements could potentially improve acceptability and attractiveness of Indian bonds among foreign investors. However, there is also a view that one needs to be conscious of the downside risks such as liquidity getting fragmented as some of the FPIs presently operating in India may like to move off-shore and development of a parallel Government securities yield curve outside India [creating yet another NDF-like market overseas with all the attendant issues]. You may perhaps like to debate this issue as well during the course of your deliberations.

8. Let me now flag a few issues related to market development and where we see the role of PDs.

(a) Auction Participation

(i) Active Participation: Obviously we expect your continued active participation in both the primary and secondary markets for G-Sec and in bringing in new investors to the market. Active participation is expected across all maturities, not only in benchmark bonds. To meet the diverse funding and hedging needs of the participants, there is need for a wide array of instruments and products which would also offer benefits of portfolio diversification. Over the years, several instruments like zero-coupon bonds, floating rate bonds, Separate Trading of Registered Interest and Principal of Securities (STRIPs), bonds with call and put options, cash management bills, inflation indexed bonds, etc. have been introduced after wide consultations with market participants. The success with regard to these products has been disappointing. We look towards primary dealers to be active not only in auctions of fixed rate bonds but also to contribute significantly to popularizing other interest rate products.

(ii) Responsible Bidding: Responsible bidding is expected from PDs and we look to them as providers of valuable information with regard to pricing of the bonds in auctions. I am afraid that our expectations on this count are not fully met at least in some cases. The bidding behavior of actively cornering commission in underwriting auctions and defensively bidding in auction to avoid allotment does not do justice to the PD role. I want you to reflect on this and also cogitate on whether a system of "success ratios for dated G-Sec Auctions" is an open option to encourage responsible and tight bidding in auctions or a negative incentive could be thought of for curbing wayward bidding and aid in better price discovery.

(iii) Robust Business Model: The primary dealer business is exposed to interest rate cycle and adverse movements would expose their balance sheets to losses. Further, geo-political and economic risks and consequent volatility in domestic or international financial markets could potentially damage the financials. This risk is amplified for standalone PDs due to small balance sheet size. It is essential that PDs have strong financials and risk management capabilities. In order to protect PDs from downside risks, Reserve Bank has allowed PDs to diversify their businesses. However, only a couple of PDs have diversified.

The PD Boards must review the corporate strategy and de-risk the business from vagaries of interest rates and financial market volatility.

(iv) *Exclusivity*: An issue that has been debated for some time is whether we can think of exclusivity to primary dealers. Exclusivity would enable issuer to sell bonds easily and also strengthen primary dealers. However, exclusivity gives commercial advantages and this aspect must be kept in mind in a market where major investors have regulatory and statutory mandate to invest in government securities. In a situation, where some of the primary dealers are banks, exclusivity would mean that level playing field does not exist for access to SLR assets. Further, standalone PDs with small balance sheet size and limited holding capacity need to reflect on huge demands exclusivity would impose on them, given the large size of issuances.

(b) Market Making

Primary Dealers are mandated to make markets in G-sec and provide liquidity. However, market making efforts of PDs are limited to few liquid bonds. Once RBI starts rolling down the HTM limit, forcing churning of portfolio by banks, particularly in the public sector, PDs get to play a more active role in market making.

Gandhi Working Group had recommended that one of the ways for improving liquidity is to consider allocating specific securities to each PD for market making and, if required, rotate the stock of securities among the PDs at periodic intervals. This would ensure continuous availability of prices for a select group of securities. Reserve Bank is in consultation with Government and PDAI to operationalise this recommendation. Initially semi-liquid securities would need to be chosen. We plan to operationalise the market making scheme in the next fiscal and expect significant improvement in liquidity. In this context, the present annual minimum turnover ratios of 5 times for Government dated securities and 10 times for T-Bills/CMBs of the average month-end stocks need to reviewed as the market has grown significantly during recent years and the prescribed turnover ratios are far too low at present.

(c) Market Development

(i) *Widen investor base*: It is the responsibility of the primary dealers to provide liquidity in government bonds as well as interest rate products. In order to do so, PDs need to make efforts to widen the investor base, distribute securities more efficiently and bring in retail and mid-segment investors. Reserve Bank has imposed targets for retail and mid-segment business, but PDs must cultivate the clients as a business opportunity rather than regulatory compulsion. Even now certain entities are depending on brokers to buy G-Sec at high costs. PDs need to expand their reach and PDs reluctance to do so in this technology driven era raises fundamental questions relating to their commitment.

(ii) *Develop Interest rate derivative markets*: Another aspect of market development is to deal in interest rate derivatives and provide liquidity. As entities dealing in interest rate risk, it is surprising that PDs are not active in using the derivatives for hedging and trading. IRS market is still dominated by select foreign banks. Reserve Bank permitted cash settled Interest Rate Futures (IRF) on 10-year Government of India security with settlement price based on a single benchmark bond after extensive consultations with stakeholders. The IRF has received reasonably good response from the market with average trading volume at around Rs. 3000 crore. However participation is not widespread as many market participants including PDs are yet to start using the product. PDs, as expert investors are expected to actively use the available products to hedge. This would perhaps call for PDs warehousing more securities for market making. The interest rate risk that this may entail needs to be mitigated through greater participation in the IRF market. Why this is not happening needs serious soul searching.

(iii) *Market Intelligence:* Debt management operations of the sovereign, especially large scale borrowings can be accomplished only with active engagement with all stakeholders.

We have been meeting the market participants regularly and exchanging views on several issues such as auction calendar, demand, maturity of instruments, introduction of new products etc. PDs have been great sources of information and provided valuable inputs while preparing the auction calendar and introducing products like inflation indexed bonds, interest rate futures etc. We would like to keep the channel of communication free and open.

(iv) *Prevention of market abuse*: As you all know, the recent instances of market manipulations in major global financial markets have seriously undermined the integrity and stability of financial markets. Market regulators across several jurisdictions have strengthened their surveillance system over the financial markets for curbing market abusive practices and so has been the case with RBI. During the last few years, the Indian G-sec markets have witnessed significant increase in its depth and breadth with increasing participation of cash-rich corporate entities with large treasuries and foreign portfolio investors. There have been instances of off-market transactions especially in the OTC segment involving institutional clients of the Banks/PDs. The PDs, being the responsible players in the market, have to take appropriate steps to educate and sensitize their clients so as to refrain from such unethical trading practices.

(d) Issues for Reserve Bank

Our debt portfolio is reasonably stable and sustainable and due to our conscious strategy of elongation of maturity, low level of foreign currency debt, large domestic investor base, risks are at a low level. There is, however, an unfinished agenda of consolidation of public debt. Going forward in the medium term, we will continue to follow the principle of predictable and transparent issuances by sharing information with market participants. The endeavour to build a low risk portfolio at a low cost in the medium term would also continue as hitherto. The measures to elongate maturity for reducing rollover risk and large benchmark issuances to foster liquidity would go on. We are planning to carry forward operations to smoothen the liability profile of the government through an active switch / buyback program and release a switch calendar along with the indicative half year calendar for issuance of bonds. Our efforts to improve liquidity would continue with special focus on building liquidity in state development loans. As announced, work on allowing re-repo of G-sec is underway. We will be pursuing the goals of debt management in close coordination with all the stakeholders including primary dealers.

9. To conclude, the market borrowing programme of the government is being conducted in a non-disruptive manner in spite of large increases in quantum. The PD system performed well by helping build a stable, dependable source of demand for securities in primary market and providing liquidity in secondary market. However, there is need for gearing up and continuing the good work in the future as the elevated supply is expected to continue and the geo-political and economic risks could engender volatility. The need of the hour is to build resilience and strength of the balance sheets and participate in both primary and secondary markets including corporate bonds actively. The moot point is as to how research and seminars can be converted in to action. The Reserve Bank recognizes PDs as valuable stakeholders and would continue to work closely in achieving common goals.

10. I wish the conference a great success.