Mr Reddy looks at some issues in developing the government securities market in India

Inaugural address by Dr Y V Reddy, Deputy Governor of the Reserve Bank of India, at the Seminar on Government Securities Market organised by Primary Dealers Association of India, Calcutta, on 4 January 2000.

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Mr Ramesh and friends,

I am happy to be here with you today at the Second in the series of seminars conducted by the Primary Dealers Association of India. Since I delivered the inaugural address at the first seminar in Chennai last year, the number of Primary Dealers (PDs) has increased from six to fourteen. So, let me welcome the new additions to the family at this Seminar.

I participated in a Bank for International Settlements meeting last month in which one of the subjects related to debt markets. During the discussions, it became evident that after the recent Asian crises, the issue of development of domestic bond market has gained credence. Many central banks of emerging markets have recently shown interest in developing their debt markets. They were appreciative of the fact that we in India concentrated on financial sector reform early in the reform cycle, and we are focussing not merely on development of equity markets but also on debt markets, especially Government Securities market.

Among the initiatives taken by Reserve Bank of India (RBI) in developing the Government Securities market, undoubtedly the institution of PDs is very significant. The RBI initially promoted and owned a primary dealership; and within a few years, divested itself of controlling interest. Soon, domestic financial institutions promoted some Primary Dealerships. More recently, we have PDs with the benefit of international experience. The RBI believes that this is an appropriate path and pace for bringing about gradual but speedy and sustainable reform in the financial sector.

The RBI has been closely coordinating with Primary Dealers on a number of policy and operational issues, both through continuous consultations with the Primary Dealers and through Mr Ramesh's membership in the Technical Advisory Committee on Financial markets. And, I must place on record that we are appreciative of the contributions. Together, we are ahead on the learning curve in this regard, and we will continue to learn from the experience gained from our own reform process and from the international experience.

Developments in government securities market

Let us briefly recall the objectives of reforms relating to the Government Securities market in India since 1991-92. First, reform has aimed at increasing the operational autonomy of the RBI by measures such as abolition of automatic monetisation through Ad Hoc Treasury Bills and introduction of a system of Ways and Means Advances for the Central Government. Second, improvements in institutional infrastructure were sought to be achieved through the system of PDs. Third, the breadth and depth of markets were sought to be improved by introduction of a variety of new instruments (fixed coupon, floating rate, capital indexed bonds, 14/91/182/364-day T-Bills, Zero Coupon) and improvements to market microstructure (yield based and price based auctions, tap loans, pre-announcing notified amounts, non-competitive bids outside notified amounts, reissue of dated securities, announcing calendar of T-Bills, DVP system, underwriting by PDs, liquidity support). Fourth, progress in enabling sound legal and regulatory framework has been demonstrated by the Amendment to Securities Contracts (Regulation) Act and proposals for introduction of Government Securities Act. Fifth, technology related developments include initiation of computerisation of all Public Debt Offices of RBI and of real-time gross settlement systems. Finally, in RBI and in its relations with market participants, high on the agenda are improvements in transparency and introduction of standardised codes for market practices, for example, through dissemination of information by RBI, monitoring of market activities and encouraging standardised accounting norms.

Before I dwell on reviewing progress in reforms, I would like to spend a few moments on reviewing the management of the market borrowing programme during the current year, in which both the RBI and PDs are closely involved.

The market borrowing programme during the current year has been large and there were occasions when the RBI had accepted private placements that were later released to the market when interest rate expectations became favourable. Some PDs have expressed that this strategy has deprived them of business, but such a decision has always been taken by us after assessment of the market situation and in my view it has minimised the risk on PDs. During the year, we prolonged the maturity structure and thanks also to the role played by PDs, it has been possible to elongate the maturity to 20 years. Over 60% of the dated Government Securities issued during 1999-00 had a maturity of 10 years or above. As a result, the weighted average maturity during the current fiscal year so far increased to 13.03 years as compared with 7.07 years during the corresponding period of the previous year. Another noteworthy aspect of the internal debt management operations has been the shift from yield based auctions to price based auctions. This has resulted in a number of beneficial impacts. First, with larger amount of outstanding stock in each security, the liquidity in these securities has improved. Second, it has led to a more efficient price discovery process in primary auctions as reflected by the considerable narrowing in the range of bids in yield terms. Third, the opportunity of reopening existing issues has been used to undertake passive consolidation of debt, which has resulted in evolution of benchmark securities and also improved the liquidity in the market.

For the record, let me narrate the specific reform measures relating to the market that have been implemented during the current year. These are: apart from price based auctions, reintroduction of auction of 182-day Treasury Bills, issuing a calendar of T-Bills issuance, a system of minimum bidding commitment of PDs to cover 100% of notified amounts in T-Bills auction, underwriting by PDs of 100% of notified amounts in respect of dated Government Securities, permission to non-banking entities to borrow and lend money in the repo market and availment of special ways and means advances by State Governments against collateral of T-Bills in addition to dated securities.

Progress in reforms

A number of other reform measures are in different stages of implementation and the Primary Dealers Association is actively involved in most of them. It is useful to recall the status and flag issues for further consideration.

Widening the repo market

A sub-group of the Technical Advisory Committee on Government Securities Market had prepared a Technical Paper on Repos, which had been circulated among major players in the market for comments. Three of the recommendations of the sub-group were announced for implementation in the monetary and credit policy of April 1999. These related to permitting non-bank entities who were hitherto permitted to undertake only reverse repos to borrow money through repos; issuing clarifications regarding maximum period for repos and allowing repos to be undertaken in all PSU bonds and bonds issued by corporate and financial institutions held in dematerialised form in recognised stock exchanges.

In order to operationalise the recommendation relating to widening the repo market, another sub-group was constituted to go into the legal and regulatory aspects of setting up a Clearing Corporation. The sub-group is in the final stages of submitting its Report. Once the Clearing Corporation is established, it will pave the way for introduction of over-the-counter and tripartite repos. I would appreciate your views on the scope and modalities for such a Clearing Corporation.

Incidentally, we are vigorously pursuing with the Government the issue of clarification on applicability of stamp duty to enable widespread dematerialisation.

Standardised practices and uniform codes

There are a number of other recommendations of the sub-group on repos that deal with existing systems and procedures in the context of standardised practices and uniform codes. These relate to uniform accounting practices, master repo agreement, code of conduct for repos, etc.

I would urge the Primary Dealers Association and FIMMDAI to coordinate and implement these recommendations as quickly as possible, since as I understand, these are issues where participants themselves can work out the modalities for implementation.

Legal and regulatory issues

A landmark development in the regulatory framework in the financial sector relates to recent amendments to Securities Contracts (Regulation) Act 1956. With the amendment, it is possible by Government to delegate some responsibilities to the RBI.

These amendments would help RBI put in place, from time to time, appropriate regulatory frameworks, keeping in view rapid changes in financial institutions, instruments and practices governing money, Government Securities and forex markets, apart from gold-related financial products. With the delegation of powers by Government to RBI in these matters, the procedural delays and constraints can be eliminated.

There are two major issues in regard to regulation in the financial sector which need attention. The first relates to regulation of private placements in debt markets. There are several possibilities and these are being explored by a Technical Committee. I hope these would be resolved soon. Recognising the urgency, RBI has been highlighting this issue in the last couple of years and more recently, the unregulated nature of the private placement market has come in for adverse notice among international financial analysts. The second relates to regulatory gaps and overlaps in financial sector, which could be resolved by formalising, with some changes through a statute, the Informal High Level Committee on Capital Markets. If you are interested in details, you may seek them during technical discussions and oblige us with your comments.

On the repeal of the Public Debt Act 1944, and the introduction of the Government Securities Act, the draft Bill has been circulated to state Governments for concurrence. The RBI is following up vigorously with the Central/State Governments to obtain their approval.

I am sure you would also be interested in early passage of this Bill. We have been assured of early action by the Ministry of Finance, the Government of India and Finance Secretaries of State Governments.

Technology issues

The RBI has just commenced a project for complete automation of the operations of RBI’s Public Debt Office. It will provide for connectivity between different PDOs, and facilitate on-line screen based execution for trade settlement in Government Securities transactions. The project will be implemented in phases. The first phase will cover the PDO computerisation at Mumbai and facilitate screen based negotiated dealings in Government securities and money market instruments, tendering of screen based applications in auctions, full-fledged audit trail, debt servicing, information dissemination, price list for open market operations, central information system for access by monitoring and regulatory authorities, etc. It is expected that the first phase will be operationalised well within a year. In the second phase, other regional PDOs would be linked with the central PDO system. This phase will facilitate active open market operations of RBI through all regional PDOs. The entire project is expected to be operationalised in about a year. The RBI is also separately putting in place a real-time gross settlement system, which is scheduled to be operational within the same time frame.

Do let us know if you have any suggestions to make in this regard and we will consider them seriously - since close interaction between the Public Debt Offices and PDs is very critical.

Current issues

Now, I will turn to some other issues that are currently engaging our attention.

Retailing of government securities

The growth in the Government Securities market has perhaps not been adequately reflected in the depth of the market as the main investors continue to be commercial banks, insurance companies and provident funds. Consequently, the retail segment of the market has not developed. While alluding to this issue in my earlier speeches, I had noted that there is an inherent potential for households to diversify their investment portfolio encompassing Government Securities. With this in view, commercial banks were given the facility of a second SGL account to enable them to hold Government Securities on behalf of customers in safe custody in demat form. The feedback received is that many large banks with country-wide networks have yet to make this facility available to their branch customers. Similarly, not much headway has been made in retailing Government stock by NSE, NSDL and NSCCL, which were also given the facility of a second SGL account.

We in RBI are totally convinced that there is need to promote and publicise gilts as an investment instrument and we would greatly appreciate your cooperation in this endeavour. There is scope to reduce the cost of borrowing to Government by retailing and the investors, especially small investors, will benefit by access to safe gilt edged securities. I am sure there is good business potential for PDs also.

Currently, the counterparties to PDs in the secondary market are predominantly PDs themselves and commercial banks. But, we understand that many urban and other cooperative banks are maintaining deposits with eligible institutions to comply with SLR stipulations merely because they are not easily able to find Government Securities. NBFCs also seem to be facing a similar problem. RBI would urge that PDs take special efforts to satisfactorily meet the demand of this segment.

In a competitive environment, considerations of safety, liquidity and reasonable return appeal to retail investors and Primary Dealers should take up the task of building up awareness regarding these characteristics in Government Securities among retail investors. We hope that the Primary Dealers Association would be more proactive in publicising the advantages of holding Government Securities.

Despite my repeated requests, I have not seen brochures or advertisements issued by the Primary Dealers Association on the Government Securities market. Permit me to reiterate that the RBI is willing to extend full cooperation to you in this endeavour.

It is recognised that there are a few structural and tax issues that render Government Securities somewhat unfavourable as compared with other financial instruments available to savers. First, the rates of interest paid on small savings and tax exemptions available to such instruments cause a dampening impact on retailing of Government Securities, and also increase the cost to Government. Secondly, interest income from Government Securities is subject to tax beyond a certain level, while for some other instruments, such a ceiling does not exist. It can be argued that exemption from dividend tax for Gilt Funds is justifiable on the same lines of equity mutual funds. Of specific interest to PDs is the matter relating to tax deduction at source on the interest income earned on call/term/notice money transactions. Let us hope that these matters will be resolved soon.

Auction based market borrowings of state governments

Consistent with developments in financial sector reform, the RBI has taken a few important initiatives with respect to state finances. First, the RBI has been holding periodic meetings with State Finance Secretaries, where important policy issues are discussed. Second, in order to reflect market realities, currently the coupon rate for State Government Securities is being pre-determined at about 25 basis points over the coupon rate for Central Government Securities of similar maturity. However, financial markets are becoming conscious of the levels of fiscal management of different states. Further, under the current system, there is no scope for better managed States to access funds at competitive rates of interest. Third, an option was given to the State Governments to enter the market through a flexible approach on their own to the extent of 5 to 35% of their gross borrowings. Some States have already exercised this option. The ultimate aim is to make all the States raise the entire market borrowings in a flexible manner.

Some State Governments have indicated that they would like PDs to play a larger role and PDs may also find substantive business opportunities in this process. I would urge PDs to discuss this subject in today's meeting. It may be of interest to note that in the deliberations with State Finance Secretaries, two options on the role of PDs were flagged, viz., underwriting of State loans by PDs and issuing loans through bookbuilding exercises undertaken by PDs.

Separation of monetary management from debt management

Recently, there has been renewed articulation of a view that Government debt management be separated from monetary management by RBI. Let me share with you our position. An Informal Working Group was set up within RBI to examine the issue internally. The Group was of the view that the RBI needed to exit its role as a debt manager in the interest of price stability and favoured separation of debt management from monetary management. The Group suggested taking out all issuance and debt management related activities from the RBI and assigning them to a separate institution to be set up for this purpose. The RBI would then retain only core activities related to monetary policy operations such as undertaking open market operations including repos, carrying out Bank's own investment activities, undertaking market making functions and regulating the Government Securities market.

The recommendations were examined within the RBI. There seems to be little evidence that in the current stage of market development, and given the large market borrowing programme of Government, separation of the two functions would result in a more advantageous situation than is the case now. While it can be argued that separation of the two functions may put pressure on the Government to reduce its borrowing requirements, on balance it may be better to coordinate the two functions for the present, while vigorously pursuing with Government a reduction in Government borrowings to more sustainable levels and developing the Government Securities market further.

It has been concluded by us that while status quo could continue, the issue will have to be reviewed from time to time. Perhaps, after some more progress in fiscal consolidation and after the adoption of Fiscal Responsibility Act, the issue could be revisited appropriately.

Revitalising the Treasury Bills market

There has been some concern about lower primary market response and reduced secondary market activity in Treasury Bills during the current year. Market interest rate in T-Bills is seen to be generated only when call money rates fall below the refinance rate of 8%. In the primary auctions, the number of bids and the aggregate volume of bids have been very low. Most of the bids are from PDs, perhaps because they have bidding commitments to fulfill. There is little trading in the secondary market in the T-Bills segment and market participants have been complaining about lack of liquidity in T-Bills.

These issues were addressed in the Technical Advisory Committee on Financial Markets based on a Report of an Internal Group constituted to look into related issues. Basically, the issues flagged for further debate are: (i) whether there is a case for cutting down the number of T-Bills that are currently being auctioned; (ii) whether there is a case for increasing the notified amounts in the auctions; (iii) whether the PDs should be allowed exclusive access to primary auctions of T-Bills; (iv) should the RBI withdraw itself from primary auctions of T-Bills and restrict its operations to the secondary market? If so, whether the RBI should give two-way quotes at all times or enter the market at its own will? (v) If the RBI's operations are restricted to the secondary market, should its dealings be restricted to PDs or should it operate with all participants?

PDs may like to discuss these and other issues and favour RBI with operationally feasible plan for its consideration.

Valuation of banks' investment portfolio

The banks have a large portfolio of Government Securities and the method of their valuation is of special interest not only to RBI and bankers, but also to PDs who deal significantly in the market. Currently, banks have been asked to bifurcate their investments into Permanent and Current categories. We had earlier said that our endeavour is to reduce the proportion of investments under the permanent category in the banks' portfolio with a view to achieving 100% marking of portfolios of commercial banks. The policy of valuation, apart from reflecting the fair value of securities, has also encouraged increased trading in the secondary market as many banks restructured their existing portfolios by substituting old loans for new loans. However, on a request to review this approach, an Informal Group was set up in RBI and the Report has been circulated as a Discussion Paper on the RBI website. After studying the international experience, the Group recommended that banks may classify their entire investments into three categories, viz., Held for Trading, Available for Sale and Permanent. The Permanent category should not exceed 25% of total investment. The Group recommended that securities classified as Held for Trading should be marked to market monthly, if not more frequently. Securities in Available for Sale was recommended for marking to market at the year end or at more frequent intervals as decided by the Board of Directors. Securities held in Permanent Category can be carried at cost or market value whichever is lower.

If you do find it worthwhile to vent your views, perhaps in consultation with bankers present here, please do so and come back to us soon.

Active consolidation of government debt

As mentioned earlier, we made a beginning during the current year with regard to consolidation of Government debt. Consolidation has improved the liquidity in the market with consequent reduction in the liquidity premium. Encouraged by the results, we would now like to embark on an active programme of consolidation consistent with the market borrowing programme of Government. Currently, there are about 98 outstanding loans with residual maturity of up to ten years, covering 78% of outstanding value. There are 20 loans with maturity over 10 years covering the remaining 22%. Over the last few years, the investor profile in these loans has changed, partly reflecting the valuation norms introduced by the RBI. A number of banks have resorted to substitution of old loans for new marketable loans. Keeping all these developments in view, some options can be explored. Wherever there are a large number of fragmented issues in any year, these could be consolidated through recall of some loans against reissue of others. Another option is to convert loans maturing, say in the next few years into certain actively traded securities coinciding with the same maturity or with elongated maturity. Even if this does not result in reduction in the number of outstanding loans, the objective of improved liquidity in a few benchmark securities will be achieved. PDs may like to examine these issues in greater detail.

Operationalising liquidity adjustment facility

The Committee on Banking Sector Reforms (Narasimham Committee II) had suggested that the RBI's support to market should be through a Liquidity Adjustment Facility (LAF). Under this facility, the management of liquidity by the RBI will have to be through repos and reverse repos at rates reset by the RBI periodically, if not daily. Pending upgradation in technology and legal/procedural changes to facilitate electronic transfer and settlement, the RBI operationalised an Interim Liquidity Adjustment Facility (ILAF). Under this facility, injection of liquidity to banks/PDs is by way of collateralised lending at predetermined interest rates and absorption of liquidity is by way of fixed rate repos.

An Internal Group in the RBI has been set up very recently to consider further steps towards a Liquidity Adjustment Facility by considering interrelated aspects of making the Bank Rate a true signalling rate, delinking Bank Rate from repo operations and substituting ILAF with LAF. This would also imply that liquidity support to PDs will need to be reviewed. Regarding PDs, the view is to move over from the system of liquidity support at a fixed interest rate in phases. In the first phase, the Additional Collateralised Lending Facility could be at a variable interest rate. In the second phase, both Level I and Level II liquidity support could be at a variable interest rate and in the final phase only a minimum level of support could be assured without any assurance regarding the rate. The timing, phasing and sequencing are all issues that need to be worked out.

While the PDs may prefer the comfort of assured liquidity at a fixed interest rate, the compulsions of liquidity management and interest rate operations demand that we ensure alignment between support to PDs and other monetary operations of the RBI. The real issue is one of smooth transition from assured liquidity support at pre-determined interest rates to a market determined liquidity support from RBI.

PDs may discuss this in the overall framework of reforms in the financial sector and effective transmission of monetary policy.

Concluding remarks

Friends, I have flagged a few issues that are currently engaging our attention. I have also spelt out the thinking in the RBI on these issues. As I have already mentioned, I would urge the PDs to deliberate on these issues and forward their view to the RBI.

I wish the deliberations all success.