**PDAI Chairman's Address**

Respected Mr. B P Kanungo, Deputy Governor, Reserve Bank of India, Mr. Vasily Pozdyshev, Deputy Governor, Bank of Russia & Guest of Honour, Mr. Prasanna, Chairman, FIMMDA, my fellow board members from FIMMDA and PDAI, my dear friends and colleagues from the industry, Ladies and Gentlemen.

A warm welcome to you all to the 20th edition of the FIMMDA & PDAI conference taking place at Moscow today.

"May you live in interesting times" This is a Chinese proverb which accurately reflects the current world order where we move from one crisis or shock to another and conditions change faster than what we have been used to in the past. Today, important global policy changes/intentions are first announced on twitter. Can anything be more interesting than that?

The year 2018-19 was clearly an interesting year with the two halves having diametrically opposite narratives. During the first half, bond yields rose sharply with the benchmark 10 Year yield rising from 7.40% to 8.20% on the back of rising crude oil prices, sharp fall in INR exchange rate and expectations of higher CPI inflation on the back of sharp MSP hikes which exerted pressure on bond yields. RBI raised its policy rates by 50 bps and changed the stance to one of 'calibrated tightening'. However, all this changed during the second half as crude prices fell off the cliff after OPEC increased output and Iran sanctions proved less daunting than feared. Brent crude prices fell from more than USD 85 per barrel in early October to near USD 50 per barrel in December 2018. US bond yields also peaked in November around 3.25%, and subsequently trended down as trade war uncertainties and weak data elsewhere led markets to reprice US Fed rate hike prospects. There were large domestic triggers as well. The key upside risk to food inflation in particular from sharply higher MSP's announced in the early part of fiscal did not crystalize, and in fact food inflation contracted 0.7% year on year in the second half of fiscal. The crisis in the shadow banking space triggered by IL&FS default aggravated growth concerns and prompted RBI to act to sharply ease liquidity conditions through OMOs and embark on a rate cutting cycle which has continued into the current financial year as well.

**Market Activity**

Secondary Market Participation: The last couple of years saw average G Sec volumes drop almost 50% from daily average of Rs. 630 Bn in FY 17 to Rs. 325 Bn in FY 19. Amid heightened volatility, Standalone PDs have consistently accounted for 15-16% of secondary market share. This has remained broadly consistent over long period despite excessive market volatility.

One disheartening trend has been the poor share of long bonds in the secondary market activity. In FY 19, volumes in greater than 14 Year G-secs were less than 3% of the overall volumes. This reflects a trend where large long term bond buyers continue to prefer the primary market and shun the secondary market. As a result, it is the pricing in primary markets which is driving the secondary market pricing. While PDs have been doing their bit, the market requires long term investors to access secondary market for their investment needs so that intermediaries like us can perform our roles better. Bulk of the volumes continued in the 5 to 10 year segment which accounted for 76% of the total volumes with the benchmark 10 year bond alone accounting for roughly half of the total volumes.

Another interesting development in the Financial Year 2019 has been the increase in volume of strips generated or traded which were Rs. 133 Bn in FY 2019 compared to only Rs. 20 Bn in FY 2018. This was aided by the change in regulation which expanded the universe of securities from just 2 earlier to all outstanding Government Securities. Q1 of FY20 has seen continuation of the trend with Rs. 49 Bn of strip bonds already created. While active secondary market trading in strips is yet to begin meaningfully, the signs are encouraging.

Primary Market: Average subscription in central government auctions remains close to 50% for PDs. Primary devolvement data is somewhat a reflection of the market outlook for bonds. Thus, in a year of highest market borrowing by the Centre, we have seen a devolvement of only Rs. 16 Bn till date which is less than 0.5% of total borrowing so far and compares with an average of over 2% for the last couple of years.

**Regulatory Changes**

Reserve Bank of India continues to play a key role in expanding and deepening the G-sec and derivative market through various regulatory changes. The key changes were:

**ONE: Short Sale in Government Securities** – limit was increased to 2% of outstanding or Rs. 500 crore for LIQUID securities and 1% of outstanding or Rs. 250 crore for ILLIQUID securities. Also other regulated entities were allowed to short.

**TWO: When Issued market in Government Securities** – RBI liberalised the eligible participants' base and also relaxed the entity-wise limits for taking positions in the When Issued market.

**THREE: Expanding Activities of Standalone Primary Dealers** - In order to facilitate Standalone PDs to provide comprehensive services to their FPI clients, they were allowed to apply for limited Foreign Exchange licence.

<u>October 2018</u>

**FOUR: Voluntary Retention Route (VRR) for Investment by FPIs** – FPI were allowed higher flexibility for voluntary commitment to retain investments under the VRR scheme.

<u>December 2018</u>

**FIVE: Access for Non-Residents to the Interest Rate Derivatives Market** - Non-residents were given access to the Rupee Interest Rate Derivatives (IRD) market in India.

June 2019

**SIX: Retail Participation in the Government Security Market** - Stock Exchanges were allowed to act as Aggregators/Facilitators for non-competitive segment of the primary auctions.

August 2019

**SEVEN: Introduction of stripping / reconstitution facility for SDLs** – RBI has decided to introduce the stripping/reconstitution facility for SDLs. After resurgence of stripping of G Secs in last one year, SDL stripping opens up one more avenue for passive investors to invest without reinvestment risk. We expect demand especially from mutual funds, corporates and maybe FPIs in this space. FIBIL SDL valuation model was one of the key enabler for stripping approval by RBI.

**Going Forward**

Market Making Scheme for PDs - RBI is about to introduce a new market making scheme for primary dealers. It is a welcome initiative. PDAI would request RBI to consider our suggestions like flexibility in security selection and relax the need to continuously put two way prices on screen since NDS OM is an order driven platform and not suited for market making.

LCR for SPDs – Imposition of LCR on Standalone PDs will inhibit their activity in the corporate bond markets as majority of the corporate bonds do not qualify as HQLA. This will be a great set-back for the trading model of Standalone PDs which hold liquid securities and churn them quickly but will have to go for expensive long term borrowings to fund these short term positions.

Retailing – The market for Government bonds continues to be a wholesale market with minimal participation from retail investors. The small saving schemes last year collected Rs 2.2 trillion of retail savings as they continue to offer significantly higher tax free returns to retail investors compared to what is available on G-secs. Retail investors also continue to channelize their debt savings through Mutual Funds as they are more tax efficient compared to holding G-secs directly. What does it take to encourage retail participation in G-secs? It is very critical to give the retail investors tax benefits for interest income from government bonds. A radical idea here would be to extend the same tax benefits to retail investors to hold G-secs which are extended to small savings scheme and to gradually do away with the small saving schemes. This would improve monetary transmission by aligning all interest rates to the market economy and improve secondary and primary market activity in G-secs. Needless to say, Government will save a considerable amount through lower interest and administrative costs. The only issue is one of last mile connectivity.

One can use fintech to help retail investors access the bond market through on-line payment apps and through NSE platform for primary market for gilts. It is critical that the intermediation cost be reduced for distribution and the only way to do this is by use of fintech. It is also critical to reduce the other costs like demat, broking etc. One of the impediments faced by institutional fixed income players is that the KYC of retail investors is onerous and time consuming. One can explore the option of any one holding a valid demat and bank account to be able to deal with debt market participants like primary dealers.

Officials of PDAI have been meeting officials of RBI regularly. Members of PDAI also interact with officials of RBI on a one to one basis as RBI calls us for seeking feedback and suggestions for bringing about changes for improvement. We place our demands before them for their favourable consideration. We hope that some of those will be considered favourably.

Look forward to active participation from all the participants. Thank you.