Speech of Shri. B. Prasanna, PDAI Chairman at the 17TH FIMMDA –PDAI ANNUAL CONFERNCE

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Respected **Shri H R Khan**, Deputy Governor, Reserve Bank of India, Other **respected dignitaries** from the Reserve Bank of India, my **fellow board** members from FIMMDA and PDAI, My dear **friends and colleagues** from the industry, **Ladies and Gentlemen**.

Let me first wish you a very **warm welcome** to yet another edition of the FIMMDA – PDAI annual conference, very aptly titled **"Indian Markets – towards globalization"**. This is that time of the year – When we all take a step back to take a look at the **unfinished agenda** of the year gone by – When we all deliberate to **identify and remove bottlenecks** in the development of our market. It is of course a great **sweetener** for us to have these discussions in the lovely city of London…

The PDAI chairman speech is always one of the **toughest things to deliver**. Coming sandwiched between a brilliant recollection of the last years activities of FIMMDA by our Chairman Shri Venkatesh's and a power packed speech packed with forward looking guidance and announcements for the markets from our beloved Shri HR Khan, who all of you are no doubt waiting to hear…I clearly don't want to stand in your way. But attempt I shall…

Primary dealers are supposedly the **torch bearers** for improving bond market liquidity and hence I will choose bond market liquidity both from a domestic and global perspective as my theme.

Liquidity in bond markets in FY17 was characterised by a **peculiar lack of a clear direction**. It suffered from spurts of global volatility, lack of FPI flows and smaller range of yields resulting in the market-wide metrics related to volumes and turnover looking worse than in FY15. Let me elaborate.

The **total trading volumes** in dated government bonds had increased from 59 Lac Cr in FY13 to 91 lac Cr in FY15, (a CAGR of nearly 24% in YoY terms) only to fall back to Rs 75 Lac Cr in FY16. The average daily trading volume increased from Rs. 24,460 Cr in FY13 to Rs 38,645 Cr in FY15 but decreased to Rs 35,522 Cr in FY16. The **share of Primary dealers** though has remained intact at very healthy 19% like last year. This number had substantially increased from 16% in FY13.

In terms of the overall turnover ratio **the status of the Indian bond market amongst its Asian peers** has remained stagnant this year. The ratio had improved dramatically from 1.3 to 2.47 in last 8 years only to fall back to 2.03 in FY16. We are currently still better than countries like Malaysia (ratio of 1.37) but slipped lower than countries like Indonesia (2.5) and Thailand (2.6) while we continue to be lower than South Korea (2.7).

In terms of **dispersion of trading volumes**, while the less than 15 year buckets had a very healthy incremental turnover ratio of around 21 times, the longer buckets trade approximately at a mere 1.5 times thus skewing the overall turnover ratio down. So 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. I restate the need for a **regulatory nudge** for the same that might help bring about improvement in market liquidity.

We seem to have fared marginally better on **Concentration risk** though. The volume share of the single most traded security has now decreased to 34% in FY16 from 45% in FY15 while the share of top five traded securities has marginally decreased from 79% in FY15 to 77% in FY16. There is an urgent need to **consolidate issuances** and have a **higher threshold of outstanding for each bond** so that more bonds become liquid. Out of the 86 securities that are outstanding currently, only 50 securities have an outstanding of more than Rs 50,000 Cr. Buyback and switches within the same maturity bucket could also be planned actively by the RBI and the government to help remove kinks in the curve and help kick-start liquidity across the entire curve.

As far as global development is concerned, there are a few main drivers of change that have been shaping liquidity in global financial markets. Amidst global uncertainty following the 2008 crisis, central banks, and regulatory bodies and in large parts financial investors have adopted a policy of risk avoidance.

First was the Volcker Rule (a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act). This rule was designed to prohibit activity that may expose banks to high-risk strategies that could lead to substantial financial losses, the primary idea being to prevent banks from engaging in speculative trades while using customer deposits and federal deposit insurance. The rule also seeks to prevent proprietary trading under the guise of hedging. Here, banks are required to provide detailed information for supervisory review to classify the trade as a hedge.

In tandem with the Volcker Rule, was the European equivalent popularly known as MiFID II. Traders have likened these fixed income market rules to effectively forcing them to play poker with their cards showing, with the end result that markets may become more illiquid and investors pay more for their trades.

Secondly, regulatory guidelines towards the **implementation of Basel III norms by itself** have resulted in an increase in the capital requirements of banks.

Thirdly, the Basel Committee on Banking Supervision **(BCBS)** has released its new guidelines under **"Fundamental Review of the Trading Book"** in

January 2016 which amongst others includes a **Shift from VaR to Expected Shortfall (ES) framework**. ES is the expected loss once VaR has been breached. It is expected that ES risk is on average 1.4x of VaR leading to an increase of 40% in Capital requirement of 40%.

These developments are recreating the landscape of our financial markets, mainly resulting in the way that banks and other intermediaries transact with each other. While the **Volcker rule focusses on a concerted effort to improve the culture and governance of trading** the rule also takes a hard line on the **role of the supervisor** accepting nothing short of substantial proof that the rule is being adhered to.

As a result of these measures, the trading volumes of bonds as a percentage of outstanding Bonds have declined from a peak of 3.5% in 2005 to 1.8% currently while the total traded volume has fallen by 25% in the last 8 years. **Inter-dealer trades** have declined from over USD 80tn in 2012 to just above USD 50tn in 2016. **Trading revenues and ROEs** at some of the large financial institutions have declined. Increasingly **many of the proprietary trading activities are moving away from banks to hedge funds.**

With this backdrop; I see the following risks to our domestic markets in the near term:

a) **Lower Foreign bank participation -** With the impact of capital charges, and legislation; treasuries of foreign banks may not be inclined to continue with their current limits on trading positions

b) As **domestic Banks'** NPA recognition norms fructify, **focus could be on balance sheet repair** as they eschew market risk. Further, the **reduction in HTM/SLR and introduction of LCR** might create demand for low duration assets while high duration still forms almost 100% of the incremental supply.

c) Greater emphasis may be laid on **"Agency" business** opportunities over principal trades.

These factors are likely to further lead to a **fall in market liquidity and increase in bid-ask spreads** chiefly as banks who have been active risk takers in the past withdraw liquidity from the capital markets. **Long term funds, primary dealers and asset managers are well suited to fill that funding gap**. However, it is not only a matter of ability and willingness. We need to create the **right incentives** and at the same time **remove barriers** that constrain the participation of these players. While regulation can be an effective tool for creating financial stability and restoring and maintaining confidence in the financial markets they could also have the unintended effect of sometimes discouraging or even prohibiting long-term market development.

To paraphrase the words used by our very own governor in one of his earlier speeches… **"The policy of being too cautious is the greatest risk of all"**. Now people in the bond market can now appreciate this more than ever before.

There is one another issue that needs regulatory attention at the highest levels. This is the enormous impact SDL yields have been having on the overall

micro structure of yields in the economy. The Gross supply of SDL at 2.95 Lac cr was a YOY growth of 23% while the net supply of SDL of Rs 2.6 lac cr was nearly 40% of total net SLR supply. Not only had the **average SDL spreads** shot up from around 25 bips at the beginning of the year to around 80 bips at the end, but the **variances of cut-off in SDL issuances on the same date** have been as high as 20 bips. **The high correlation between SDL spread and gsec yield curve spread** was evidenced by the long bond spread moving from 30 bips at the beginning to 50 bips, **running counter** to the accommodative stance of the RBI. Given all this, the pricing of SDLs in cutoff, size of the auctions the timing of these auctions require more active management. The **sanctity and transparency of the SDL borrowing calendar** on the lines of G-Sec borrowing should be aimed for.

As far as the **overview of PDAI activities** is concerned I am not going to elaborate here but suffice to say that it has been a somewhat **joyous** year for all of us with a very proactive RBI engaged with us for increasing the product suite available in the market as well as to respond to the concerns of the PD industry. With Currency futures and a higher SBL/GBL limits the RBI has surely made the PD business model a lot stronger than what it was without them.

We **thank the Reserve Bank for all the above measures** as well as for seeking constant feedback from market for implementing financial market reforms. **A few more of our demands** are being pursued and I hope that the Reserve Bank will make some favorable announcements very soon. We hope that the pace of new market reforms will only accelerate as we go forward.

Thank you.