Primary Dealers at the Crossroads

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The government securities market is evolving rapidly. The broad trend in the direction of interest rates since the end of 2003 has been in the upward direction. The 10 year benchmark yield which had gone below 5% has since moved up to around 7.60%.

The upward journey has been slow and arduous for most debt market players in India. Lulled by a singular trend of falling interest rates since 1995, there was very little semblance of serious attempts to brace for life in a rising interest rate scenario.

Hence, when the day did dawn, most market players were found wanting as far as their preparedness was concerned. Very few had robust mechanisms to shoulder such shocks. The market system too was biased in favour of falling interests. One could only take long positions in bonds. This meant that one could make money only when bond prices rose which happened only when interest rates fell. Even if one were to abandon a short term trading approach and look at a medium term horizon, the sheer depreciation in valuation could wipe out chunks of precious capital. As in most markets, the myth that markets are a zero-sum game was shattered when nearly all treasuries posted losses, some big and others small. This was as a result of a simple change in the price at which one valued one's portfolio.

Trading volumes were the main casualty of this scenario. In most developed markets, dealers are able to benefit from either way movement. Since this was not possible in India, volumes dried up whenever there was a bearish sentiment in the markets.

The changed scenario called for reforms on the market front. All this while, one could take only long positions in the securities market. Having taken such a position, one had to wait until interest rates fell (and security prices rose) so that one could book one's profit. While this was all very well in a falling interest rate scenario, there was precious little that one could do when interest rates were rising. One option was to do what banks did last year – gradually withdraw their presence in the securities market and concentrate on credit. This they did after classifying their existing investments into a category known as "Held to maturity" – which essentially shielded them from booking losses based on market prices.

The other option was to suffer losses – which is what the Primary Dealers (PDs) did, since they did not have the option which the banks had. The year 2004-05 saw most Primary Dealers in the red and a few of them who managed to stay afloat did so mostly on the basis of alternative income streams.

And these red bottomlines spurred the PDs, albeit belatedly, into action!

Numerous representations were made to the authorities so as to alleviate the troubles of the beleagured industry. These representations focused primarily on two areas:

a) reforming the interest rate market to enable profitable existence even in a rising interest rate scenario;
b) diversification of revenue streams of PDs to hedge the volatility arising out of debt market fortunes.

Understandably, the authorities took their time to commit to these suggestions, given the enormity of the ramifications. While the reforms on the interest rate market were already being pursued even earlier, there were some reservations regarding permissions on short positions. On the case of diversification of PD revenues, the concerns regarding dilution of PD focus had to be addressed.

In view of the urgency expressed by the industry, the authorities decided to offer an option to some PDs who were floated by banks, to merge back with their parent banks. This was seen as a move by the authorities to buy some breathing time and pace their reforms announcement at their own comfort.

It was expected that some of the PDs floated by foreign banks would immediately opt for this merger, since they were the original proponents of this recommendation. In the case of foreign banks, the primary dealer units are little more than extension counters of their bank treasuries. Moreover, the new guidelines stipulate after the merger, the PD component of the bank's book be maintained separately and be valued at market levels, i.e. classified under the "Held for Trading" category. Foreign banks do not utilize the option of categorizing their SLR portfolio into "Held to Maturity" books, they mark-to-market their entire portfolio. Thus, they are indifferent to the inclusion of the PD book within the bank.

However, in the case of PSU banks, the apparent benefits of merger which appeared on a casual glance seem to have evaporated after deeper study. A primary reason for this is that there are many PDs who are unable to merge with their parent banks due to

(a) their sheer size
(b) stakeholding complexities or
(c) their parent being a non-bank.

In such cases, the interests of these entities have to be protected in the new scheme of things and a level playing field has to be created vis-à-vis the merged bank PDs. And in doing so, it appears that the prima-facie benefits of merger can get all but erased.

Moreover, there are other factors which appear to have kept the banks from jumping at the offer:

a) Assuming that markets will remain bearish, the direct hit that a banks portfolio could take on its PD operations could be significant. While the bank can currently protect itself from market fluctuations by transferring its portfolio to the "Held to maturity" category, they cannot do so for the PD component.
b) While the bank can afford the option of keeping aloof from the securities market in a bearish tone, they will be unable to do so in case it has a PD within its wings. The higher networth of the bank could prevent the PD from refusing to take on higher commitments which could be detrimental to its interest in a bearish market.
c) The capital adequacy for bank-PDs is lower than in the case of stand-alone PDs. In order to have a level playing field, the RBI is expected to re-align this anomaly. Once done, the distinction between a stand-alone PD and the bank-PD as far as capital adequacy requirement stands blurred.
d) The RBI is expected to allow PDs to diversify into related areas such as equity markets etc. and also float subsidiaries for other businesses like forex and commodities. Based on this, a subsidiary having diverse revenue streams would be able to weather business cycles far more efficiently. Hence housing the PD within a diversified unit would offer the entity more resilience.
e) The banks are governed with far more stringent guidelines which hamper their investment and trading styles. In case of a bank-PD, such constraints would get extended to the PD operations as well.

In any case, the envisaged benefits of merger can be replicated by having a better formal arrangement between the bank and the PD in terms of distribution and bidding without disturbing the current arrangement.

After nearly three years of bloodbath, the market is finally witnessing the emergence of market mechanisms to help debt dealers. The introduction of "Short Selling" is a major departure from the erstwhile philosophy on this issue. While some may argue that the caveat of "intra-day" is self-defeating, it is nevertheless a definite beginning to what is being called as Phase I. It is expected that in later phases, the option of keeping overnight short positions open will be available to market players.

Another significant move is the introduction of the "When-Issued" market in gilts. The Fiscal Responsibility and Budget Management Act, 2003 was mooted in order to inculcate fiscal discipline in the country's finances. However, the implementation of this Act in April 2006 comes at a very inconvenient time. The rising interest rates leave very little appetite for banking system to absorb fresh issuances. Hence, it had become imperative to make the situation conducive such that Primary Dealers could continue to survive. The "When – Issued" market is one such measure which is expected to aid the PDs while they participate in primary auctions. The removal of statutory ratios such as Bidding Commitment and success percentage too come as a big relief to PDs.

Once the "Short sale" and "When Issued" markets assume their full proportions, life for the interest rate trader is expected to be less dismal.

While interest rates are expected to harden for some more time, there is an increasing expectation that they will soon plateau. This is on account of the expected pausing of interest rate hikes globally as well as the detrimental effects of high interest rates on the economy. This would mean some respite from hardening interest rates by say, the last quarter of this fiscal and the chance to make some profits. But then, with the new market reforms in place which allow bi-directional positions, this should not strictly matter.

In view of these factors, most of the PDs, atleast among the PSU category, appear to have opted for the stand-alone option. Along with the guidelines for merger of PDs with their parent banks, the RBI has also announced guidelines for banks to become PDs in a move to increase the number of entities in this segment. However, it may be difficult to expect new players to enter this business at the current juncture.

The next step that needs to be taken is the activation of interest rate futures. The Over the Counter derivatives are currently the only ones active in the market. However, the lack of standardization in this instrument keeps

many players away. The Exchange traded nature of futures induces more confidence and stability as regards valuation methods used. A number of issues is currently hampering the introduction of futures. Prime amongst them is the reluctance to allow banks to take pure trading positions in this instrument. Apart from this, the ZCYC valuation methodology used does not synchronise with the YTM method used in the cash market. The absence of STRIPS in the Indian markets prevents the natural formation of a liquid Zero Coupon curve. Hence an alternative valuation method which adapts the YTM curve in the futures segment as well has been developed.

But then, this and other such measures are currently on the anvil and have been long awaiting the final hammer. When the final blow will be dealt, only time will tell!