FIXED INCOME RESEARCH

Improving the "When Issued" Activity: Will Exclusivity to PDs Help?

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The trading volumes in When Issued market in India have been very low. Out of the many causes for sluggish growth in When Issued trading, we try to address here the issue of absence of exclusivity to primary dealers in auctions. In this report, we first highlight the developments of the when issued market and need for exclusivity to improve its performance.

Background

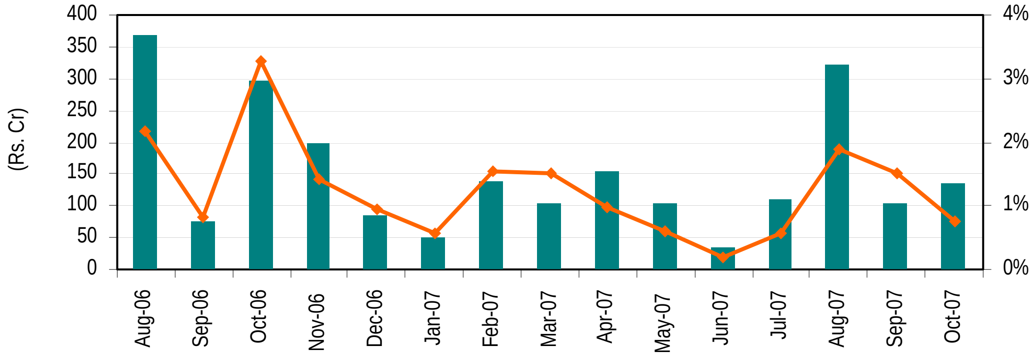
A When Issued market provides a platform whereby market participants can trade in securities that have been announced for issuance through primary market at a future date. A when issued market remains operational from the date of announcement of the auctions to the auction date for the security. Participants take positions depending upon their view on the market. The participants are liable for delivery, depending upon their outstanding positions, only at the close of the market. Since participants are not liable for delivery in the initial days, trading volumes can be large. The total volumes in when issued market, over the entire period, could also exceed the actual auction size.

"When Issued" market in India started operations in the month of August 2006. The when issued market was introduced with the purpose of aiding the price discovery process and gauging of demand for the relevant securities at the auction. The operation of a when issued market also aimed at extending the process of securities distribution. This in turn would aid absorption of large issuances. (The guidelines for the operations given by RBI are mentioned in Box 1.)

Trading in When Issued Market

The trading activity in the when issued market has remained lackluster since its inception. The volumes in when issued market have barely been around Rs 100-300 cr (Figure 1). The volumes in when issued market, as a percentage of the issuance size, have rarely crossed 2%. Whereas one would expect the trading volumes in a vibrant when issued market to at least equal the primary auction size, if not exceed.

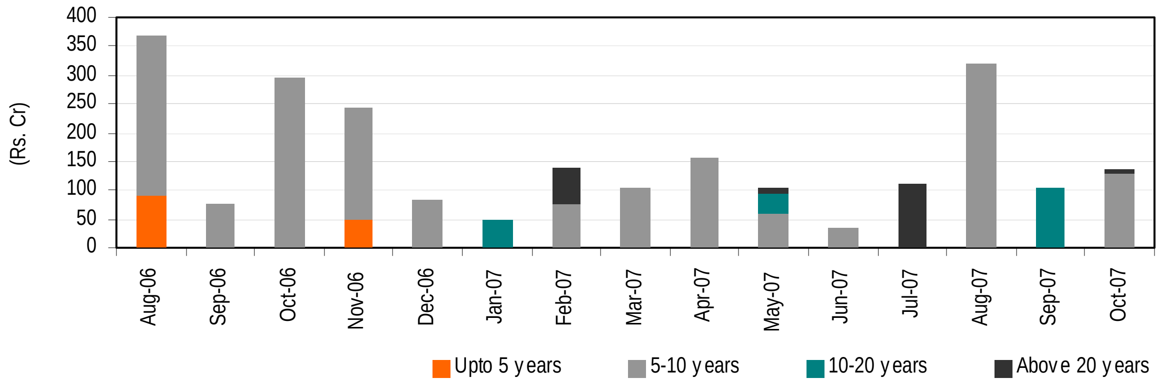
Figure 1: WI Volumes and Trade Vol as % of Issue Size



Source: IDBI Gilts Limited and CCIL

It can be also observed in maturity-wise breakups of WI trade volumes, that majority of the trades are executed in the 5-10 year segment (Figure 2), since it is this maturity range that is most liquid. As the secondary market volumes too are the highest for this maturity segment.

Figure 2: Maturity-wise Breakup of WI Mkt Volumes



Source: IDBI Gilts Limited and CCIL

Reasons for Absence of Vibrant WI Market

The when issued market provides participants with an opportunity to buy a security before the actual issuance. The quantum of long positions in when issued market would then depend upon the market expectations for the auctions. Higher the demand for securities in when issued, the higher expectation of aggressiveness in bidding. Apart from buying earlier, the when issued market also provides a facility, especially to the primary dealers, with a ready market, prior to the issue, to sell securities they expect to receive through the primary auctions. However, the facility of buying/selling prior to the auction has not proved to be helpful in deepening the market. Moreover, as seen in Figure 2 above, the trading remains concentrated in particular maturities. We will now address some of the major reasons for the sluggish growth in When Issued Market.

1) **PDs hesitant to take positions:** One of the primary reasons for the sluggish development observed in when issued market is hesitance from the primary dealers to take up positions in the securities auction. This especially is observed in times of rising interest rate environment. Unfortunately, the operationalisation of when issued market has coincided with a period of tight monetary policy.

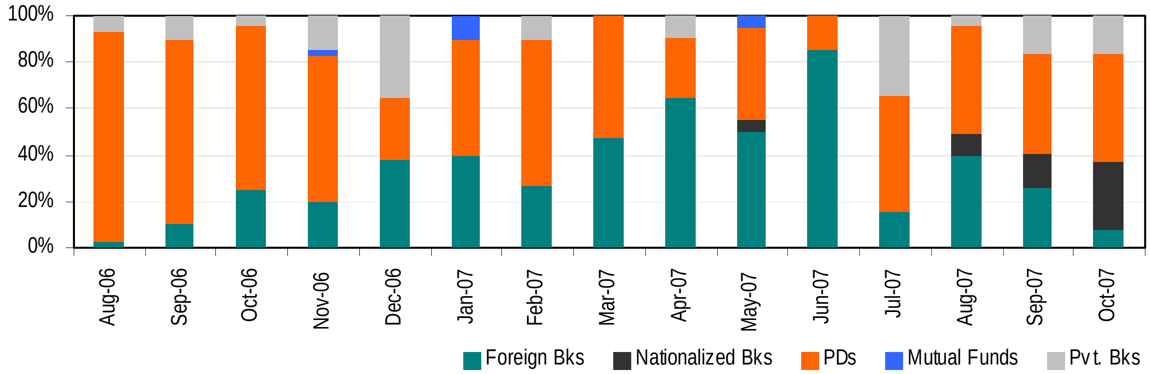
2) **Short Tenor Securities see demand from Banks:** Banks usually prefer to buy the short tenor securities to meet their SLR requirements. As a result banks buy aggressively at Treasury Bill auctions and G-Sec auctions of maturities below 10 years. Banks usually purchase the securities and transfer them to the 'held to maturity' category. In case of a rising interest rate scenario, short duration securities prove to be a valuable investment for the banks as it minimizes their interest rate risk.

3) **Aggressive buying by Insurance Companies in longer-tenors:** The auctions for longer tenors hold a tendency of being cornered by large insurance firms. The insurance companies have long-term liabilities which they try and match with investments in longer tenor securities. Insurance companies bid aggressively in maturities above 20 years. Moreover, the securities bought by such companies, again, are largely in form of investments held till maturity and are rarely traded post primary issuance.

4) **PD, no longer an essential counterparty:** As per the initial RBI guidelines on When Issued market, it was essential to have Primary Dealer as counterparty in a transaction. A compulsion on keeping PD, as counterparty would only prove to be a hindrance, especially when PDs lack any exclusivity in the primary market. As a result, this guideline was revised later and one leg of the transaction was not reserved for primary dealers. (Refer to Box1). However, the revision of guideline has not been beneficial in improving the volumes in when issued market. The volumes have not picked up much since the revision of the guideline. In fact they have declined from levels seen in the introductory phase. (Figure 1)

It is also observed that the activity of primary dealers in the when issued market has declined from earlier levels, post November 2006. In spite of the fall in share of volumes, PDs remain a significant contributor to when issued volumes. (Figure 3)

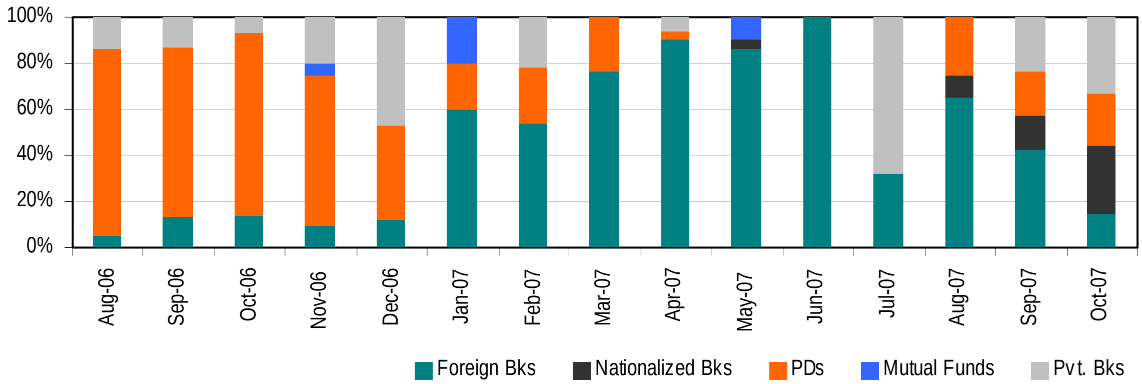
Figure 3: Category-wise Breakup of WI Trade Volumes



Source: IDBI Gilts Limited and CCIL

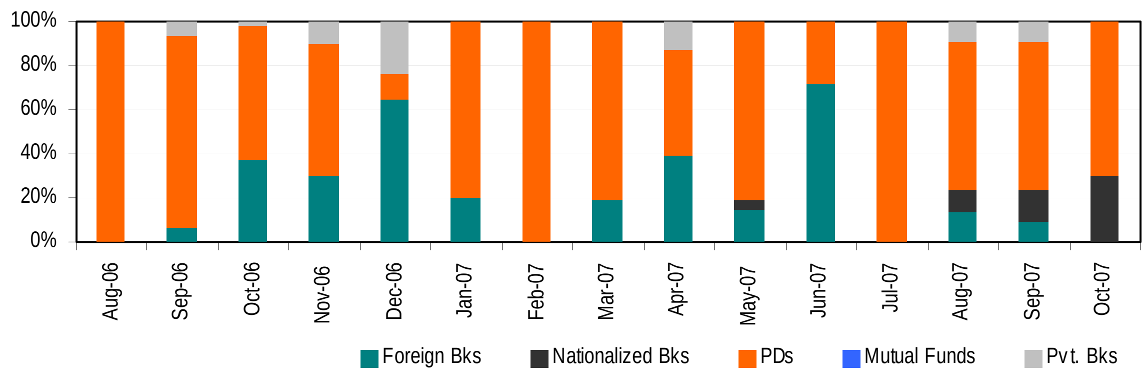
Another interesting aspect emerges in from the analysis of buy-side and sell-side data. When it was mandatory to have PD in one leg of the when issued transaction; activity of PDs was active equally on the buy as well as the sell side. However, after removal of the compulsions to have PD as counterparty, the activity of PD was more dominant on the sell side (Figure 4 & 5). This implies that apart from being hesitant to take positions in primary auctions, the PDs also avoid taking any call in the when issued market. This has hindered the development of the when issued market.

Figure 4: Category-wise Buy-Side Break-up of WI Volumes



Source: IDBI Gilts Limited and CCIL

Figure 5: Category-wise Sell-side Breakup of WI Volumes



Source: IDBI Gilts Limited and CCIL

Need for Exclusivity to PDs

From the above analysis it is felt that there is a need to provide exclusivity to PDs, to infuse activity in when issued market. Exclusivity means that only the primary dealers would be allowed to place bids in the government securities auction.

Dr. Y. V. Reddy, as a Deputy Governor, in his inaugural address at the Primary Dealers Association of India in 1998 had highlighted absence of exclusivity to PDs in primary auctions as an operational issue to be dealt with. He stated that "If exclusive access is a preferred option, then it may be feasible only with an increase in the number of PDs. Changes may also be required in the form of liquidity support, underwriting, mode of bidding, possible ceiling on the amount bid, etc."

Arguments for Demanding Exclusivity

1) **Balance between obligations and privileges:** The primary dealership system has come into existence for performing certain roles. (These roles as per an IMF study have been discussed in Box 2). Primary Dealership system in India was introduced in 1996 with a set of obligations towards primary auctions like bidding commitments, success ratios, turnover ratios and scheme of underwriting of auctions. However, in light of the FRBM Act, RBI's participation in primary auctions was withdrawn from April 2006. This led to revisions of earlier bidding commitments and success ratios. From fiscal year 2006-07, PDs were no longer subject to annual bidding commitment and success ratios (except for Treasury Bills where the PDs continue to be subjected to bidding commitment and a semi-annual success target). RBI then introduced a system of Minimum Underwriting Commitment and Additional Competitive Underwriting, which ensured that 50% of every issue would be underwritten completely and equally amongst all PDs. Underwriting success for remaining 50% would be based on competitive bidding. These developments have thus increased the devolvement quantum of PDs, which was previously shared in part by RBI. However, all the above-mentioned obligations do not come with any privileges. When we talk of privileges, it is largely exclusivity to Primary Dealers in bidding at the government auctions. RBI too in its report on Central Government Securities Market (2005) has mentioned "It may be iniquitous for PDs to discharge their obligations if they have to compete in primary auctions with entities that do not have such responsibilities." Exclusivity in primary auctions would encourage PDs to take responsibility for distributions of securities in the secondary market, which essentially is a buyer's market.

2) **Move towards lowering of SLR:** Banks have been the major investors class in the government securities market. RBI report on Central Government Securities Market (2005) stated that "Captive demand for government securities in terms of Statutory Liquidity Ratio (SLR) requirements under the Banking Regulation Act, 1949 has been shrinking with the SLR having been brought down to the minimum statutory level." Moreover, an SLR Ordinance was passed in January 2007, which has enabled further lowering of the ratio. The passing of Ordinance, however, has not as yet culminated into actual lowering of SLR. This is largely on account of Government's concern over meeting its fiscal borrowing requirement. Exclusivity to primary dealers for bidding in auctions would help overcome these concerns. The Government and RBI would be then able to go ahead with their objective of carrying out financial sector reforms.

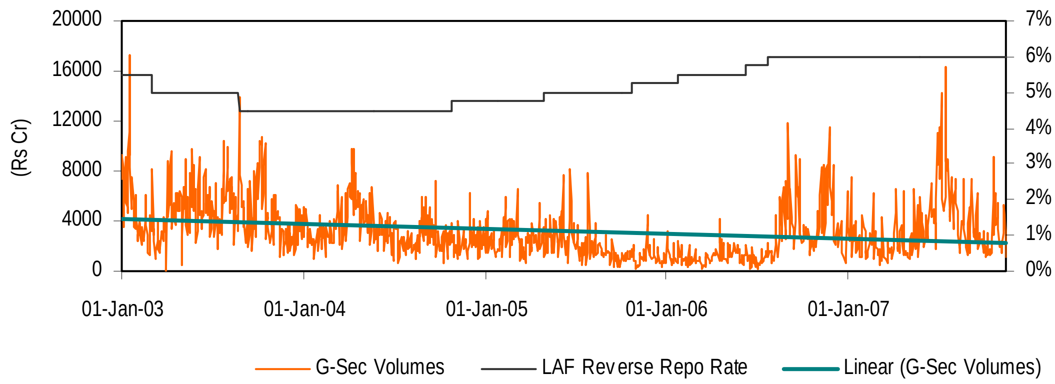
   Looking at data since 1998-99 till 2006-07, it is observed that banks' rise in G-Sec investment portfolio, as a percentage of gross borrowing for the relevant fiscal, has been around 50%-90% (Figure 6).

Figure 6: SLR Growth v/s Gross Government Borrowing

Source: IDBI Gilts Limited

However, investment by banks in government securities to a large extent also depends on the interest rate cycle. It has been observed that in the last stage of falling rate cycle and initial phase of rising interest rate cycle, banks tend to reduce their investment books and increase their credit portfolios. The fiscal year 2005-06 has seen a negative growth in investments, contrasted by more than 30% in credit deployments. This also results in reduction of the secondary market base (Figure 7).

Figure 7: Trend in Secondary Market Volumes



Source: IDBI Gilts Limited, NSE and CCIL

3) **Better Distribution of Securities:** Primary Dealers being market makers are more interested in trading of securities, rather than holding them until maturity. Exclusivity would result in a larger portion of the issue falling in the hands of PDs. As a result, activity in the secondary as well as when issued market will receive a boost through rise in the trading activity.

4) **International Experience:** As per the RBI report on Central Government Securities Market (2005), international experience shows that exclusivity to PDs in primary auctions is a common phenomenon. Apart from the countries stated in Table 1 below, countries like Germany, South Africa, Nigeria and Sri Lanka too have provided exclusive access to primary dealers in auctions. Mauritius has also considered providing PDs with exclusive access to bid at auctions once the secondary market is well established.

Table 1: Exclusivity to PDs: An International Experience

Country	Exclusivity	Country	Exclusivity
Argentina	No	Italy	No
Armenia	No	Kazakistan	Yes
Austria	Yes	Korea	Yes
Belgium	Yes	Mexico	No
Brazil	No	Morocco	No
Canada	No	Netherland	Yes
Czech	Yes	Norway	No
Finland	Yes	Portugal	No
France	No	Singapore	Yes
Ghana	Yes	Spain	No
Greece	Yes	Sweden	Yes
Hungary	Yes	Thailand	No
Iceland	Yes	UK	Yes
India	No	USA	No
Ireland	Yes		

Source: RBI

Even though the United States does not restrict bidding in primary auctions (refer Table 1 above), the competitive bidding in Treasury auctions is dominated by primary dealers. The reason for this dominance is that primary dealers have an easy access to information that is essential for effective bidding.

Possible Issues with Exclusivity

There could be some issues raised with giving exclusivity to the primary dealers in auctions. The issues could either arise from the regulatory body, the primary dealers themselves or other market participants.

1) **Cornering of Stock:** The most important concern over exclusivity could arise from fear of some PDs cornering certain stock. This could create a temporary shortfall and resultant excessive rise in secondary market prices. However, this issue can be handled by putting restrictions on bidding/success quantum of individual PDs. The US Treasury market had experienced this situation in 1991, whereby Saloman Brothers allegedly cornered two-year notes. This led to some changes in auction regulations. Now, competitive bidding in Treasury auctions is limited to 35% of issue amount for each bidder.

   One could also consider giving exclusivity to primary dealers in the introductory phase only in certain maturities. Exclusivity could initially be granted in the shorter and medium segment, which is the most active even in the secondary market. Since there is a captive demand for longer tenor securities from insurance companies, this segment could gradually be brought under exclusivity.

   Instead of restricting the exclusivity to certain tenors in the introductory phase, we could also look at a possibility of introducing exclusivity in all issuance (i.e. all tenors), but limit it to a certain percentage of the issue. For example, in the introductory phase exclusivity could be 25% of the issue, and then gradually increasing it to 50%, then 75% and ultimately 100% exclusivity to primary dealers in all issuances. The development process would certainly depend upon the comfort level of all the market participants, including primary dealers.

2) **Cartelization by PDs:** Apart from cornering of an entire issue, there could also be some anxiety regarding cartelization by PDs to get the auction stock at a particular price. This could also mean that PDs come together and bid at a very high yield, which is not acceptable to the issuer. In order to tackle this issue, the method of underwriting would play the most important role. As per the current guidelines on underwriting, the primary dealers in equal proportions underwrite 50% of notified amount, which is the Minimum Underwriting Commitment (MUC). The remaining 50% is open to competitive underwriting, i.e. the Additional Competitive Underwriting (ACU). Each primary dealer is required to bid minimum 3% and maximum of 30% of the notified amount under ACU. However, the success of underwriting depends upon aggressiveness of individual primary dealer. Instead of this dual underwriting by primary dealers, a single window of underwriting could be considered whereby all the PDs compulsorily underwrite the entire issue. In a scenario of giving exclusivity to PDs, such an arrangement would deal with the anxiety of cartelization. Moreover, as per RBI report on Central Government Securities Market (2005), the central bank "retains the ability to control the issuance cost by devolving on the PDs".

3) **Sudden Liquidity Crunch:** Exclusivity to PDs in government issuance is expected to result in rise in the secondary as well as when issued market trading volumes. Under such a scenario, it is possible that the gross outstanding long positions of the PDs rise substantially. This would in turn increase the quantum of outflows on a gross basis. However, if on the date of issuance, the payments are netted off, it could result in lowering of the funding requirement by some margin. As a result, settlement of payment on net basis on the date of issue of auction security would partly allay the fears of a sudden liquidity crunch.

4) **Cost of Funding for Stand Alone PDs:** Giving exclusivity to primary dealer would necessarily mean rise in bidding commitment and resultant rise in their leverage ratios. However, the recent trend has seen widening of the primary dealer base. This in turn would result in lowering of the commitment.

   Another important issue is also regarding the cost of funding for standalone PDs vis-à-vis PDs that are essentially a department in a bank. PDs earlier were set up as separate subsidiaries of the banks. Recently, some of the PDs have folded back into their parent banks as a separate department. The cost of funding for banks is generally lower compared to that of a stand alone PD, which would only prove to be disadvantageous. As per an RBI publication (A profile of banks 2006-07), the average cost of funds for the banking systems has been around 4.0-5.0%. However, during the same period the average overnight rate has been above 7.0% and the market repo rate above 6.0%. Currently, the primary dealers have access to the call market, repo markets and LAF to meet their funding requirement. PDs have also been given the facility to borrow under the Standard Liquidity Facility, which is at the LAF Repo Rate. Post the revised scheme of underwriting (MUC & AUC), the facility now remains available only to the stand alone PDs. (Box 3 mentions the revised scheme of liquidity support to stand alone PDs).

However, a special liquidity support would be needed for the stand alone PDs post issuance of auction securities. The additional liquidity support to stand alone PDs could be in form of a special repo dealing only with the latest auction stock, that too for a limited period. RBI too in its report on Central Government Securities Market (2005), has considered a possibility of "repo" on the "auctioned stock with RBI for a limited period after the auction" to take care of the funding requirements. Consideration for a longer tenor repo (e.g. a week) would then be at the discretion of RBI. Absence of any such method of liquidity support, could lead to sharp rise in overnight rates.

Conclusion

The slow development of when issued market has only reinstated the need for providing exclusivity to the primary dealers in government issuances through the primary market. This is obviously going to require changing the underlying mindset of participants and the initial fears over exclusivity; and the task is definitely going to be very daunting. Nonetheless, we feel that a gradual approach toward introduction of exclusivity is only going to aid the widening and deepening of the government securities market in India. A vibrant government securities market in turn would aid the development of other fixed income markets like corporate bonds, swaps etc.

Box 1

RBI had issued guidelines regarding development of the When Issued market in May 2006. The guidelines and mechanisms for operation were as follows:

- Transactions to be undertaken only in the case of securities that are being reissued as well as newly issued*
- Transactions would commence on the notification date and it would cease on the working day immediately preceding the date of issue
- Transactions for all trade dates will be contracted for settlement on the date of issue
- At the time of settlement on the date of issue, trades in the WI security can be netted off with trades in the existing security
- Transactions may be undertaken only on NDS-OM #
- Only PDs can take a short position in the WI market
- Open Positions in the WI market are subjected to the following limits:
  - Non-PD entities - Long Position, not exceeding 5 per cent of the notified amount
  - PDs - Long or Short Position, not exceeding 10 or 6 per cent respectively of the notified amount
- In case a PD is unable to deliver securities to the buyer after the auction on the settlement (or issue) date, the transaction will be settled as per the default settlement mechanism of CCIL
- In the event of cancellation of the auction for whatever reason, all WI trades will be deemed null and void ab initio on grounds of force majeure

* Guidelines for trading in new issuances was announced in November 2006

RBI announced permission to transact outside the NDS-OM system at its Mid-Term Review of Monetary Policy 2007-08

Note: The revised guidelines of November 2006 dispensed with the earlier stipulation whereby the one of the party to When Issued transactions had to be a Primary Dealer

Source: IDBI Gilfts Ltd.

Box 2

As per an IMF study (2003), Primary Dealers are financial intermediaries that, generally in exchange for government securities agree to perform specific obligations or functions in the operation of markets for government securities. Their roles include;

a) Acting as a channel between debt manager and investor in the primary market (for example by participating in auctions);

b) Performing as bookmakers and distributors by having dealers that canvass investors' interest and distribute securities ahead of auctions through when-issued markets;

c) Acting as providers of immediacy of liquidity to primary and secondary markets;

d) Acting as providers of asset transformation and market-making services by being willing to hold inventories of government securities and allowing investors to swap between various outstanding issues of government securities on a continuous basis helps bring liquidity to the market;

e) Promoting continuous markets and efficient price discovery by organizing dealers with an appropriate market structure that can encourage efficient price discovery;

f) Acting as agents and relationship managers educating investors about the attractiveness of government securities as an investment; and

g) Being advisors to the government by formulating and adopting appropriate strategies for the development of products and markets.

Source: IDBI Gilfts Ltd.

Box 3

Scheme for liquidity support to stand-alone Primary Dealers, as per a notification dated 4 April 2006:

In terms of the "Guidelines for Primary Dealers in the Government Securities Market", PDs are provided with liquidity support by the Reserve Bank of India through repos /refinance against Central Government securities. In view of the revised scheme of underwriting commitment, the methodology of calculation of liquidity support to individual PDs has been changed. The liquidity support will be provided to stand-alone PDs only. The parameters based on which liquidity support will be allocated are given below:

a. Liquidity Adjustment Facility : The stand-alone PDs will be able to access the Liquidity Adjustment Facility as hitherto.

b. Liquidity support: Of the total liquidity support, half of the amount will be divided equally among all the stand-alone PDs. The remaining half (i.e. 50%) will be divided in the ratio of 1:1 based on market performance in primary market and secondary market. Performance in primary market will be computed on the basis of bids accepted in the T-Bill auction and G-sec auction in the proportion of 1:3. Similarly, the secondary market performance will be judged on the basis of outright turnover in T-Bills and G-secs in the proportion of 1:3.

c. The PD-wise quantum of liquidity support will be revised every half-year (April-September and October-March) based on the market performance of the PDs in the preceding six months.

Source: IDBI Gilfts Ltd.

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