

# Inaugural address by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India at Primary Dealers Association of India on March 23, 1998 at Taj Mahal Hotel, Mumbai

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Chairman Mr.Mukherji and friends,

I am happy to be here at the inaugural function of the Primary Dealers Association of India. This is a culmination of the continuous efforts made by the first set of Primary Dealers registered in 1996. I consider today's event as an important landmark in the development of Government Securities market and I trust that the Association will play a vital role in the current process of financial markets integration. Let me congratulate all those who have taken the initiative and offer my felicitations to the Association.

## **Market Performance**

The Government Securities market need to be made specially vibrant, broadbased and efficient in view of its role in setting a benchmark for the development of the financial markets as a whole and in bringing about an effective and reliable transmission channel for the use of indirect instruments of monetary control. The whole set of primary dealer obligations and the facilities and support provided to them are conceived on this basis. We should all be happy to observe that the performance of the Primary Dealers(PDs)so far has been satisfactory and a healthy relationship between the Reserve Bank and the PDs has evolved.

During the last two years, PDs' presence in the Government Securities Market has brought about an element of dynamism, both in the primary and secondary segments. During 1996-97, the PDs bid Rs.9,275 crore in Central Government dated securities and Rs.24,230 crore in Treasury Bills and achieved a success ratio of 81 per cent and 51 per cent, respectively. During 1997-98 (upto end-February), the bids tendered by PDs were Rs.19,302 for Government dated securities and Rs.17,000 crore for Treasury Bills and they achieved a success ratio of 62 per cent and 66 per cent respectively. On the whole, including devolvement, PDs purchased securities in the primary market to the extent of 16 per cent of the gross issues in auction Treasury Bills and 38 per cent of the gross issues in Central Government dated securities.

In the secondary market, during 1996-97, PDs achieved a turnover of Rs.26,730 crore in Treasury Bills and Rs.63,723 crore in Government Dated Securities (This includes both purchases and sales including repos). During 1997-98 the corresponding figures were Rs.26,318 crore and Rs.70,709 crore, respectively.

In the backdrop of this performance, I would quickly like to recount the general environment in which the PDs conducted their operations in the recent past.

First, liquidity conditions were relatively easy through most of the period reflecting the reduction in CRR and other inflows into the system.

Second, PDs were assured for most of the time, liquidity support through reverse repos with the Reserve Bank, in Central Government dated Securities and auction Treasury Bills related to the annual bidding commitments made by them. Only after January 16, 1998, as a response to extraordinary circumstances in the exchange market, was the liquidity support made discretionary.

Third, the system of payment of commission on purchase of securities has been replaced in 1997-98 by a system of payment of underwriting fees on the amounts underwritten by them, through competitive bids. Incidentally, we are using uniform pricing approach in accepting bids for underwriting as compared to discriminatory pricing approach in regard to auctions in Government Securities. In order to facilitate continued presence in auctions, we had invited bids for underwriting in respect of all auctions. Upto end-February 1998, they had offered Rs.35,918 crore for underwriting, and as against the bids received, accepted bids to the tune of Rs.15,762 crore, in respect of both Treasury Bills and Government dated Securities. The amount that has devolved on PDs so far is Rs.6,488 crore.

Fourth, routing operations in the call money market were allowed through all PDs, which I believe have generally served to increase the profitability of PDs. Fifth, to facilitate ease of operations, PDs have been allowed to open one current account and two SGL accounts.

Sixth, PDs have been allowed the facility of transfer of funds from one centre to another under the RBI's Remittance Facility Scheme as also the facility of collection of cheques through clearing.

We could perhaps agree, therefore, that the conducive environment and the extent of support provided to PDs have also contributed to their impressive presence in the Government Securities market. We should reinforce these as we go along, for mutual benefit.

### **Current Issues**

There is a continuous dialogue between PDs and the Reserve Bank at the operational level and periodic meetings with the top management of the Bank. A number of issues affecting PDs' operations and the market in general are discussed, and joint efforts are made to find solutions. I am confident that the formation of the Association will strengthen the coordination between the Reserve Bank and the PDs.

A couple of weeks ago, I had the pleasure of meeting all the PDs for a free and frank discussion. Today, I would like to flag three issues that were raised in this meeting, viz., liquidity support, when-issued market and underwriting.

#### *Liquidity Support*

Liquidity support to PDs is currently linked to bidding commitments. There is a suggestion that it should be linked to allotment of securities. There is some merit in this argument in terms of linking liquidity support to actual performance. A suitable mechanism could be evolved after considering both the incentive effect and the monetary impact. I would welcome your views.

#### *When-Issued Market*

There has been a constant demand for the introduction of the when-issued market. In an environment where short selling is not permitted, when-issued market is not possible. We are actively pursuing this matter with the Government. In the meantime, there are a number of related operational issues on which I urge upon this audience to contemplate. In the event of introducing a when-issued market, a crucial question that arises is whether to allow exclusive access to PDs

in primary issues or continue the wider participation as it exists now. 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. All these require deeper examination.

### *Underwriting*

There is an opinion among PDs that the level of underwriting currently permitted could be increased, or underwriting bids could be received without any specific limit, within the notified amount of issue. There is no doubt, scope for increasing the underwriting offers even up to 100 per cent of the size of the issue and also allow both the PDs and SDs to underwrite, since the ultimate objective of the Reserve Bank is to completely withdraw its support in the primary issues of Government. A related issue is whether a sub-ceiling should be placed on the extent of underwriting by a single PD and if so, what should be the basis for such a sub-ceiling. I presume that in the event of the introduction of a when-issued market, the system of underwriting will need to be re-examined. I would be happy to hear your views on this.

### **Role of Primary Dealers Association**

Befitting the occasion, let me address a few issues specifically relevant to the Primary Dealers Association of India. There are certain critical areas in the development of the financial markets which should be addressed by self regulatory organisations like Primary Dealers Association.

The first among them is achieving a harmonious integration of different segments of the markets. Such integration implies among several factors, the evolution of consistent and prudent policies for market participation, trading and settlement of financial instruments. It is a matter of satisfaction for us, that the establishment of sound policy and practices in the market has been included as a stated objective in the Memorandum.

The second area is building a healthy relationship between different segments of market participants. For example, let us consider PDs' relationship with Satellite Dealers. Earlier, two models were considered; one, linking Satellite Dealers' functioning to each PD and second, a free relationship between Satellite Dealers and PDs. The guidelines evolved evidently favoured the latter model. Here, the Satellite Dealers are free to deal with any of the PDs depending upon the forms of their business and their geographical concentration of business. Satellite Dealers' guidelines also provide for the integration of Satellite Dealers as part of PDs Association in membership and in its activity. The PDs Association should bring about this healthy business relationship. This kind of relationship could be extended to other counterpart bodies like FIMMDA which is in its formative stage. The objective should be to bring about a harmonious blend of such entities in achieving orderly functioning of the entire financial market.

The third important role is in the area of removing some legal, procedural and administrative bottlenecks in the efficient functioning of the market. Illustratively, the TDS on Government Securities was one such impediment which was removed after a long dialogue with the Government. There are several other impediments which are constantly discussed like stamp duties and tax incentives. The Association should focus upon building up a strong ground for removing such impediments by consultations with appropriate authorities in Government.

Thus, while the role of Primary Dealers has been carved out essentially in the area of Government Securities market, the PDs' Association may have to expand their horizon to other segments of the market. That would lead us to some micro issues which may need to be addressed.

### *Market Making*

One of the basic obligation of PDs is to offer firm two-way quotes in Government Securities, thereby providing continuous liquidity in the market. In the UK, Gilt Edged Market Makers (GEMMs) are required to make on demand and in any trading conditions, continuous and effective two-way prices at which they stand committed to deal. Some countries require PDs to deal at the prices they display; in others the displayed prices are only indicative. The UK requires market making across the whole range of Government Securities, including index-linked securities whereas in some other countries such as the USA and France, the obligation is to make a market in leading securities only. I would like to impress upon you that there is need for greater transparency in the market making function of PDs in order to impart credibility to PDs' operations. The Primary Dealers Association should focus on this important aspect of market making and frame transparent operational rules.

### *Retailing of Government Securities*

One of the objectives of PDs was to encourage voluntary holding of Government Securities amongst a wider investor base. Some countries require evidence of commitment from PDs in the retail market, particularly for individual investors. Although there are no such explicit guidelines in our case, PDs are expected to be proactive in retailing Government Securities. PDs were allowed to open a second SGL account with the Reserve Bank in order to facilitate retailing but are yet to make any significant headway in this respect. I admit that it would be entirely reasonable for spreads on retail business to be wider than in the wholesale market because of the relatively high cost of retail market making and distribution. Perhaps, there may be a case for linking PDs' performance to retail clientele since serving a captive market may not be an efficient benchmark for assessing the performance of PDs. I understand that one of the objectives of the Association of Primary Dealers in Sri Lanka is to sponsor workshops, seminars, training courses and meetings and develop material for the members of the trade and the general public as the case may be, in order to promote awareness and understanding of the Treasury Securities and encourage wider participation in the market.

The issue of arranging publicity about Government Securities was discussed with PDs. The Primary Dealers Association must consider taking initiatives and move ahead in building awareness of individual investors about the Government Securities market. The Reserve Bank would consider specific requests for any support or backing that is necessary for this purpose.

### *Dematerialisation*

The Reserve Bank of India is in the process of giving a final go ahead to the National Securities Depository Limited (NSDL) for the dematerialisation of Government Securities through the NSDL. We believe that this facility will greatly enhance the ability of the non-banking entities such as the provident funds, trusts, corporates and other participants in the securities market to deal in government securities on a nationwide basis. This is of particular importance to the PDs. On the one hand, increased ability to trade in these instruments will encourage investors to participate in the primary auction of securities and on the other hand serve to increase the client base for Government Securities.

It is not difficult to envisage the PDs putting in bids on behalf of a number of clients and, if successful, distributing the allotment amongst various clients in an effortless manner using the NSDL system in a when-issued system. About 15 banks, nationalised and private, have already joined the NSDL system as Depository Participants. I understand that a few more are on the way to doing so. The dematerialisation of Government Securities through depositories like the NSDL offers an excellent opportunity for the clients of these banks to hold the securities in dematerialised form and derive the benefits of trading on a nationwide basis.

### *Screen-Based Dealing*

While transactions of Government Securities across countries take place both in exchanges and outside, OTC or over the counter trading is the most popular in a number of countries such as Canada, China, Germany, Sweden and the UK. In other countries such as Australia, Belgium, France, Japan, Switzerland and the USA, trades in Government Securities are effected through OTC and also through stock exchanges. In the Indian scene, the National Stock Exchange (NSE) has provided the screen for exchange trading. The OTC market outside the NSE entirely depends upon telephone deals.

Screen based dealing lends transparency and efficiency to market operations. Ideally, the screen could cover OTC deals in money market instruments like call and notice money, term money, repos, as also Government Securities including Treasury Bills. Besides banks, PDs, financial institutions and other market participants, the Reserve Bank could also use the screen in the conduct of its open market operations.

It is felt that self regulatory organisations like Primary Dealers Association (PDA) and Fixed Income Money Market and Derivatives Association (FIMMDA) should be closely associated with the implementation of this system. The Reserve Bank has already opened a dialogue with you in this regard and we would be prepared to consider funding of this project in an appropriate manner, if you take prompt initiatives. We accord high priority to this.

#### *Information Dissemination*

You would agree that all central banks expect its PDs to provide it with relevant market information. A system for exchange of information is already in place. I am sure that PDs would continue to provide the Reserve Bank with relevant and meaningful information on market developments, via contact with the operational staff and through periodic meetings with the Reserve Bank. The Reserve Bank on its part is constantly endeavouring to provide more and upto date information to all through its publications.

#### *Standardisation of Practices*

I would like to flag the vital issue of the need to evolve standard practices in the market with regard to the manner of quotes, the conclusion of deals, the manner of pricing and accounting standards. Code of best practices has to be evolved also for repo transactions. The Association and the Reserve Bank should jointly set up a time frame for standardising the documentation and market practices and develop a code of conduct so that when the dealing screen is set up, it is made compatible to such codes of best practices.

I am happy to hear the emphasis placed by Shri Mukherjee on professionalism and internal regulation or self-regulation. We in RBI will fully support such self-regulation.

Let me hasten to add that RBI will discharge its duty to ensure that PDs Association does not undermine competition and does not give an impression of cartelisation.

I would like to mention here that recognition of PDs is a continuous process. I expect some addition to the number of PDs soon, and thus RBI will help you in expanding your membership.

I have attempted to broadly identify the future role and agenda for further course of action by the Association. The agenda may seem formidable, but, you will admit it is not overambitious. On my part, I assure you that the Reserve Bank will extend all support to the Primary Dealers Association in the endeavour of developing and modernising the Government Securities market.

Before I conclude, I must place on record my deep appreciation of the cooperation extended by PDs to the RBI. Also, I must record the excellent progress being made in the reform process in the Government Securities Market with guidance from Shri Subrahmanyam, our Executive Director, Shri Patil and Shri Kanagasabapathy, Chief General Managers and their team of dedicated and professionally competent staff. I have no doubt about a long and fruitful relationship between the Reserve Bank and Primary Dealers. I am also thankful to Dr. Prasad who helped me immensely in today's task.

I wish the Association all success in its endeavour.