The problem with Reserve Bank’s dual role

The bond market is going through a state of flux, and the reasons have been well discussed, which include inflation concerns, crude oil behaving slippery, government slipping on fiscal deficit, US bond market suddenly realising that the Fed has been hiking rates, banking system liquidity dripping from surplus to neutral, and people engaging in the guessing game on when the Reserve Bank of India (RBI) is likely to hike rates.

Apart from these fundamental factors, there is another ‘on the ground’ issue, which has upset the biggest customer of government bonds, public sector undertaking (PSU) banks, when they are already reeling under mark-to-market losses on bond yields moving up every day. PSU banks are sulking on being admonished by the RBI deputy governor, as if their existing problems were not enough.

RBI deputy governor, Viral Acharya, at an event by Fixed Income Money Market and Derivatives Association of India (FIMMDA), on 15 January 2018, said that interest rate risk of banks cannot be managed over and over again by their regulator, and such asymmetric options—heads I win, tails the regulator dispenses—are akin to the use of steroids. He said banks must put in place processes for efficient management of interest-rate risk. Did he say something wrong? No. Did he need to say that? Not really. There was no compelling reason to rub salt into the wounds of mark-to-market losses of banks. If banks failed to read that yields would travel northward, the RBI was talking of the inadequate pass-through of rate cuts done so far, which is a southward signal. What happened thereafter?

Bond yields immediately shot up on 16 January by about 20 basis points. The government stepped in, announcing (it may be a coincidence but that doesn’t matter) on 17 January that the additional borrowing for the remaining part of the fiscal year will be Rs20,000 crore and not Rs50,000 crore as announced in December 2017. One basis point is one hundredth of a percentage point.

Government borrowing auctions flopped thereafter. In the auction on 19 January 2018, of the four securities on offer, the auction for two were cancelled after receiving bids. Again, the auction on 2 February was cancelled after receiving bids. The cancellations can be attributed to the general weak sentiments prevailing in the market. And the deputy governor’s comment did not help.

The ownership pattern of government dated securities shows that about 41% are held by commercial banks, about 23% are held by insurance companies, and 15% are held by the RBI itself, among the major holders. The rest hold in single digit percentages—for instance, provident funds hold about 6% and foreign portfolio investors 4%. That shows the importance of banks as the biggest customer of government securities (g-secs), the issuance of which is vital for funding the fiscal deficit of the government. Even if we separate PSU banks from other banks, taking a ballpark of 70%, going by the relative business level of public sector banks in the overall banking picture, they account for 70% of the 41%, which is about 29%, which means they are still the biggest customer.

What is the issue here? It is the dual role of the RBI. On one hand, it is the regulator of the banking system and on the other hand, it is the merchant banker of the sizable g-sec issuance programme, which is more than Rs6 lakh crore (Rs6 trillion) a year, on a gross basis, that is, before maturities and buybacks.

This dichotomy is not a new discovery. It has been discussed for ages that the roles should be separated. The government proposed an independent debt management office (DMO) long time

back, but it is yet to be implemented.

What is the fallout of the ‘difference of opinion’ between the regulator and the regulated? Not much in the immediate term. The government borrowing programme for the current year, FY2018, is over and in the absence of any fresh negative inputs, sentiments are stabilizing.

The real issue will start come April. The government spends more, and borrows more, in the initial part of the financial year. If the biggest customer of government bonds remains upset, success of the borrowing programme will be in question and sentiments will drift further. In whose favour is it loaded now? Banks, clearly. And not only because they are big buyers. They are statutorily required to purchase g-secs to an extent (statutory liquidity ratio), and also for a marginal requirement known as liquidity coverage ratio (LCR).

Currently, the SLR is 19.5%. Scheduled commercial banks held g-secs worth Rs33.74 lakh crore (Rs33.74 trillion) as on 19 January 2018. Their aggregate deposit as on that date is Rs109.78 trillion. Assuming net demand and time liabilities (NDTL) of scheduled commercial banks to be Rs109 trillion, they are holding 30% of NDTL in g-secs.

On top of that, credit growth has started picking up. The credit off-take growth percentage, which was languishing in single digits for a long time after demonetization, is now in double digits—10.6% as on 19 January 2018. As and when GST uncertainties and concerns of non-performing assets settle down, credit growth should improve further.

This is not to say banks cannot or would not buy more g-secs. Fresh deposits would accrue. However, by virtue of comfortable excess holding (30% vis-à-vis 19.5%) they can afford to go slow, at least for some time.

Come April, the RBI will have the task of ‘merchant banking’ the government borrowing cut out. It needs to be incentivised in some form, maybe through open market operation (OMO) purchase of g-secs by the RBI.

Joydeep Sen is founder, wiseinvestor.in.

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