Impact of SLR cut on G-Sec appetite

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The financial year 2010-11 has been a year of steady transformations for the bond market. Transformations in the form of the economy's buoyant recovery, RBI's monetary stance, the liquidity scenario and the Central Bank's strategy to conduct the borrowing program have all progressively left an impact on the G-Sec yields. Several other one-off events that influenced the G-Sec market have been: the windfall revenue gain for the Government from the 3G and BWA auctions, hike in the FII limit for investment in G-Secs and corporate bonds, deregulation of petrol prices, two supplementary grants approved by the Government and change in the base year for the computation of GDP, IIP and WPI data releases.

RBI's monetary policy stance has remained timely and even pre-emptive in adapting to the changing economic and financial dynamics. The mid-quarter review of the Monetary Policy released on December 16 stood out distinctively with an outright focus on easing the liquidity crunch. The tight liquidity persisting since June 2010 aggravated post the December advance tax outflow. In anticipation of the same the RBI reduced the Statutory Liquidity Ratio (SLR) by 100 bps from 25% to 24% (effective December 18). The RBI also announced OMO purchases worth Rs.48,000 Cr to be conducted in one month starting December 16. While a reduction in the SLR implies a reduction in the mandatory requirement of investments in Government securities, thereby also implying a reduction in future G-Sec demand, the fixed income market rallied post the policy on news of the OMO purchases.

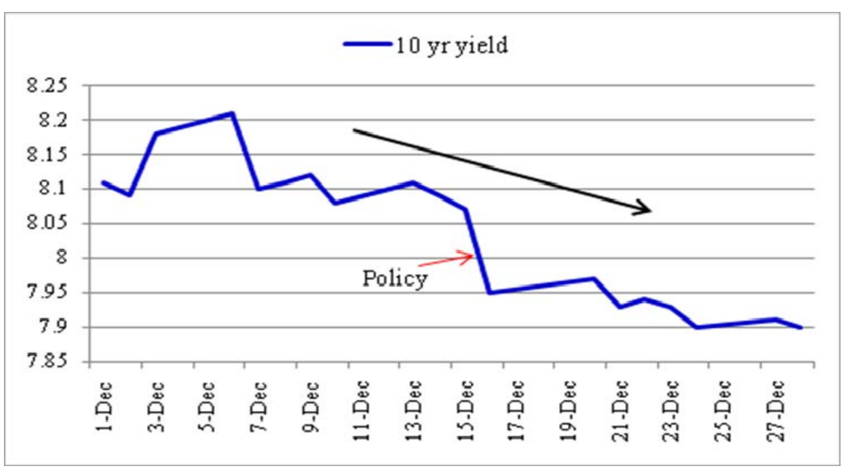
This report aims at studying the impact of the reduction in SLR on the G-Sec market. It pencils out the demand for Government securities till the end of fiscal year 2010-11. The report also presents a scenario in case the SLR did not stand reduced.

Impact of SLR reduction

I. Pre & Post policy review:

Steep decline in the benchmark 10 year yield post policy

- Robust rally in G-Sec market



The month of December has witnessed extreme volatility in the 10 year benchmark yield. The 10 year yield moved a whole 31bps between the maximum (8.21%) and minimum (7.9%) witnessed in the month. The table below indicates the shift in the trading stance by the various market players. It gives the cumulative net Buy-Sell position before and after the policy. The aggressive market players, viz. the foreign banks and the primary dealers resorted to significant buying after the policy, leading to a bullish sentiment.

(Rs. Cr)	Foreign banks	PSUs	Private Banks	Mutual Funds	Others	Primary Dealers
1-15 Dec	-2311	4197	1060	-840	488	-2594
16-27 Dec	6287	-7292	-129	860	-240	513

II. G-Sec appetite till March 2011:

The attempt here is to estimate the extent to which various factors would affect G-Sec demand up till March 31, 2011. The period under review remains December 18, 2010 (effective date for SLR cut) up till March 31, 2011. An analysis of several factors that will impact the demand for G-Secs is as follows:

A. Supply Side:

i. G-Sec auctions:
According to the Issuance calendar released by the RBI as on September 23, 2010, G-Sec supply worth Rs.69,000 Cr is scheduled to hit the market post December 18. It comprises of 6 auctions amounting to Rs.64,000 Cr and an initial adjustment of Rs.5,000 Cr tracking the reduction in the auction size for December 10.

ii. Reduction in SLR holdings tracking SLR cut:
The SLR cut came into effect for the fortnight beginning December 18. Banks would be expected to maintain the revised SLR based on NDTL as on December 3 (Rs.52,93,937). Assuming the banks reduce the entire 1% leeway given in the SLR, the markets would witness a reduction in the G-Sec holdings by the banking sector by Rs.52,939 Cr.

iii. OMO purchases:
RBI announced OMO purchases worth Rs.48,000 Cr for a month beginning the policy. The RBI has already conducted two OMOs leading to a buyback of around Rs.19,559 Cr post mid-December. We expect a total mop-up of securities worth Rs.30,000 Cr by the RBI from the market. The net G-Sec supply would thus be reduced by the total OMO buyback to around Rs.39,000 Cr (69,000 – 30,000). However, going ahead, the OMO purchases could be higher, thereby increasing the net demand for G-Secs. (The RBI in its January policy could hike interest rates to tame inflation. To support the market sentiment and provide liquidity, the RBI could also announce further OMO purchases for the month of February).

B. Demand Side:

i. Incremental SLR demand:
The growing deposits mandate the banks to maintain incremental SLR investment in G-Secs. The deposit growth in the current fiscal has remained muted at around 15%. Assuming a 15% YoY deposit growth, the NDTL as on March 31, 2011 can be estimated to be around Rs.56,42,362 Cr.
Computation for the same is as follows:
Aggregate deposits on March 26, 2010 stood at Rs.44,86,574 Cr. A 15% growth would imply aggregate deposits at Rs.51,59,560 Cr.
NDTL computation also comprises of 'Borrowings' and 'Other demand and time liabilities'. Assuming a 10% growth in 'Other demand and time liabilities' YoY and 'Borrowings' to remain steady at current levels, we have:
Other demand and time liabilities = Rs.3,63,278 Cr
Borrowings = Rs.1,19,524 Cr.
Thus, NDTL = 44,86,574 + 1,19,524+ 3,63,278
NDTL as on March 2011 = 56,42,362 Cr

Therefore, in wake of the growing deposits up till March 2011, Incremental SLR demand = 24% of (NDTL as on Mar 31, 2011 – NDTL as on Dec 3, 2010)
Incremental SLR demand = 0.24* (56,42,362 – 52,93,937)
Incremental SLR demand = Rs.83,622 Cr

ii. Replacement demand:
The last quarter of the fiscal year has the security 12.32% GS 2011 maturing on Jan 29 and 6.57% GS 2011 maturing on Feb 24. The outstanding amounts for the two securities are Rs.8,845.65 Cr and Rs.17,082.53 Cr respectively. The G-Sec market will thus mark a replacement demand of around Rs.25,928 Cr till March end.

iii. FII demand:
On Sept 23, 2010, the Government hiked the investment limit for FIIs in G-Secs by $5 Bln USD. The incremental limit of $5 Bln is to be invested in securities with maturity greater than five years. This limit of Rs.22,000 Cr was allocated to market participants through bidding process on December 2. The FIIs paid upfront an average fee of around 15 Paise/ Rs.100 (merely Rs.30 Cr). The time period for utilization of the Government debt limits allocated to successful bidders is 45 days. Since December 2, the FIIs have not resorted to any robust buying in G-Secs. In the same period the MIFOR costs have increased making investment in G-Sec less attractive for FIIs. We estimate FIIs to invest upto around Rs.7,500 Cr in longer tenor G-Secs in these 45 days.

iv. Special Deposit Scheme (SDS) money:
Every December 31st SDS interest money is released into the system. The SDS interest payments are expected to be to the tune of around Rs.10,000 Cr. This interest money is supposed to be invested in the pattern subscribed by the Ministry of Finance. It mandates 25% investment in SLR securities and the same can be taken upto a maximum of 55%. We roughly estimate a 30% investment in G-Secs leading to a demand of around Rs.3,000 Cr.

C. In a nutshell:

The net demand for G-Secs up till March 2011 can be briefly summarized as follows:

G-Sec appetite for Dec 18 - Mar 31, 2011:

Supply	Rs. Cr	Demand	Rs. Cr
G-Sec supply	69000	OMO purchases	30000
Reduction in SLR holdings (1% of NDTL)	52939	FII demand	7500
		Incremental SLR demand	83622
		Replacement demand (maturities)	25928
		SDS investments	3000
Total	**121939**		**150050**

Net G-Sec demand = Rs.150050 – Rs.121939
= Rs.28,111 Cr

III. No SLR cut, no OMO scenario:

The SLR cut announced by the RBI, left several market players questioning the rationale of the move as against a CRR cut. Let us consider the scenario wherein, the RBI would not have reduced the SLR and would not have announced OMO purchases. In that case the incremental SLR demand over growing deposits would increase (25%). Also, the market would not witness the reduction in SLR holdings by banks to the tune of 1% of current NDTL.

The net demand for G-Secs in this case would look like:

Supply	Rs. Cr	Demand	Rs. Cr
G-Sec supply	69000	FII demand	7500
		Incremental SLR demand	87106
		Replacement demand (maturities)	25928
		SDS investments	3000
Total	**69000**		**123534**

Net G-Sec demand = Rs.123534 – Rs.69000
= Rs.54,534 Cr

The SLR reduction has impacted the bond market with the differences as exhibited above. However, the impact on the market is largely based on the assumption that securities equivalent to the entire 1% of SLR would be sold-off. That may not be the case, as several banks maintain excess SLR.

Conclusion:

The G-Sec market has rallied post the December policy review. The market seems to be poised for a bullish sentiment for at least till there is support from the OMO purchases. However, several other factors would impact the G-Sec market adversely. The rising inflationary concerns may prompt the Central Bank to hike rates before the fiscal year ends. This would put upward pressure on G-Sec yields. The fiscal year end witnesses a drag in demand and trading interest from the market players. On the other hand, the Government has held a tight hand over its expenditure, leading to increased Government deposits with the RBI. Once the Government increases its spending, liquidity is expected to improve, aiding the shorter end of the curve. The RBI may announce further OMO purchases to aid the borrowing. The SDS interest payment would lead to a positive sentiment in the first week of January. The market sentiment would also depend a lot on the FII interest. The market is expected to see-saw between these factors. The most liquid 12 year paper, viz. 8.13% GS 2022 is expected to trade in the range of 7.90 – 8.10%.The monetary policy scheduled on January 25 could lead to an upward spike in yields. We expect the RBI to hike the Repo and the Reverse Repo rate by 25 bps in the January policy review.

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