Analysis of a New 10 Year Benchmark Issuance in the Bond Market

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The domestic bond markets have been an important source in financing the Government of India's fiscal deficit and on an average about 65-70% of the total financing is done via issuance of dated securities (G-Secs). The quantum of gross market borrowings is of great significance to financial markets and is closely tracked by investors, both domestic and foreign, and also by the various international credit rating agencies. The expected amount of gross market borrowings is announced in the Union Budget and barring exceptional circumstances such as the ongoing Covid-19 pandemic, borrowings have been largely aligned around the announced numbers. The Reserve Bank of India (RBI) issues a calendar of the government's borrowing programme in advance so that participants in the financial market in general, and the bond markets in particular, get a roadmap of the supply of government bonds over the next six months. The dynamics of the demand-supply equation in the government bond market determine, more or less, the market interest rates for sovereign bonds as well as other fixed income assets like State Development Loans (SDLs) and corporate bonds, as the government bond yields are a reference point for the pricing of other assets in the financial market. In particular, the yield of the 10-year benchmark G-Sec is the most closely tracked interest rate in the Indian financial markets.

The present economic conditions in India, in light of the COVID-19 pandemic, have necessitated substantial relief measures by the Central Government which has had to increase the size of its gross market borrowing from the Rs.7.80 Lakh Crore announced in the Union Budget FY21 in February 2020 to Rs.12 Lakh Crore in May 2020 and further revised to Rs.13.10 Lakh Crore as announced in October 2020. A similar response was last seen in the aftermath of the Global Financial Crisis in FY09, when the government had raised the size of its gross market borrowings mid-year from Rs.1.45 Lakh Crore to Rs.3.06 Lakh Crore. With FY21 witnessing the highest gross market borrowing planned till date, the possibility of more issuances of new dated securities in general and of the 10 year maturity in particular has increased.

The government issues bonds in various maturities ranging up to 40 years, while raising short term funds through T-bills having maturity less than a year. The demand for various maturities is dependent on the prevailing macroeconomic conditions and the consequent risk appetite of the market participants as well as the investment horizon of investors (short or long term). While bonds of various maturities issued by the government cater to the requirements of a varied investor base, the new 10 year security issued during a financial year enjoys a special status in the Indian bond market. The average share of borrowing in the 10 year maturity bucket in overall government borrowings has been 21% in the last 5 years. In terms of secondary market trading, the 10 year has been the most traded maturity, and the various securities issued in this maturity bucket have been among the top traded securities till the time they were replaced by newer 10 year benchmark securities. The issuance of a new 10 year benchmark security is an important event in the bond market as it sets the tone for the yields in the short term and also results in churning of portfolios.

Indian bond markets are accustomed to an 8-10 month shelf life for a new 10 year benchmark security. In the wake of the increased market borrowings this year, the average auction size of 10 year security issuances have also spiked due to which the security 5.79% GS 2030 issued on

11th May 2020 was replaced in less than 3 months by a new 10 year security 5.77% GS 2030 on 3rd August 2020 and the latter is due to be replaced with new 10 year security shortly. The issuance of multiple 10 year securities in such a short time window is a new development for the Indian bond market. In this light, we analyse the impact of the issuance of a new benchmark on the bond markets.

The Benchmark in the Indian context: Neither the RBI nor the Government officially designates any particular security as a "benchmark". The designation of a benchmark status is conferred by the market participants to a particular security, due to attributes like outstanding size, liquidity and maturity, conditional on the security fulfilling certain criteria as follows:

1. There is demand for that security
2. The coupon is competitively set reflecting market rates
3. The target size is reached quickly before the coupon goes off-market[1]

In theory, benchmark securities can be at any tenor across the yield curve, but in India, the 10 year benchmark is the most sought after security. The auction cut-off of a new 10 year security issuance reflects underlying market sentiments which in turn give an indication of the interest rate environment in the near to medium term.

The first condition given above is easily met in the 10 year maturity, as it is widely demanded across the investor base. The second condition is met through design as the coupon of any bond issued by the government is arrived at by competitive bidding in auctions, and thus, the coupon reflects competitive price setting as per prevailing macroeconomic conditions. The third and the most important condition is that the security reaches its target size quickly before the coupon goes off-market. To attain the requisite traction in the markets, and become the benchmark security, the security has to have a critical size in terms of outstanding. The security 5.79% GS 2030 had reached the outstanding size of Rs.1.04 Lakh Crore in a span of less than three months, owing to the high issuance size per auction, which is an exception in India rather than the rule. . The security 5.77% GS 2030 will be reaching the outstanding size of Rs.1.14 Lakh Crore ,in a span of less than 3 months since its issuance on 3rd August 2020.

As pointed out earlier, the Indian bond markets are accustomed to a longer for the benchmark security i.e. 8-10 months, to remain liquid, and sometimes even close to a year. The unusual situation of reaching the target size in terms of outstanding with closely set coupon rates was hitherto not being witnessed. This also explains why the coupons of the securities 6.45% GS 2029 and 5.79% GS 2030 carried a significant difference of 66 basis points, indicating the time difference as well as market yield movement between issuances. In contrast the coupon of the latest 10 year benchmark security 5.77% GS 2030, was merely 2 basis points lower than the outgoing benchmark as this security was issued only three months after the 5.79% GS 2030 security was issued.

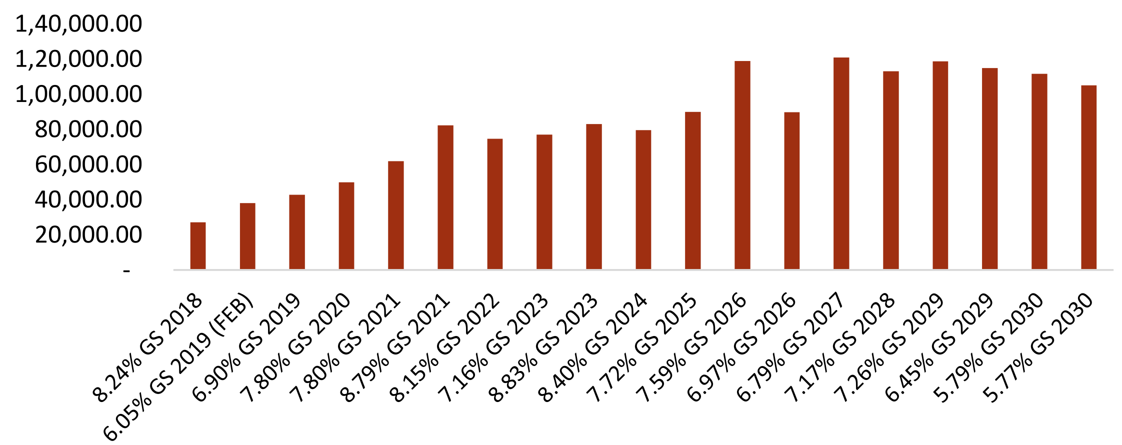
Issuance limits: The most pertinent question for the market is the target size at which the Government stops issuing any given security. Just as the designation of a benchmark is not official, this limit is also not formally announced in any government communication. While not setting any exact numerical limits, RBI's Medium Term Debt Management strategy document

[1] Issuance plan for Government Securities – Guidance Note , April 2015 , World Bank Group

published in 2015 broadly mentions: "*To ensure that debt rollover is within manageable levels every year the upper issuance limits for annual maturity bucket and also for individual security in a particular annual maturity bucket are capped. This limit is calculated on the basis of a sustainable debt trajectory, projected increase in debt stock, government's cash flow imperatives, etc. The limits are periodically reviewed keeping in view the macroeconomic environment and repaying capacity of the Government. In view of large borrowing programme and to ensure supply of securities across the yield curve, the limits could be enhanced incrementally in a calibrated manner as the rollover risks are being addressed through switches*"[2]. Thus, the actual limit is a dynamic one, changing as per the macroeconomic environment which also gives the government some degree of freedom in managing its financing requirements and the market has to estimate the limits by observation. Also, the limit is not sacrosanct and the Government need not necessarily continue issuing the security to fulfil the limit.

A Brief History of 10 Year Issuances: The issuance sizes of the 10 year securities in the past decade reflect the increase in Government borrowings. The total issuance of a 10 year security has risen from an average of Rs.60,000 Crore during the pre-Global Financial Crisis era, to Rs.1.21 Lakh Crore at which the Government has been observed to stop further issuances.

Chart 1:Total Outstanding (Rs.Cr) of Various benchmarks issued since 2008

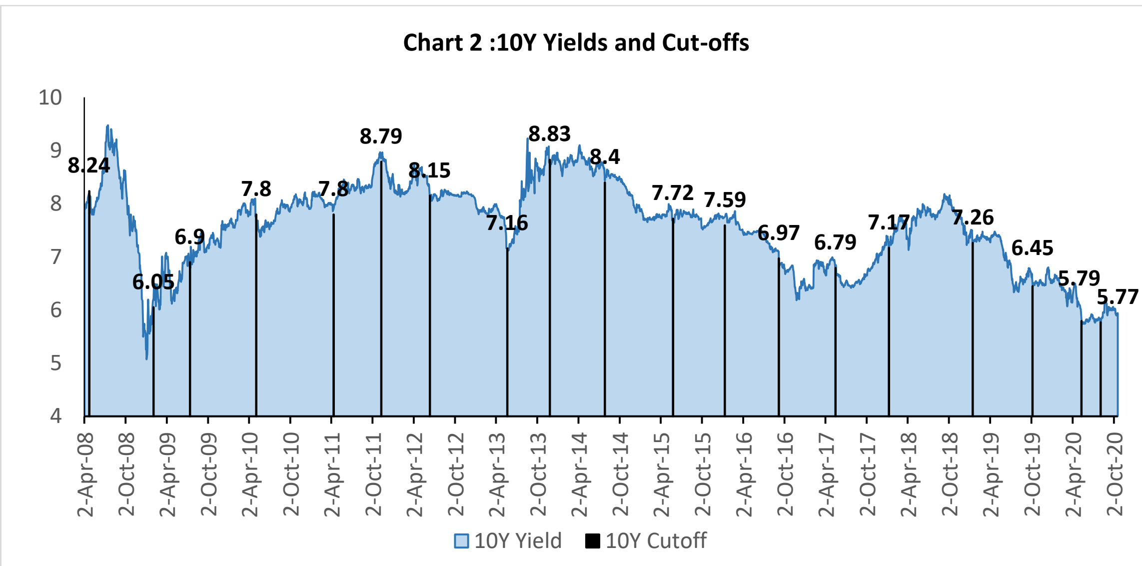


Source: RBI, STCI PD Research

An essential part of the Debt Management Strategy (DMS) is to ensure that roll over risk remains within a manageable level by elongating the maturity and implementing limits for issuances such that no particular maturity bucket faces heavy redemption pressures. The issuance size per auction of the benchmark security in H1:FY21 has been Rs.18,000 Crore, as a result of which the 10 year security 5.79% GS 2030 neared the observed cap of Rs.1.20 Lakh Crore in approximately 10-12 weeks or 6 auctions, making a case for replacement by a new 10 year security. The present circumstances are a case in point. The existing 10 year benchmark security 5.77% GS 2030 is nearing the observed cap of Rs.1.20 Lakh Crore in approximately 10-12 weeks or 6 auctions (by 1st week of November 2020), making a case for replacement by a new 10 year security.

[2] Debt Management Strategy for India-Reserve Bank of India, December 2015

Performance of Benchmark Securities: Under normal circumstances, the yield premium in the auction cut-off of a new 10 year benchmark and the secondary market yield of the outgoing benchmark is around 15-20 basis points depending on extant macroeconomic conditions. In the case of the benchmark issued in May 2020, the cut-off for the security was 5.79% as compared to the market yield of 6.01% of the outgoing benchmark i.e. 6.45% GS 2029. This yield difference of 22 basis points factored in the substantial policy rate cuts implemented by RBI. The current 10 year benchmark security i.e. 5.77% GS 2030 was issued at a coupon of 5.77%, a difference of a mere 6 basis points from the secondary market yield of the outgoing 10 year security i.e. 5.79% GS 2030 which was trading at 5.83% on the auction day. This compression in the benchmark premium occurred due to two reasons: the increased auction size and the reluctance of the market to further anticipate lower secondary market yields due to macroeconomic uncertainty. The market was pricing the spread between the policy Repo rate and the 10 year benchmark at ~200 basis points, given the huge supply of sovereign bonds in the near future. In the chart given below we trace the secondary market yield for the 10 year security vis-à-vis the auction cut-offs for the new 10 year issuances since 2008.

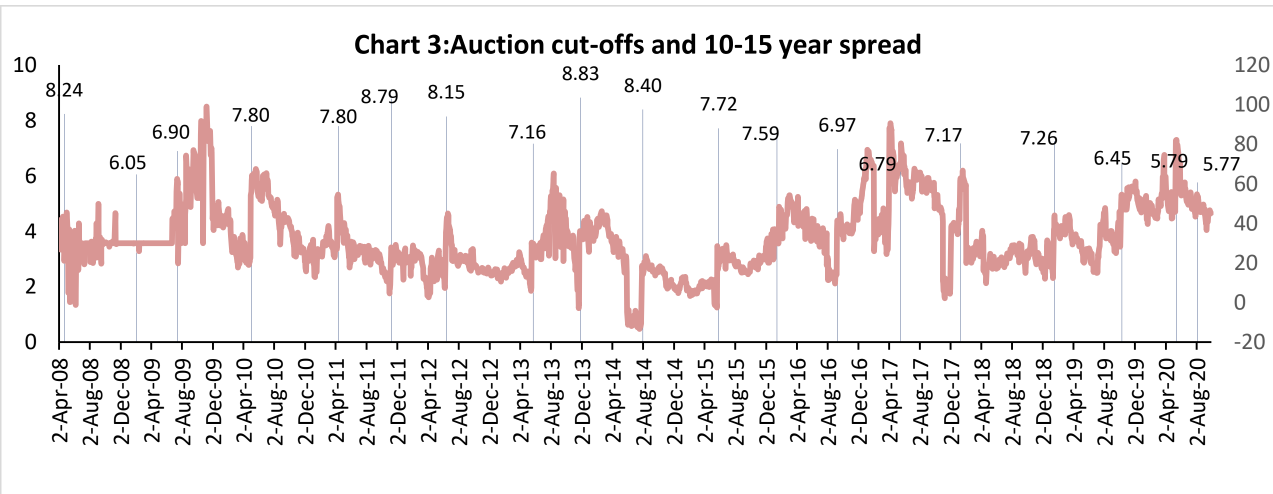


Source: RBI, STCI PD Research

RBI's asset purchases and sales (OMOs) are a crucial factor and influence on market yields of securities. In the context of this article, recent experience with the two 10 year bonds has been somewhat paradoxical due to the regular purchase of the 5.79% GS 2030 i.e. the old 10 year benchmark security by the RBI in Special Open Market Operations, as a part of the overall strategy to manage the yield curve. This has resulted in the old benchmark trading with at a lower yield to the current benchmark over some period of the second quarter. The continuous purchase of the 5.79% GS 2030 security by the RBI, led the yields of the old 10 year benchmark to trade below the existing 10 year benchmark, which would rarely happen under normal circumstances. This phenomenon of the RBI OMOs changing the normal yield behaviour might be repeated with the 5.77% GS 2030 when the government issues a new benchmark. This is a temporary event and will not sustain over a long term as the old 10 year benchmark will remain in favour only as long as the RBI keeps purchasing the security.

Yield Behaviour: Historically, once the auction of a new 10 year security is announced, the yield of the outgoing benchmark begins to drift higher as the market starts pricing in an illiquidity premium. As the new 10 year maturity is widely demanded by investors across the investor spectrum, the cut-off yields tend to converge near the secondary market yields with due weight given for its benchmark premium. The auction cut-offs do not display much divergence from the average cut-off. After the new 10 year security is issued i.e. the auction cut-off is fixed, its market yields generally tend to drift lower. Exceptions to this phenomenon may arise when macroeconomic conditions and the demand-supply equations are imbalanced due to some extreme conditions like the present one. As seen in Chart 2 above, none of the benchmarks issued over the past 12 years had a cut-off yield widely off-market. A wider range of bids may be seen more often in the case of other securities, especially the very long end for the 30-40 year securities where the investor base narrows down to insurance companies and pension funds.

Yield behaviour of other near maturity securities:



Source: Bloomberg, STCI PD Research

Chart 3 shows that spreads widen between the 10 year and the near maturity securities like the 15 year prevailing at or around the time of auction of the 10 year benchmark. Under normal conditions, the 10-15 year spreads widen by ~15-25 basis points. This has been historically observed and the widening may happen on the auction day or in the week following the auction. Even in the recent past the conventional trend of spread widening has largely been the norm, except in the case of 5.77% GS 2030, which saw the 10-15 year spread widening by only 7 basis points, whereas the earlier benchmark 5.79% GS 2030 had witnessed this spread widening by 36 basis points, giving due weightage to the macroeconomic conditions that had changed within the three months between the two benchmarks.

New 10-Year Benchmark-expectations: A benchmark security commands a "benchmark premium" because the market expects it to have a liquid shelf-life of at least 8-12 months. The huge borrowing programme has forced the government to issue new 10 year securities more frequently than has been customary in the past leading to narrowing of the benchmark premium. An unintended effect of this narrowing of the yield premium is that it may nudge the market participants to look for other securities across the yield curve thereby improving overall liquidity distribution. However, appetite for a more frequently issued benchmark security with a lower shelf life wanes rapidly after its issuance as its outstanding notional amount increases rapidly.

The recent experience with the current 10 year benchmark, 5.77% GS 2030, reflected this with the security being devolved in four successive auctions on primary dealers, as the RBI signalled its discomfort with the higher yields being tendered by the market.

The current outstanding of the 10 year benchmark security, 5.77% GS 2030 is Rs.1, 05,000 Crore as on 19th October,2020 .An additional Rs.9,000 Crore has been announced to be issued on 26th October 2020,for the 10 year maturity, which will result in a total outstanding of Rs.1.14 Lakh Crore. Since the observed issuance limit for sovereign bonds is at ~Rs.1.20 Lakh Crore, we expect the issuance of a new 10 year benchmark security in the first half of November 2020.This is based on the assumption that the Government in consultation with the RBI does not increase the issuance limit. As mentioned earlier, one of the qualifying conditions of a benchmark security i.e. reaching its target size before its coupon turns off-market was not being met in the Indian context due to the elongated shelf life of 8-10 months. That situation, at least, temporarily appears to have changed with the frequent issuances of new benchmark securities. Similarly, the rush to exit the outgoing benchmark has changed as the outgoing benchmark becomes a potential OMO candidate. It is quite likely that a converse trend will be observed with the new benchmark security being issued or traded at a higher yield than the outgoing benchmark security.

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