ICRA

ICRA Rating Feature

Rating Methodology for Primary Dealers

This rating methodology updates and supersedes ICRA's earlier rating methodology document on primary dealers (PDs) published in February 2018.

PDs are financial intermediaries which help in developing the primary and secondary markets for Government securities [(G-Secs; dated securities and Treasury bills (T-Bills)]. The Central Bank of a country may employ the PDs to fulfil one of its objectives, which is to help the Government complete its borrowing programme at the lowest cost.

The system of PDs was introduced by the Reserve Bank of India (RBI) in 1995 with the following objectives:

- To strengthen the infrastructure in the G-Sec market to make it vibrant, liquid and broad-based
- To develop underwriting and market-making capabilities for G-Secs outside the RBI so that the RBI could gradually divest these functions
- To improve the secondary market trading system so that it would contribute to price discovery, enhance liquidity and turnover, and encourage the voluntary holding of G-Secs among a wider investor base
- To make PDs an effective conduit for conducting open market operations

Norms laid down by RBI for operating as a PD

Any company, which is a subsidiary of a scheduled commercial bank, an institution, a company incorporated under the Companies Act, 2003 or a joint venture, with net owned funds (NOF)[1] of at least Rs. 150 crore could apply to be a PD. If a PD intends to diversify into other permissible activities, a minimum NOF of Rs. 250 crore is required. Also, an entity applying for a standalone PD registration should be registered as a non-banking financial company (NBFC) under Section 45-IA of the RBI Act, 1934 for at least one year prior to the submission of the application. The applicant should also have experience in the securities business, particularly in the G-Sec market for at least one year prior to the submission of the application. Additionally, during the year preceding the year of application:

I. The turnover of the applicant in the G-Sec business should be equal to at least 15% of its total turnover
II. The applicant's G-Sec assets should be at least 15% of its total assets

Banks, which do not have a partly or wholly-owned subsidiary undertaking a PD business, can also apply for undertaking a PD business departmentally if they have a minimum NOF of Rs. 1,000 crore, a minimum capital adequacy of 9%, net non-performing assets (NNPAs) of less than 3 per cent and a profit-making track record for the past three years.

[1] NOF is calculated as (a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance sheet of the company after deducting (i) accumulated balance of loss (ii) deferred revenue expenditure and (iii) other intangible assets; and (b) further reduced by amounts representing (1) investments of such company in shares of (i) its subsidiaries (ii) companies in the same group (iii) all other NBFCs; and (2) the book value of debentures, bonds, outstanding loans and advances made to and deposits with (i) subsidiaries of such company and (ii) companies in the same group, to the extent such amount exceeds 10 per cent of (a) above

Currently, there are 21 PDs (7 standalone PDs and 14 banks authorised to undertake PD business departmentally) operating in India. Their operations are regulated and monitored by the RBI. As per the current regulations, PDs are not allowed to have step-down subsidiaries.

Snapshot of a PD's operations

As per the RBI's guidelines, the major roles and obligations of PDs are as below:

- They are required to support auctions for the issuance of G-Secs (including T-Bills) as per the minimum norms for the underwriting commitment, bidding commitment and success ratio (ratio of total bids accepted to bidding commitment) as prescribed by the RBI from time to time. The RBI may also invite PDs to underwrite the auction of state development loans (SDLs)
- They should also achieve a minimum success ratio of 40% of the bidding commitment in T-Bill (including cash management bills – CMBs) auctions. The success ratios are monitored on a half-yearly basis, i.e. April to September and October to March, separately
- They should offer two-way prices in G-Secs through the Negotiated Dealing System-Order Matching (NDS-OM), the over-the-counter (OTC) market and recognised stock exchanges in India and take principal positions in the secondary market for G-Secs
- They should annually achieve a minimum turnover ratio of 5 times for Government-dated securities and 10 times for T-Bills of the average month-end stocks. The turnover ratio (ratio of total purchase and sales during the year in the secondary market to average month-end stocks) in respect of outright transactions should not be less than three times for Government-dated securities and six times for T-Bills
- Their investment in G-Secs, T-Bills and corporate bonds on a daily basis should be at least equal to the net call/notice/REPO (including collateralised borrowing and lending obligation - CBLO) borrowings plus net RBI borrowings (through liquidity adjustment facility (LAF)/intraday liquidity/liquidity support) plus the minimum prescribed NOF
- They should maintain adequate physical infrastructure and skilled manpower for efficient participation in primary issues, trading in the secondary market, and to advise and educate investors
- They shall have an efficient internal control system for the fair conduct of business, the settlement of trades and the maintenance of accounts
- They will provide the RBI with access to all records, books, information and documents as and when required
- They should submit periodic returns as prescribed by the RBI from time to time
- Their operations are subject to the prudential and regulatory guidelines issued by the RBI from time to time

While performing the above operations, a PD borrows funds from the call money market or from the RBI under the LAF and buys G-Secs. In addition to access to the RBI's LAF, PDs are provided with liquidity support by the RBI against eligible G-Secs and SDLs at REPO rates depending upon their performance in the primary and secondary markets. The spread between the cost of the borrowed funds and the yield on the G-Secs provides the PDs with a net interest income (NII). With the majority of the G-Secs having a fixed coupon rate while the source of funds typically deployed by PDs during the auction are through call money borrowings, the ability of the PD to borrow at the best rates to maintain a positive NII is crucial to maintain profitable operations. In addition, depending on the market conditions, PDs may choose to hold or sell the G-Secs with the objective to improve the profitability or reduce the possible losses. Thus, the interest rate movements in the secondary market and the PDs' interest rates outlook tend to have a bearing on its profitability. The three scenarios of interest rate movement are discussed below.

Steady interest rate scenario

In this scenario, the trading opportunities for the PD may be limited. Thus, the principal source of profitability is the NII, earned by way of a coupon on the G-Sec and its borrowing costs. A higher net worth (or lower leverage) results in relatively lower levels of borrowing and improves the net interest margins (NIMs) of the PD. However, the lower NII leads to a lower return on the net worth. A PD may continue to hold the investments by rolling over its borrowings (against the G-Secs/T-Bills) or by gradually offloading the same to other investors.

Falling interest rate scenario

In this scenario, the trading opportunities are plenty and the probability of making trading profits is higher. Apart from underwriting operations, PDs make use of the falling interest rate regime to actively trade in their G-Secs portfolio by increasing their investment books and borrowings (against these investments). At the same time, the gross interest spreads may reduce as the spread between the borrowing costs and the yield on investments may decline. With the increase in the leverage, the NIMs may also go down even though there may be an absolute increase in the NII because of the larger portfolio size driven by the increased leverage. The earnings profile of the PD may likely change in favour of the income from trading operations rather than the NII on the portfolio held. Such a scenario could help a PD grow its profits and reserves, which would act as a buffer during adverse market conditions.

Rising interest rate scenario

In this scenario, a PD may face a difficult time with regard to the NII as well as making trading profits. During such periods, the NII could be negatively impacted as the call money rates tend to become volatile and the PD's funding costs could increase. To reduce the vulnerability to rising interest rates, a PD may reduce the portfolio size and correspondingly its leverage, thereby reducing its NII. With a rise in interest rates, the prices of G-Secs fall, resulting in losses for PDs. Based on strategies and the market outlook, a PD may redraw its strategy for such volatile periods in the markets, which may include reducing the leverage, scaling down the operations, not carrying the positions for the longer term and booking the profits/losses at higher frequencies. Thus, the PD's risk management systems and its operating strategies are crucial in such a scenario.

Given the role of PDs in the Indian debt market, there exists a need for these players to borrow money from the market and leverage their operations. In light of the above, ICRA considers the following rating criteria while rating the debt programmes of PDs.

Rating criteria for PDs

Market Risk

The source of market risk for a PD emanates from the volatility in the market price of its assets i.e. primarily debt securities. ICRA analyses the various primary dealer returns (PDRs) submitted by the PDs[2] to assess the movements in the investment portfolios (in terms of size and composition) as well the funding mix of the liabilities. Additionally, the PDRs are analysed to see the movements of the duration of the assets and liabilities, leverage levels and hence the duration of the NOF, to assess the impact of the movement in the interest rates on the NOF. A stress test for different durations and leverage levels of the PD is analysed to see the loss-absorption cushion available from the NOF. ICRA views the NOF to potential loss ratio as an important metric to evaluate PDs. In case of a weak cover, the PDs scale down their operations or infuse more capital in the form of equity.

Credit Risk

PDs primarily deal in G-Secs, where the credit risk is negligible. However, the credit risk for PDs may arise from their exposure to corporate debt papers. ICRA evaluates the internal norms and the control systems put in place by the PDs to adhere to such norms to evaluate the credit risk borne by the PDs. The internal norms analysed include the internally approved limits for investment in corporate bonds, value at risk (VAR) limits in relation to the NOF across product levels, and the credit rating-wise approved investment limits in corporate bonds.

[2] *PDRs are submitted to the RBI by PDs on a fortnightly (PDR1), monthly (PDR2) and quarterly (PDR3 and PDR4) basis as per the regulatory requirements*

Capital

The RBI norms stipulate a minimum NOF of Rs. 150 crore for undertaking standalone PD operations and a minimum NOF of Rs. 250 crore for undertaking other permissible activities. The eligibility for the inclusion or deduction from the NOF gets classified as the Tier I capital[3] of the PD. Additionally, a PD can have Tier II capital arising from revaluation reserves, general provisions, hybrid capital instruments and subordinated debt. PDs are required to maintain an overall capital adequacy ratio (CAR) of 15% of the risk-weighted assets (RWAs) with the total Tier II capital not exceeding 100% of the Tier I capital. Within the Tier II capital, subordinated debt[4] is limited to 50% of the Tier I capital.

As standalone PDs are required to maintain at least 50% of their total investments in G-Secs (actual holding is much higher) at any point in time, as per the RBI's regulations, the RWAs are limited as G-Secs carry zero credit risk weight. Hence, the RWAs are largely a function of other balance sheet and off-balance sheet exposures like corporate bonds, interest rate futures, etc, apart from the market risk on the bond portfolio, calculated as per the criteria defined by the RBI for PDs.

The market risk for PDs arises from their exposure to debt instruments and their associated price sensitivity to interest rate movements and bond portfolio duration. As per regulatory requirements, 50% of the capital required for credit risk weighted assets should be met through the Tier I capital.

The capital required to mitigate the credit risk is driven by the nature of the investments (whether corporate/G-Secs, etc). The capital required to mitigate the market risk is a function of the duration and the scale of operations (i.e. the size of the investment book/portfolio), which is typically an outcome of higher financial leverage. The financial strength to absorb market risks and the ability to scale up, in the event of trading opportunities, are driven by a PD's capital levels. A high net worth/Tier I capital acts as a buffer against adverse movements in interest rates. ICRA views the net worth of a PD, in relation to the PVBP[5] of the bond portfolio, apart from the VAR and the duration of the NOF to assess the solvency profile of a PD. A high net worth in relation to these parameters acts as a strong buffer against potential market movements.

Funding and Leverage

PDs are permitted to borrow funds from the call/notice/term money market, commercial paper (CP), non-convertible debentures (NCDs), REPO (including CBLO), inter-corporate deposits (ICDs) and foreign currency non-resident (bank) [FCNR (B)] loans. PDs are also eligible for seeking liquidity support from the RBI under the LAF as well as additional liquidity support from the RBI (beyond LAF), aspects that impart superior liquidity.

There have been changes in the RBI's liquidity management framework as per the circular dated February 6, 2020. As per the circular, the access to the overnight and other shorter-tenure (less than 13 days) LAF has been curtailed for all participants like banks and PDs and will be decided by the RBI, based on an assessment of the liquidity conditions. The conducting of such short-tenure liquidity operations is at the discretion of the RBI. Accordingly, the ability of PDs to borrow for overnight requirements under LAF is restricted. Moreover, as these operations are at the discretion of the RBI, the availability of such funding on a regular basis is uncertain.

However, the LAF access through the 14-day variable rate REPO is still available for banks as well as PDs. The liquidity will be made available to participants through an auction conducted by the RBI on a weekly basis every Friday for a notified amount.

Hence, PDs will have to plan their funding requirements in a better manner as overnight funding through the LAF window will no longer be available. PDs will have to depend on call money markets (unsecured) to fund

[3] Tier I capital is calculated as the sum of paid-up capital, statutory reserves and other disclosed free reserves, adjusted for investments in subsidiaries, intangible assets, deferred tax assets, losses in current accounting period and losses brought forward from previous periods

[4] Subordinated debt should have a minimum maturity of 5 years and subject to a progressive discount for inclusion in Tier II capital during the last 5 years of maturity. The instrument should be plain vanilla with no features like options and should carry a fixed coupon rate

[5] Price value of a basis point (PVBP) measures the gain/loss on the entire portfolio for a 1 basis point (0.01%) movement in the interest rate

their overnight/next day liquidity requirements. While borrowing from call money markets shall not be an issue for stronger institutions in a surplus liquidity scenario, it is expected that in a situation of liquidity tightness in call money markets, the RBI will either increase the notified amount in the 14-day variable rate REPO window and/or conduct overnight and shorter-tenure LAF operations to provide liquidity to banks as well as PDs.

Further, for fulfilling their underwriting commitments for G-Secs/T-Bills, PDs will have to rely on either the call money borrowings or the LAF window under the 14-day variable rate REPO operations of the RBI.

In a scenario of surplus systemic liquidity, the call money rates are expected to be lower than the REPO rate and the market REPO will form a larger part of the borrowings for the PDs as it will be cheaper than the RBI REPO borrowings. However, when liquidity conditions tighten, the RBI REPO borrowings will increase as these could be cheaper than the market REPO.

If a bank or a PD is not being able to borrow at all in the call money market because of any issues with the institution and it has G-Secs created through a short-term liability like overnight call money borrowings, which needs to be repaid the next day, the following are the ways to repay such borrowings:

a) Sell the G-Secs and/or
b) Borrow through REPO on The Clearing Corporation of India Ltd.'s (CCIL) platform, where the settlement is guaranteed by CCIL and has no linkage to the underlying institution

Hence, the curtailment of overnight LAF access will require better liquidity management by the PDs, especially in situations of tighter money market conditions.

In surplus liquidity situations, the call money borrowing or borrowing under LAF (REPO) may be the cheapest source of money for a PD and the share of borrowings through this route may increase during such periods. However, as borrowings through call money and REPO are re-priced daily and the rates can inherently be volatile, a larger share of the borrowings through this route imparts volatility to the cost of funds besides hampering the liquidity in tight liquidity situations in the money markets. Major reliance on the short-term call money market in the overall borrowing pie is, however, restricted as the RBI allows the average borrowings through the call/notice/term money market during a fortnight at a maximum of 225% of the NOF (subject to periodic review by the RBI). However, the peak borrowings from the short-term call money market may be much higher than 225% of the NOF during periods of G-Sec and T-Bill auctions, as PDs may have to borrow more on a temporary basis to meet their underwriting commitments.

The end use of the funds borrowed from call money/LAF is also restricted by the RBI as PDs are required to maintain investments in G-Secs (including T-bills) and corporate bonds (up to 50% of NOF) on a daily basis, which would be equal to the borrowings from the call money market plus the net borrowings under the LAF and the minimum prescribed NOF.

With restrictions on using the call money market for investments in corporate bonds (i.e. 50% of NOF), a PD willing to undertake other activities related to the dealing/underwriting of corporate bonds may have to rely on other sources of borrowings like CP and ICDs (ICDs allowed up to 150% of the NOF at the end of the preceding financial year) to fund these activities. The liquidity risk for a PD may emerge if it is not able to roll over these borrowings for funding the non-SLR book because of volatile market conditions, while at the same time, these investments also turn illiquid because of market volatility. The ability of the PDs to maintain a granular non-SLR book across high-rated issuers and frequently test the portfolio for liquidity can mitigate the liquidity risks.

While there are no regulatory limits on PDs with regard to leverage or CP borrowings, adherence to the internally approved limits as per the risk management policies on a regular basis is analysed. Also, the leverage level in relation to peers is compared to assess the overall risk appetite of the PD. Apart from the comparison of the leverage level in relation to peers, the leverage drives the duration of the NOF and the sensitivity of the net worth to interest rate movements. Accordingly, maintaining a low leverage and hence a low duration of NOF are viewed positively.

As investing and trading in G-Secs is their primary business, PDs maintain a high share of investments in SLR securities, which are highly liquid. ICRA assesses the daily average source of funds, eligible for funding the non-SLR book against the actual non-SLR book, to evaluate the extent to which the non-SLR eligible funding may be parked in the SLR book as it provides additional liquidity comfort. Furthermore, ICRA assesses the internal norms guiding the non-SLR investments and actual holdings in the non-SLR portfolio of the PDs to evaluate the quality of the non-SLR book.

Risk Management and Systems

ICRA evaluates the internal operating guidelines and risk management systems such as the prudential norms and VAR thresholds set by the management. The adherence to and the efficient usage of such systems by the management are considered favourably. A discussion with the risk management team and auditors is done on instances of breach of risk management policies and the implementation of subsequent corrective action plans. In addition, ICRA evaluates the PD's compliance with regulatory norms in respect of primary and secondary market operations in terms of bidding commitments and turnover ratios, etc.

Profitability

The financial performance of a PD is significantly influenced by the external environment such as the economic cycle, the Government's borrowing programme and interest rate movements. The ability of the PD to adapt quickly to the changing environment is expected to alleviate income volatility.

The historical trends in the profitability of a PD are assessed for their level and stability vis-à-vis peers. ICRA notes that the profitability of a PD is dependent on the degree of its aggressiveness reflected in the asset characteristics and leveraging levels. Nevertheless, the liquidity risk for PDs is low as most of their assets are in G-Secs, which are highly liquid. The strong REPO market for G-Secs further alleviates liquidity concerns. As the PDs' main business revolves around trading, their non-G-Sec investments are usually in instruments that carry high credit ratings (ratings of AA and equivalent and above), thereby mitigating the credit risk and the provisioning requirements due to a credit loss. Apart from interest income, trading income and underwriting income, other sources of income such as debt syndication fee and corporate bonds underwriting fee, etc, offer diversity to the revenues and impart some stability to profitability.

Promoters and Management

Most PDs are backed by strong promoters and their ability to provide ongoing support to the PDs such as capital infusion as well as extraordinary support in times of stress, if required, is factored in while evaluating the credit profile of a PD. ICRA favourably views a stable and experienced management to manage the interest rate and liquidity risk profile of the business.

Summing Up

ICRA 's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the entity and the instruments being rated. For a PD, the income and profitability are driven by the sensitivity of its assets (primarily debt securities) to interest rate movements. The impact of interest rate movements gets amplified by leverage with the capital acting as a buffer against such adverse movements. The risk management policies and prudential norms of a PD reflect its degree of aggressiveness and need a careful assessment to gauge its risk profile.

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