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Roundtable Meeting of Treasury Heads of Public Sector Banks (PSBs)

August 2014

Roundtable Meeting of Treasury Heads of Public Sector Banks (PSBs) held at CAFRAL in August 2014 - Highlights and Takeaways

There is basic asymmetry in the G Sec trading and derivative market participation. Objective of the meeting was to discuss reasons for muted participation of PSBs in G Sec trading and derivatives market (IRS, OIS & IRF) compared to foreign banks and private sector banks. The highlights of the discussions are below:

Some of the facts:

- **PSB participation in G Sec Trading**: Public sector banks share in G Sec trading activity was limited to 23.2 % of total trading volumes compared to 28.2 % of foreign banks, 19.5 % of private banks and 16.5 % primary dealers in last quarter of 2013.
- **Facts: PSB participation in derivatives market**: Market share of PSBs in IRS (MIBOR) for May 2014 was negligible (0.43 %) compared to 68.88 % by foreign banks, 19.54 % by PDs and 11.15 % by private banks. Participation by PSBs in the derivative market is of the **view** taking type and not **hedge** taking type. The reasons for current dichotomy in OIS and G Sec market may be a result of the view taking instead of hedge taking approach of PSBs. PSBs participation can make market more scientific and dynamic. PSBs prefer using IRF due to its being correlated to benchmark and relatively less uncertainties. Whereas off balance sheet items (contracts/derivatives/credit contingents together) of PSBs are just 48% of the total assets, in contrast, ten times of their total assets foreign banks.

Compelling reasons for PSBs to take up G Sec trading and IRS IRF OIS derivatives:

- **Profitability from derivatives**: Comparative analysis of contracts & derivatives/total assets and profit/loss on forex operations as % of PAT shows that in March 2014, foreign and new private sector banks made substantial profits in treasury operations as compared to PSBs, despite PSBs holding almost 70% share of securities. Profit from forex operations by foreign banks was 50 % of their total profits against 24% by PSBs.

- **Carrying huge exposure to interest rate/market risk on their balance sheets:** Globally, swap rate is always higher than G Sec rate, but in India it is not always so, especially during volatile periods. Distortions in swap rates are due to inefficiencies caused due to PSBs keeping away from the market. If all major banks participate, swap curve will trade above bond curve as it should in a mature market even during volatile periods. An aversion to hedging market risk, leads to carrying huge exposure to interest rate/market risk on their balance sheets. Therefore, although derivative market is full of speculators, view takers and arbitragers, but not the hedgers (PSBs). As long as PSBs don't see derivatives as hedge management tool, distortions in swap curve during volatile conditions may not disappear. Playing safe is like a ship happily porting in the harbour avoiding sea, which is against the purpose it is made for.

- **ALM & compensating G Sec trading losses**: Active trading in hedging instruments like IRS, OIS will be useful from various perspectives like ALM, compensating losses on G Sec portfolios, developing active trade management by PSBs and evening out the distortions in interest rate swap market etc. These are the only hedging tools available for duration matching in ALM assets and liabilities and progressively reducing HTM portfolio. Although deposits are repricing themselves, there is a hidden interest rate risk in 70% of banking assets.

- **Proven correlation of underlying G Sec and derivatives market movement-against the popular perceptions:** Popular perceptions regarding OIS liquid derivative and overall derivative markets is that these are volatile, with little correlation between underlying bond market and swap market, and transmission of interest rates is only through bond markets. Last two and half years data (from Feb 2012 onward) on bond and swap market shows movement in G Sec bond curve is corresponded by movement is swap curve and that there is compensatory correlation relationship from both interest and liquidity perspective.

- **Developments like standardisation:** Under the umbrella of CCIL, FIMMDA and overall guidance of central bank, developments like standardisation of derivative products, their traded volumes, and proven sensitivity of swap curve to pressures on interest rate or liquidity should develop change the approach of PSBs. Well-managed treasuries of foreign and private banks have become profit centres.

Constraints for PSBs:

- **Lack of specialisation for investment banking**: Investment banking (capital and managing risk) and commercial banking (deposit/credit based) are two segregated functions in banks of developed nations and foreign banks in India. Different business philosophies govern these functions, leading to developing specialisation and honing talent for investment banking. In contrast, in PSBs of India these disciplines are merged which results in adopting the same generic practices of commercial banking like rural transfer, one city or one department posting cut off limits etc. being followed in treasuries also, retaining talent and development of expertise. It will be important to establish such enabling conceptual divide in PSBs.

- **Lack of involvement of PSB Boards in investment function:** Generally Boards and senior management of banks are aware of their needs of risk management and trading. But they don't have time to go into details of the treasury operations. They rely on the reports of risk management committees, whose duty is to ensure management of best practices and avoidance of untoward risks. The stability of the deposit-credit based business doesn't compel them to do so. Developing a will and involvement of top management & Boards and specialisation of talent are the areas on which PSBs may have to focus for active market participation in IRS, IRF, OIS, G Sec Trading, etc.

- **Preparing for declining HTM and valuation issues**: With a regulatory policy environment of declining HTM, marking to market the entire investment portfolio would be necessitated. It would be necessary to activate the banks to take calculated risks by taking Boards in confidence and explain how treasuries can take profit position by optimising hedge (buying selling OIS IRS) to counter volatility in G Sec market to distribute risks on investments across tenor curve for better risk management.

- **Term money market is not developing beyond 14-day:** Evolution of banking and term money market overseas and in India have certain basic differences arising from deposit funded banking in India as against purchased funding based banking system in the developed overseas market or even foreign banks in India. Actively traded benchmark indexes and term money swaps built around it have developed in developed countries.

- Another difficulty in development of active term money market emanating from the fact that in the post crisis era, most of the banking system in India and even globally, are encouraged to be liquidity surplus, so there is nobody on the other side of the market to buy the surplus.

Required Change of Approach of PSBs:

- Approach of looking at derivative market needs a fundamental change. Fear of unknown and loss can be tackled only if PSBs look at the derivative market over a longer period horizon, at least over a 3 year horizon, as suggested by the experience of some major private banks. Behaviour of derivative products can be understood by staying with the product over a longer horizon in controlled environment. From experiences of participating larger players like private banks shows that the ROI in derivative markets (OIS, IRS) over longer horizons can be much higher than credit. It is also necessary to be present in all the markets all the time. Various investors enter market with as investors, speculators, arbitragers, hedgers at different times with different motives. Prudence lies in optimizing by operating in all the markets. Essentially, presence in all the markets all the time has proved to work better for risk management, as markets are volatile and can go on different trajectories. To be present in all the market helps to optimise and take advantage of market movements for better returns.

- The risk management team of the bank must ensure that strong risk management policies assure top management of the bank who would review risk management policies.

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