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UNDERSTANDING THE RECENT SURGE IN G-SEC YIELDS & HOW THE RBI CAN CAP SUCH RISE

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HIGHLIGHTS

May you live in interesting times! This is a Chinese proverb which accurately reflects the current state of the Indian debt market. The current fiscal is an interesting year with the two halves having diametrically opposite narratives. During the first half, bond yields were mostly below 6% on the back of effective yield management by RBI. However, all this changed after the budget when the Government upped its borrowing programme for the current fiscal and has announced an aggressive one for FY22. With just over a month left in FY21, the market is still expecting a consolidated borrowing amount of more than Rs 2.5 lakh crore as per the auction calendar of Centre & States. The average increase in g-sec yields across 3,5 & 10 years is around 31 basis points since the budget. AAA Corporate bond and SDL spreads have jumped by 25-41 basis points during this period.

While this significant increase in bond spreads is a manifestation of the nervousness of market players, we believe the central bank will have to resort to unconventional tools to control the surge in bond market yields. This is important as any further upward movement in G-sec yields even by 10 bps from the current levels could usher in MTM losses for banks that could be a minor blip of a rather wise exceptional year in FY21 bond markets with the RBI assiduously supporting debt management of Government at lowest possible cost in 16 years, that otherwise could have threatened financial stability. In fact, RBI strategy of devolving on the primary dealers may have its limitations as Standalone PDs account for 15-16% of secondary market share that may not be enough to move the market. This share has remained broadly consistent over long period despite excessive market volatility.

We believe one of reasons for the recent surge in yields might be short selling by market players. While going short or long are typical market activities that aid in price discovery, but in times it can result in price distortions too as it might be happening now. The strategy of short selling involves the sale of a security which the seller has not yet purchased but borrows the security from others in the market through the CROMS platform of CCIL. The banks and the primary dealers resort to short selling when their view is bearish - that is, the prices of the bond will fall and the yield will rise. They make money if the bond prices drop and yields rise, and over a point of time this could become a self fulfilling prophecy as such short sellers keep on rolling over their borrowed security from the repo market till the time they believe that yields will continue to rise. The only way to break such self fulfilling expectations is for RBI to conduct large scale OMOs to provide necessary steam to bond market to rally and with increase in price, many short sold position will trigger stop losses and market players will scramble to cover open positions. This will hasten a rapid fall in yields over a short period of time.

Specifically, the RBI can think of the following steps.

- **Speaking to market players /Off market interventions:** This will also fulfill the desired objective of RBI avoiding devolvement at auctions.
- **OMO in illiquid security**: OMO in illiquid security will help shorters (hedgers) to get relieved of those holding in OMO and unwinding of short position will happen, if the selling pressure is matched by an equivalent or better buying pressures from the market participants. Announcing a weekly outright OMO calendar of Rs 10000 crore till March end will be helpful.
- **Stopping VRR rollover**: With even short end Gsec yield (3yr Gsec at 4.9% & 5yr Gsec at 5.85%), Corp bond yields higher too (3yr AAA at 5.55%) the entire benefit of accommodative stance is neutralised. VRR is not helping in overnight rates as can be seen in last week treps rate which was averaging 2.4%.
- **Holding period:** Time period for covering short sale may be reduced from 90 days to 30 days.
- **Margin Requirement**: Margin requirement for borrowing securities in repo market while covering the short sale position may help. Short sellers may deposit collateral to the tune of 150% of value of short security.
- **Limit reduction**: Security level limit may be reduced to 1% of outstanding stock (or Rs 300 crore) of each security in case of liquid securities and 0.5% (or Rs 150 crore) in case of illiquid securities.
- **Allowing More players**: Allowing more players such as mutual funds and insurance companies in the repo market.
- **Penalizing short sellers**: The short sellers are even willing to give the money at 0.01% for borrowing bonds. Can we have not a system of negative interest that will make the transaction even costlier for them? RBI can also supply bonds in the repo market to the short sellers if it has the stock.

It must be greatly appreciated that the RBI has used all tools at its disposal in FY21 to manage a humongous government borrowing programme that perhaps was not the case prior to it, particularly during FY17-19.The markets have however moved a step ahead of the RBI post budget. It is now time for the RBI to align the market expectations with its stated objective. So goes the saying *"Monetary policy is the art of managing expectations and little else"-Michael Woodford, Professor, Colombia University*. True indeed!

GOVERNMENT BORROWINGS & LIQUIDITY SITUATION

- The Gross market borrowing of the Centre for FY21 has been recently revised to Rs 22.1 lakh crore compared to the earlier estimates at Rs 21.5 lakh crore. With just over a month left in FY21, the market is still expecting a consolidated amount of more than Rs 2.5 lakh crore as per the auction calendar of Centre & States. The average increase in G-sec yields across 3,5 & 10 years is around 31 basis points since the budget. AAA Corporate bond and SDL spreads have jumped by 25-41 basis points during this period.

IS SHORT SELLING THE REASON BEHIND THE SURGE?

- Recently, after budget and announcement of government borrowing programme bond markets have become bearish and as a result, the market players might have resorted to short sale. While going short or long are typical market activities that aid in price discovery, but in times it can result in price distortions too as it might be happening now.
- A short sale is a transaction in which a trader sells a bond which it does not own. In contrast to that, those who hold long positions make money when the bond prices go up. A short squeeze happens when there is a lack of supply of the bond which the short sellers need to borrow.
- The strategy of short selling involves the sale of a security which the seller has not yet purchased. The banks and the primary dealers resort to short selling when their view is bearish - that is, the prices of the bond will fall and the yield will rise. They make money if the bond prices drop and yields rise, as is happening now and over a point of time this could become a self fulfilling prophecy. In due course, the short-seller buys the borrowed security back from someone else in the market to meet its delivery obligations to the Clearing Corp. of India Ltd (CCIL), in order to return it to the lender. Between selling and then buying back the security, the short-seller is said to have a short position. If the price of the security falls before it is bought back from the market, the short position will always yield a capital gain (and vice versa).

REASONS FOR SHORT SELLING

- Short-selling allows essential functions to be performed in the financial market, like Market Making, Liquidity and Hedging
- **Market-making:** Short-selling allows a market-maker to continuously quote prices for securities that he does not hold in inventory. If an investor buys one of these securities, the market-maker can be sure of being able to deliver, because he knows he can borrow it if he is unable or unwilling to immediately buy that security from someone else in the market
- **Liquidity:** Short selling aids to price discovery. It helps in achieving liquidity in the security.
- **Hedging:** A long position in one security can be hedged by a short position in a similar security, so that, as prices fluctuate, changes in the value of one position will be substantially offset by opposite changes in the value of the other. It also allows the underwriting of new bond issues and is therefore essential to the primary market both for government bonds and corporate bonds.

BENEFITS & RISKS OF SHORT SELLING

- One can resort to short selling intra-day but can also keep it open overnight if the view is that the prices will drop further the next day as is happening currently. For instance, for an illiquid bond - which does not see much trading—the limit is capped at 0.25% of its outstanding stock. For a liquid security, the ceiling is higher-0.75% or Rs 600 crore, the lower of the two.
- A short seller borrows the security from others in the market through the CROMS platform of CCIL. One can borrow the security for one day and keep on rolling it over up to 90 days till one actually buys the security.

Market Borrowings through Dated Securities (Rs lakh crore)

Centre	FY21 (RE)	FY21 till Feb20	Expected in FY21	FY22 (BE)
Gross Borrowing	12.8	12.6	13.9	12.1
Repayments	2.3	2.3	2.3	2.8
Net Borrowing	10.5	10.3	11.6	9.2
State				
Gross Borrowing	8.7	6.7	8.3	11.0
Repayments	1.5	1.2	1.5	2.1
Net Borrowing	7.2	5.4	6.8	8.9
Total				
Gross Borrowing	21.5	19.2	22.1	23.0
Net Borrowing	17.8	15.7	18.4	18.1

Note: Centre is stated to borrow an additional Rs 1.3 lakh crores
Source: SBI Research

Total traded amount: Evidence of short selling?

Rs crores	5.77% GS 2030	5.85% GS 2030
13-01-2021	5734	2331
14-01-2021	4686	3319
15-01-2021	5740	2458
18-01-2021	6066	2040
19-01-2021	6008	2369
20-01-2021	5350	2279
21-01-2021	3802	2385
22-01-2021	6389	2110
25-01-2021	6255	2885
27-01-2021	5549	2814
28-01-2021	5002	2575
29-01-2021	2755	1957
01-02-2021	1952	2235
02-02-2021	2610	3620
03-02-2021	3522	3355
04-02-2021	3592	2630
05-02-2021	3585	2665
08-02-2021	5202	3280
09-02-2021	5950	3179
10-02-2021	5322	2617
11-02-2021	6859	3160
12-02-2021	5145	2020
15-02-2021	5914	2155
16-02-2021	5703	2526
17-02-2021	5521	2570
18-02-2021	5565	2975

Source: SBI Research

- However, typically, the short sellers keep on rolling over their borrowed security from the repo market till the time they believe that yields will continue to rise, and here the RBI should actually ensure that large scale OMOs to provide necessary steam to bond market to rally and with increase in price, many short sold position will trigger stop losses and market players will scramble to cover open positions.
- Hence, the RBI might be able to break the chain. If the anticipation of higher yields does not materialise, it will lead to a scramble for covering the positions as soon as possible by the short sellers, which will create more demand for securities which will again push the yields down.
- What further leads to complications in yield management is the lack of breadth in the bond market. Standalone PDs have consistently accounted for 15-16% of secondary market share. This has remained broadly consistent over long period. In the primary market too, average subscription in central government auctions remains close to 50% for PDs. So, it is the pricing in primary
markets which is driving the secondary market pricing. While PDs have been doing their bit, the market requires long term investors to access secondary market for their investment needs.
- For certain banks which act as primary dealers they can show the securities as part of their SLR, while for certain banks who have PDs in the form of subsidiaries it is not possible to show the securities bought as part of SLR.

OFF MARKET INTERVENTIONS BY RBI COULD BE THE BEST STRATEGY

- One option of managing yields in a non disruptive manner by the RBI is to follow the strategy as it has been successfully doing in foreign exchange market. Typically, in times of rupee volatility, the RBI can often intervene through designated dealers and thereby understand short positioning by counterparties / players. Speaking to such players can always dissuade excessive short covering.
- Separately, as an analogy, RBI had instituted a separate window for Oil Marketing Companies to borrow dollar during the global financial crisis and also later, in a similar vein RBI can think of investing in SDLs without the same hitting the market. Through this mechanism, RBI may cajole certain market players to buy securities at a specific rate in bidding that could be then subsequently bought by RBI. This will also fulfill the desired objective of RBI avoiding devolvement at auctions.

HOW TO CAP THE UPWARD MOVEMENT IN YIELDS

- We believe that in the Indian context the long-term yields that are currently hovering around 6% may increase further, as the Government borrowing will be high. Rise in yield will have impact on mark to market loss of banks. Hence it is better to cap the entire yield curve at some levels. This will stabilize the Government bond markets and curb the cost of financing of deficit.
- A series of OMOs will provide necessary steam to bond market to rally and with increase in price, many short sold position will trigger stop losses. Due to such OMO operation, the bond market will rally further resulting in falling yield, improvement in market volume etc. In such scenario, short sellers would curtail their position and may not initiate in large volume.
- **OMO in illiquid security**: OMO in illiquid security will help shorter (hedgers) to get relieved of those holding in OMO and unwinding of short position will happen. If the selling pressure is matched by an equivalent or better buying pressures from the market participants. Announcing a weekly outright OMO calendar of Rs 10000 crore till March end will be helpful.
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RESTRICTING SHORT SELLING SHOULD ONLY BE A TEMPORARY OPTION

- Short selling is the lifeblood for the development of any securities market as it creates liquidity and helps in price discovery. Long-only players alone cannot add depth to the market.
- Restricting Short selling will devoid market of traders and only investors would remain which in turn may dry liquidity of market.
- Shorting of Government Securities is permitted as an appropriate risk management tool. Permitting short sales enables PDs to hedge through a short position prior to an auction so that they could bid more aggressively in the primary auction, thus ensuring that the Government's borrowing programme does not suffer. This is expected to eventually lower the cost to the government as the pricing would be finer in auctions. This also addresses the issue of PDs failing to quote two-way prices for securities not held by them.

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