Bonding with retail investors

Allowing retail participation will broaden the G-sec market

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The Reserve Bank of India has allowed direct participation by retail investors in government bonds. With this move, India joins the select few countries that have given retail investors access to its trading platform, which is currently accessible to institutions such as banks, insurance companies, foreign investors and pension funds.

How will this change ownership of government securities? As of now government securities are largely held by banks (39 per cent of outstanding) followed by insurance companies (25 per cent) and RBI (15 per cent). Provident funds own 5 per cent and mutual funds and FIIs another 2 per cent each. In fact, the ownership of FIIs has been steadily falling from more than 3 per cent in December 2019. On the other hand, mutual funds have increased their holding of government securities.

In the US, where retail investors do participate in the government bond market, an overwhelming 39 per cent of government securities are owned by the US Federal Reserve followed by foreign central banks and funds who own 29 per cent. Mutual funds own more than 10 per cent. Retail investors along with corporates, brokers and dealers own over 7 per cent of government bonds. The overwhelming participation of foreign funds in US debt market is on account of the dollar's status as the reserve currency and capital account convertibility.

Skewed trading

In the Indian G-sec market, trading is skewed in favour of Central government securities (77 per cent of volume). Within this, the top-3 securities accounted for almost 50 per cent of the volume. These were securities with maturities upwards of 10 years. Only 5 per cent of securities traded had maturity of less than three years. Another 23 per cent of securities traded had maturity ranging from three to seven years.

An overwhelming 72 per cent of trading volume was in securities with maturity of more than seven years. This is in synchronisation with the maturity profile of outstanding government securities wherein only 29 per cent of securities are less than five years of maturity. As much as 41 per cent of securities have more than 10 years of maturity. This is in sharp contrast to the maturity profile of time deposits with the banking system. As much as 60 per cent of individual time deposits (₹24.8 lakh crore) are in the maturity bucket of one to three years compared with 19 per cent (₹7.8 lakh crore) in the maturity bucket of more than five years. Retail investors in the more than five-year bucket may consider investing in long-end bonds. However, they need to be prepared for notional capital gains or loss as the case may be, unless underlying security is actually sold. Any increase in interest rates leads to capital loss and a decline in interest rates implies capital gains.

In addition to this, 13 per cent of deposits are in less than one year maturity. Some of these may find their way into Treasury Bills. At present, deposit rates for one year maturity are upwards of 5 per cent compared with yield of 3.75 per cent for a one-year T-Bill. However, money will only flow once yield on T-Bills is more attractive.

Another important characteristic of the bond market is the share of foreign banks and primary dealers in trading activity. Foreign banks had a share of more than 22 per cent in (sell) transactions compared with 16 per cent for PDs. Private banks had a share of 26 per cent and public sector banks 15 per cent. Notably, foreign banks had less than 5 per cent share in domestic deposits. The volume of activity of private banks is in-line with their share in deposits at 29 per cent. Public sector banks are largely buy and hold investors. Retail participation is likely to broaden the base of buy and hold investors.

Retail investors along with corporates do have exposure to the government bond market through mutual funds. However, a large portion is dedicated to liquid and short duration funds with maturity of less than a year. The allocation to long and medium duration government funds is quite low.

Thus, opening up of the bond market to retail investors will channelise a part of household financial savings into government securities, in particular depositors in more than five year maturity bucket. It will deepen the market. However, retail investors need to be prepared for notional capital gains and losses as the case may be. Those holding the bonds till maturity will be paid out in full.

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