Rating Methodology for Primary Dealers

Primary Dealers (PD) are financial intermediaries who help in developing the primary and secondary market for government securities. They are also known as gilt-edged market makers (in United Kingdom) or Specialists in Treasury Securities (in France). The Central Bank of a country may employ these PDs to fulfill one of its objectives, which is to help the government complete its borrowing programme at the lowest cost. The official setup for PDs varies across countries. In some countries such as USA, UK and France while they are officially recognized but in countries like Australia, Japan or Germany, there are no formally recognised Primary Dealers.

In Sri Lanka there is a formal system of PDs approved by the Central Bank of Sri Lanka (CBSL). The main objectives of the system is

- To strengthen the infrastructure in the government securities market in order to make it vibrant, liquid and broad-based;
- To develop underwriting and market making capabilities for government securities ❑ To improve secondary market trading system that would contribute to price discovery, enhance liquidity and turnover and encourage voluntary holding of government securities among a wider investor base; and
- To make primary dealers an effective conduit for conducting open market operations.

The Central bank of Sri Lanka has laid down certain norms, criteria and qualifications for operating as a Primary Dealer (PD). This includes required minimum capital requirements and capital adequacy ratios. The appointment is made by the central bank.

Currently there are 12 Primary Dealers, four standalone PDS and seven banks with primary dealer units or subsidiaries. The operations of the Primary Dealers are regulated and monitored by the Central Bank.

Snapshot of Operations of a Primary Dealer

The major roles and obligations of PDs are as below:

- PDs are required to support auctions for issue of Government dated securities and treasury Bills as per the minimum norms for underwriting commitment, bidding commitment and success ratio as prescribed by CBSL from time to time.

- PDs should offer two-way prices in Government securities and take principal positions in the secondary market for Government securities.

- PDs 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.

- A Primary Dealer shall have an efficient internal control system for fair conduct of business, settlement of trades and maintenance of accounts.

- A Primary Dealer is required to provide access to CBSL to all records, books, information and documents as and when required.
- PDs are required to participate in the primary auction upto required levels.
- PDs are required to achieve certain performance standards specified by CBSL
- A PD is required to submit periodic returns as prescribed by CBSL from time to time.
- PDs' operations are subject to prudential and regulatory guidelines/directions issued by Central Bank from time to time.

While performing the above operations, a Primary Dealer (PD) borrows money and buys Government Securities. The spread between the cost of the borrowed funds and the yield on the government securities provide the PD with the Net Interest Income. With a majority of the government securities having a fixed coupon rate while the source of funds for the PDs is the call borrowing, the ability of the PD to borrow at the best rates to maintain a positive Net Interest Income is crucial to maintain profitable operations. In addition, depending on the market conditions a PD also trades in the government securities with an objective to improve his profitability. Thus the interest rates in the market form a very important factor in determining the profitability of the PD. We look at the basic three scenarios of interest rate scenario to understand the operations better.

Steady Interest rates scenario
In this scenario, the trading opportunities for the PD are limited. Thus the principle source of profitability is the Net Interest Income. A higher networth of the PD results in relatively lower levels of borrowing and helps in improving the profitability of the PD.

Falling Interest rates scenario
In this scenario, the trading opportunities are plenty. The PDs make use of the falling interest rate regime to actively trade in their government securities portfolio. But at the same time, the Net Interest Income would reduce as the spread between the borrowing costs and investment yields decline. The earning profile of the PD would change in favour of the income from trading operations than the interest income on the portfolio held. Such a scenario could help a PD to increase its reserves (with a rise in trading profits), which would act as a buffer during adverse market conditions.

Rising Interest rates scenario
In this scenario, the PD faces a difficult time on both the Net Interest Income and making profits on trading operations. In such periods as the call money rates become volatile, the funding costs of the PD could increase and thereby affecting the Net Interest Income of the PD. With a rise in interest rate, the prices of the government securities fall which may result in a PD booking loss or reducing its scale of operations. Based on strategies and market perceptions, the PDs rework their strategy for such volatile markets which include a lower scale of operations or booking smaller profits from each trading transaction. Thus the risk management systems and the operating strategies of the PD are crucial in such a scenario.

Given the role of the PD in the Sri Lankan debt market, there exists a need for these players to borrow money from the market and leverage their operations. In the light of the above, while rating of debt programmes of Primary Dealers (PD), ICRA Lanka considers the following rating criteria parameters as crucial to the operations of a PD.

Rating criteria for Primary Dealers

Capital

The Central Bank norms stipulate a minimum capital requirements and Capital Adequacy Ratios for the standalone PD operations. ICRA Lanka analyses the financial capability of a PD in terms of Net worth or own funds. ICRA Lanka expects the capital requirements to increase with increase in the scale of operations of the PD. Also, in view of the inherent risks in a PD business, a high net worth acts as a buffer. ICRA Lanka, while placing high importance, views the net worth of a PD as a very strong buffer against insolvency.

Market Risk

The market risk, one of the inherent risks in the PD business, is expressed by the decline in the market value of its assets. ICRA Lanka analyses the portfolio of the PD and subjects the same to stress analysis under varying interest rate scenarios. As the potential loss is determined by the duration of the portfolio, ICRA Lanka studies the above stress test for different duration and the gearing levels of the PD. ICRA Lanka views the net worth to potential loss as an important ratio while evaluating the PD. In case of erosion of the above cover, ICRA Lanka expects the PDs to scale down its operations or infuse more capital in the form of equity. ICRA Lanka also studies the market risk models used by the PD, if any, for their operations and evaluates the PDs contingency plans.

Credit Risk

Since the PDs primarily deal in government securities, the credit risk is negligible. However, if and when the PDs gradually increasing their exposure to corporate debt paper to improve yields and margins, the credit risk would assume a greater importance. ICRA Lanka evaluates the internal norms and the control systems used to measure the credit risk by the PD.

Funding and Leverage

Currently the funding profile for PDs is skewed in favour of call money and repo borrowings. As a PD is basically a trader, it borrows from the short-term call market and deploys them in government securities, thereby earning an interest spread. With the borrowings on call money and repo being re- priced daily and the associated volatility with the call markets, a lower leverage would mitigate the interest rate risks for the PD on the liability side. ICRA Lanka expects the PDs funding profile to change in favour of the term money market once the debt market in the country deepens. A higher proportion of the own funds in the funding profile provides comfort.

Management and Systems

This is one of the important factors while evaluating the risk profile of a PD. Currently as most of the PDs are backed by strong promoters, ICRA Lanka factors in the implicit support of the parent while evaluating the PD. ICRA Lanka views a stable and experienced management to manage the interest rate and liquidity risk profile of the business better. The ability of the management to retain key operating personnel is an important factor in this line of business. ICRA Lanka also evaluates the internal operating guidelines and risk management systems such as the prudential norms and Value at Risk (VAR) set in place by the management. The adherence and efficient usage of such systems by the management are construed as a comforting factor. ICRA Lanka appreciates that due to external market environment, there could be periods when the internal norms may be breached. ICRA Lanka studies and analyses such instances and the actions taken by the PD to rectify the same.

In addition, ICRA Lanka evaluates PDs performance as regards conformity to regulatory norms in respect of the primary market and secondary market operations in terms of bidding commitments and turnover ratios. Though conforming to these norms may not be a problem for the PDs currently with a fewer number of PD operating and steadily growing government borrowings programmes, ICRA Lanka feels that this could become important if there is entry of more players in the PD business and any changes in the regulatory norms.

Profitability

The financial performance of a PD is largely dependent on external environment such as the economic cycle, government borrowing programme and the interest rates movements. The profitability is seen over a meaningful period of time to understand the income stability of a PD with respect to its peers. While considering the performance of the PD in terms of revenues, gearing and Return on Net worth, ICRA Lanka notes that the profitability is dependent on the aggressiveness of the PD. The ability of the management to quickly adapt to the changing environment provides comfort in form of a relatively lower volatility in income.

There are low liquidity risks for a PDs as most of their assets are in government securities, which are highly liquid. As their main business revolves around trading, their investments in non-government securities are usually in instruments that carry high credit rating (rating of LAA and equivalent and above). The growing repo market for government securities further alleviates any liquidity concerns of a PD operation.