EMPIRICAL ANALYSIS OF THE FINANCIAL PERFORMANCE OF PRIMARY DEALERS IN INDIA

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ABSTRACT

The Primary Dealer System was first introduces in the US in 1960. In the US, there are around 25 primary dealers, most of which are banking or investment banking institutions. The system of Primary Dealers (PDs) in the Government Securities Market was introduced by The Reserve Bank of India in 1995 to strengthen the market infrastructure of Government Securities and put in place an improved, efficient secondary market trading system. This was to encourage holding of Government Securities on large scale and make the market more vibrant and liquid. In 2006-07, RBI gave Banks the option to undertake Primary Dealership business departmentally.

DFHI was set up by RBI along with public sector banks and financial institutions in March 1988 to activate the Money Market. It got the status of Primary Dealer in February 1996. Over a period of time, RBI divested its stake and DFHI became a subsidiary of State Bank of India (SBI). SBI had also set up a subsidiary in 1996 for doing PD business namely SBI Gilts Limited. Both these companies were merged in 2004 to become the largest Primary Dealer in the country in terms of net worth (Rs. 1,059 crores as on March 31, 2008).

Primary Dealers can also be referred to as Merchant Bankers to Government of India as only they are allowed to underwrite primary issues of government securities other than RBI who have since shed this role. This article analyses the performance of the primary dealers during the last 5 years that is from 2006-2010. The study is based on the audited annual accounts of the primary dealers, which closed their accounts during the period April 2006 to March 2006 and the subsequent financial years till April 2009 to March 2010. It is observed that the results of these primary dealers, shows the significant growth in the presence of the primary dealers in the economy. The present analysis is confined the companies and institutions dealing in primary dealership in India. The data on all the primary dealers has been presented as the total number of primary dealers in India in the respective 5 years. The study presents comparable data for the preceding 5 years for the same set of companies, based on the analysis of their accounts for the respective years.

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INTRODUCTION

In 1995, the Reserve Bank of India (RBI) introduced the system of Primary Dealers (PDs) in the Government Securities Market, which comprised independent entities undertaking Primary Dealer activity. In order to broad base the Primary Dealership system, banks were permitted to undertake Primary Dealership business departmentally in 2006-07. Further, the standalone PDs were permitted to diversify into business activities, other than the core PD business, in 2006-07, subject to certain conditions. As on June 30, 2009, there are six standalone PDs and eleven banks authorized to undertake PD business departmentally.

The objectives of the Primary Dealer system are:

1. To strengthen the infrastructure in the government securities market in order to make it vibrant, liquid and broad based.
2. To ensure development of underwriting and market making capabilities for government securities outside the RBI so that the latter will gradually shed these functions.
3. To improve secondary market trading system, which would contribute to price discovery, enhance liquidity and turnover and encourage voluntary holding of government securities amongst a wider investor base.
4. To make PDs an effective conduit for conducting open market operations (OMO).

Primary Dealers' role and obligations

PDs are expected to play an active role in the government securities market, both in its primary and secondary market segments. A Primary Dealer will be required to have a standing arrangement with RBI based on the execution of an undertaking and the authorization letter issued by RBI each year. The major roles and obligations of PDs are as below:

1. **Support to Primary Market:** 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 RBI from time to time.
2. **Market making in Government securities:** PDs should offer two-way prices in Government securities, through the Negotiated Dealing System-Order Matching (NDS-OM), over-the-counter market and recognised Stock Exchanges in India and take principal positions in the secondary market for Government securities.
3. 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.
4. A Primary Dealer shall have an efficient internal control system for fair conduct of business, settlement of trades and maintenance of accounts.
5. A Primary Dealer will provide access to RBI to all records, books, information and documents as and when required.

6. PDs' investment in Government Securities and Treasury Bills on a daily basis should be at least equal to its net call/notice/repo (including CBLO) borrowing plus net RBI borrowing (through LAF/ Intra-Day Liquidity/ Liquidity Support) plus the minimum prescribed NOF.
7. PDs should annually achieve a minimum turnover ratio of 5 times for Government dated securities and 10 times for Treasury Bills of the average month-end stocks. The turnover ratio in respect of outright transactions should not be less than 3 times in government dated securities and 6 times in Treasury Bills (Turnover ratio is computed as the ratio of total purchase and sales during the year in the secondary market to average month-end stocks).
8. A PD should submit periodic returns as prescribed by RBI from time to time.
9. PDs' operations are subject to prudential and regulatory guidelines issued by RBI from time to time.

Number of PDs

DFHI and STCI were accredited as primary dealers on March 1, 1996. On June 1, 1996, four more PDs- SBI gilts PNB gilts, Gilts Securities Trading Corporation Limited, and ICICI Securities became operational. As on March 31, 2009, there were 19 approved PDs in the gilts market. Of these, eight were non-bank entities (stand alone PDs) and the remaining 11 were banks undertaking PD business departmentally (Bank PSs) registered as NBFCs under section 45 IA of the RBI Act, 1934. The stand alone PDs are Securities Trading Corporation of India Ltd., SBI DFHI Ltd., ICICI Securities Ltd., PNB Gilts Ltd., ABN AMRO Securities (India) Pvt. Ltd., DSP Merrill Lynch Ltd., Deutsche Securities (India) Pvt Ltd., and IDBI Capital Market Services Ltd.

DATA AND METHODOLOGY

For the present study data has been collected from various issues of RBI Bulletin regarding the Primary Dealers. This article analyses the financial performance of the primary dealers during the last 5 years, from 2006-2010. The study is based on the audited annual accounts of the primary dealers in the country that comprises of the banks and the companies, which closed their accounts during the accounting period April to March for the last 5 years i.e. from 2006-2010. It is observed that the results of these primary dealers, shows the significant growth in the presence of the primary dealers in the economy. The present analysis is confined the companies and institutions dealing in primary dealership in India. The data on all the primary dealers has been presented as the total number of primary dealers in India in the respective 5 years. The study presents comparable data for the preceding 5 years for the same set of companies, based on the analysis of their accounts for the respective years.

Composition of the Primary Dealers in the last 5 years

The primary dealers operating in India for the last 5 years have been taken. The year wise classification of data has been done. The composition of the primary dealers on the basis of their total capital, main income, total net assets are presented in Table 1.

In the year 2007, the financial position of PDs declined during the year ended March 2007 as compared to the year ended March 2006. Net assets, income, capital of PDs declined by huge margins. Loans, as a source of funds, increased sharply from 7847 in 2006 to 8367 in 2007. The major reason for this decline was the sharp reduction in the number of PDs operating during 2006-07. The year 2008 saw the greatest decline in all, due to the recession in the economy. However it was in the year 2010, that there was a increase in the capital of PDs as compared with the previous year and it was on account of increase in number of PDs from seven at end March 2009 to eight at end-March 2010 as well as infusion of fresh capital by some PDs to adhere to the revised minimum NOF requirements.

Table 1. Total Net Asset (Amount in crore)

Year	Capital	Loans	Income	Total Net Assets
2006	2263	7847	2153	13953
2007	2088	8367	1950	13557
2008	1508	7430	1307	10882
2009	1121	6973	1825	10307
2010	1541	6842	804	10308

Operational Results

Performance of the Primary Dealers in the Primary and Secondary Markets (At end-March)

The primary dealers deal in Treasury Bills and **Central Government Securities in the primary market and in Outright and Repo in the secondary market.**

The success ratio achieved by PDs during the year 2006 was 42.1 per cent. The share of primary dealers in the auctioned dated securities marginally declined to 44 per cent during the period 2006-07 from 48 per cent during the period 2005-06. The PDs' share in the primary auctions of Treasury Bills issued increased to 60.5 per cent during 2008-09 from 51.7 per cent during 2007-08. The share of PDs' total turnover to the total market turnover declined from 16.1 per cent in 2007-08 to 12.8 per cent in 2008-09. The amount of bids of the PDs to the total commitment of the PDs declined during 2009-10 both in respect of Treasury Bills and Central Government Securities. During 2009-10 the share of PDs' total turnover to the total market turnover in the secondary market (both outright and repo) declined from 12.8 per cent in 2008-09 to 8.7 per cent in 2009-10.

Financial Performance

The net profits of the PDs declined by 20 per cent during 2006-07. The number of PDs posting net profit declined to six during 2006-07 from eight in the previous year. The decline in financial performance of PDs was reflected in return on average assets (ROA), which declined from 4.3 per cent during 2005-06 to 3.0 per cent during 2006-07, and return on net worth (RoNW), which declined from 13.6 per cent during 2005-06 to 9.5 per cent during 2006-07. The income earned by the PDs increased by around 40 per cent during the year 2008-09 as compared with 2007-08 due to higher trading profits posted by the PDs. In 2009, ROA rose sharply during the year as net profit of PDs almost doubled and average asset decreased by 24.5 per cent from Rs.15,039 crore in 2007-08 to Rs.11,348 crore in 2008-09. The CRAR of the stand-alone PDs as a group was at 34.8 per cent as at end-March 2009. During 2009-10, the net profit of the PDs declined by around 70 per cent as compared to the previous year. Due to the sharp decline in net profit, the Return on Assets (RoA) of PDs decreased sharply during 2009-10. The net profit of the PDs declined by around 70 per cent as compared to the previous year. The CRAR of the stand-alone PDs as a group was at 43.5 per cent as at end-March 2010.

Table 2. (Amount in crore)

Year	Net Profit	Average Assets	Total Assets	Total Capital Funds	R.O.A (In %)	C.R.A.R (In %)
2006	749	18394	13953	5992	4.1	53
2007	444	14984	13557	4026	3.0	33
2008	373	15039	10882	3611	2.5	38
2009	749	11348	10307	3464	6.6	34.8
2010	227	12815	10308	3610	1.8	43.5

Liabilities and Assets Structure

Liabilities Structure

The total liabilities of the primary dealers was the overall the highest in the year 2006 and lowest in 2010 as compared to the other years. There was a steep decline in all liabilities namely capital, reserves and the loans in the year 2008 because of the effect of the recession in the economy. It can be seen that the capital was minimum in the year 2009 at 1121 crores which was approximately half of the capital in 2006 which stood at 2263 crores. Reserves and loans were the lowest in the year 2010 that clearly shows that the year 2010 was the year where the primary dealers had the minimum liabilities as compared to all the other 4 years.

The composition of total liabilities of the primary dealers in the past 5 years is given in Table 3.

Table 3. (Amount in crore)

Year	Capital	Reserves	Loans
2006	2263	3843	7847
2007	2088	3102	8367
2008	1508	1944	7430
2009	1121	2213	6973
2010	1541	1925	6842

Assets Structure

The assets structure of the primary dealers has been comprised of the fixed assets, investments, loans and advances, non current assets, equity and mutual funds and others. It can be depicted from the structure that all the assets have considerably reduced in 2008, which was again due to the recession in the global economy. In 2008, all the assets declined by huge amounts like in fixed assets they declined to 14 crores from 72 crores in 2007. Similarly the investments, loans and advances, equity and mutual funds etc have all declined enormously. Another point to be noted is that the non current assets have been nil in all the 5 years.

The structure of total assets of the primary dealers in the past 5 years is given in Table 4.

Table 4. (Amount in crore)

Year	Fixed Assets	Investments	Loans & Advances	Non-Current Assets	Equity & Mutual Funds	Others
2006	71	1045	2398	-	-	1059
2007	72	9248	1135	-	928	2174
2008	14	8291	429	0	150	1422
2009	13	7891	959	0	22	2205
2010	14	7280	741	0	68	-28.8

CONCLUSION

It was observed from the consolidated results derived from the various statements of the primary dealers for the past 5 years that growth in income, both main as well as other income, decelerated during the year 2007-08. The ROR and the CRAR both rose tremendously in the year 2008. There was decline in the liabilities coupled with the enormous decline in the assets in the year ended 2008. Though there was revival after the meltdown in 2008, but it hasn't been satisfactory enough. The main jolt that the primary dealers had to face was in the year ended 2008 due to the global economic recession. Also there were very few primary dealers operating in that period. The entry of new primary dealers and the contribution of more capital by them has helped the primary dealers recover but still there is a stiff competition and environment that has to be efficiently tackled by the primary dealers.

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