Business Standard

Subir Gokarn: The SLR barrier

Both market development and prudential regulation objectives justify a major reform of the statutory liquidity ratio

Subir Gokarn **August 10, 2014** Last Updated at 22:50 IST

In last week's bi-monthly review of monetary policy, the Reserve Bank of India (RBI) reduced the statutory liquidity ratio (SLR) from 22.5 per cent to 22 per cent of net demand and time liabilities. Many perceived this as a kind of back-door easing, because it allowed banks some more space to expand credit. That it may do, but this particular prudential instrument has a much larger significance in the overall context of financial market development. It is the most important remaining barrier to the development of a meaningful market for government securities.

Why is this so? As a general principle, for markets to work, participants on both sides of the market must be willing to trade. Introductory economics textbooks will tell you that that trade will only ensue if sellers have things that buyers want and *vice versa*. However, If some potential market participants have things that others want but refuse to part with them for whatever reason, a market cannot emerge.

This simple proposition characterises the relation between the SLR and market development. The outstanding stock of central government securities was about Rs 35 lakh crore at the end of 2013-14. Banks owned about Rs 20 lakh crore of these. Not all of this was required under SLR; the holdings above the SLR were, theoretically, tradable. But if about half of outstanding securities are held by potential market participants and are done so because of a prudential mandate, the likelihood of a robust market emerging is small. To use a playground analogy, it is as though the kids who own the bat and the ball decide that they don't want to play. As a result, no one else gets to.

Developing a deep and efficient market for government securities has been a stated priority for the financial sector for several years. Many things have been done to facilitate this, but the cumulative impact of all of these is thwarted by the persistence of the SLR. There are two clear interests at work here. One is the government's need to borrow to finance even its operating expenditure. Pumping large amounts of securities into a relatively small and shallow market would be challenging, with uncertainty about their absorption, as well as the price/interest rate at which this would happen. Having an assured source of demand in the banking system addresses this.

The other is the banks themselves. Logically, if they are mandated to hold such a large chunk of government securities, at the expense of more profitable lending and investment opportunities, they are justified in asking for some relief. This comes in the form of exemption from mark-to-market requirements. This completely buffers the SLR portfolio from interest-rate risk, which would otherwise require banks to deduct even notional losses on their portfolios from their profits. In short, the SLR as it currently stands provides a mutually convenient arrangement between the government and the banks; there is even a sweetener for the banks by way of the mark-to-market exemption applying to a higher proportion (24 per cent of liabilities) than the SLR itself.

Does the prudential imperative outweigh market development compulsions? In reality, a portfolio fully exempt from mark-to-market requirements does not meet a strict prudential standard. If an asset is truly "liquid", it must be valued at its current market value on the banks' balance sheets. Otherwise, it does not reflect the ability of a bank to raise cash when the need arises. In effect, the mark-to-market exemption means that the value of the SLR portfolio is its face value; only the government, who originally issued the securities, would buy them back at that value. So "prudence" in this situation is equivalent to a government bail-out in a crisis.

The Basel III prudential framework, which Indian banks are in the early stages of adopting, does require liquidity buffers, but does not recognise the current SLR framework as being one. Liquid assets need to be either fully marked to market or, if a deep market does not exist, assessed at "fair value", which is what a government may be willing to pay for them. Fair value does not mean face value.

From the perspective of financial market development, a significant change in the SLR framework is necessary. Unless banks have an incentive to trade their portfolios actively, there will not be enough "play" in the market for it to develop. From the perspective of prudential regulation, the current arrangement does not conform to the standards of liquidity, which are completely logical. So there isn't any trade-off between prudence and market development. Reform is consistent with both objectives.

The RBI is presumably aiming for this through steady decreases in the SLR; the need to be as non-disruptive as possible accounts for the relatively small size of the reductions. But at this rate, neither objective is likely to be achieved in the foreseeable future. A far more aggressive approach needs to be taken, with an explicit time frame and milestones for reforming the SLR.

As an initial requirement, the government needs to reconcile itself to the fact that it can no longer use the banking system as a captive source of demand for its securities. The true cost of borrowing can only be known if these securities are sold into a genuinely open market. It is almost certain that it will be higher than it is under the current arrangement. This should be another inducement to fiscal discipline; at least, let's hope that it is.

In terms of time frame and process, a, say, three-year transition horizon needs to be announced, with an annual reduction of say, five percentage points, in both the SLR requirement and the mark-to-market exemption. This will take the mandate to below 10 per cent, which is something the system can live with (though, ideally, it should be zero). Simultaneously, the hugely fragmented portfolio of outstanding government securities should be consolidated into a few large pools, with banks being allowed a one-time swap at face value. Finally, the public sector bank managements need to be given incentives to maximise earnings from treasury operations.

All these proposals, as in so many other instances, have been floating around for a while. The cost of not acting on them is unacceptably high.

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