

Challenges for the Debt Market

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Background

The debt market in India is of some age and of some substantial size. The Government Securities market dates back to 1859 when the British Government took over from the East India Company; there has been active debt issuing by the government both before and after independence. Corporate Bonds, mainly debentures, were being issued by companies of good standing in the pre-war and post-war years. There was, of course, a decline in corporate bond issues in the decades of sixties and seventies following the arrival of term lending institutions who supplied the bulk of the medium and long term funding requirements of the private sector. The public sector's long term funding needs were met by the State.

The corporate bond market started reviving in 1980s and we now see a fairly well-segmented debt market in India comprising :

- Government securities (G-Sec) market
- Corporate Bond market (convertibles—compulsorily / optionally—PCDs, NCDs, etc.)
- PSU Bonds (taxable and non-taxable)

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THE FUTURE OF INDIA'S DEBT MARKET

- FI/Bank Bonds (recent development)

We are also beginning to see the arrival of securitised bonds, backed by assets like auto finance receivables, energy sale receivables, etc. Volumes reveal the following statistics:

<i>Outstanding Government Securities</i> (Central and State)	Rs. 3,50,000 crore
<i>Outstanding Private and Public Sector</i>	Rs. 1,10,000 crore
<i>Corporate debt</i>	Rs. 4,60,000 crore

These are impressive figures and reflect the already large dimension of the existing bond market. These figures compare well with the total market capitalisation of all stocks listed on BSE (viz. around Rs.5,00,000 crore).

The other positive side of India's debt market is that, in recent years, issuers of good standing have had no difficulty in raising resources. This has been true of both the Government and the private sector. The high real interest regime, and the languishing equity market, were also ready and performed well.

The Government Securities Market

In this case, the strong subscription support has come from banks, insurance companies and financial institutions. The point to note is, that this category has been investing strongly in gilts, not because of statutory or regulatory compulsion any more, but in pursuit of their commercial judgement. It is of course a matter of debate, whether it is in the long term interest of the economy, for banks to rush towards gilts, in preference to lending. One must certainly recognise, that the recent experience in Government Securities auction and floatation, only demonstrates that the reforms of the Government Securities market, started in 1992, have had a strong positive impact. There has been a significant growth in the volume of secondary market transactions. Primary Dealers now act as active market-makers, both in treasury bills and dated Government Securities, in wholesale segment of the market. This, the improved book entry based SGL system, and the new

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DVP system, have greatly facilitated secondary market trading. The NSE introduced a wholesale debt segment, to primarily activate a secondary market in non-government issues. However, it is interesting to note that 90% of the turnover in the WDM segment of NSE, is accounted for by Government Securities, even though the number of non-government securities available for trading in this segment, has been steadily increasing.

In addition, despite the facility of trading in the NSE, the wholesale market in Government securities has remained predominantly a telephone market. I believe that a vast majority of the Government securities transactions, which go through the NSE Screen, actually originate in the telephone market. They only get recorded at the NSE, as one or both of the contracting parties, or brokers, are NSE members. Thus, the wholesale debt market segment of NSE has so far been useful for information dissemination, and not so much as a trading platform. Data on SGL transactions, released by Reserve Bank of India (RBI), also serves as a parallel information flow and provides transparency. This pattern, viz. preponderant use of the telephone market, is however not unusual, particularly in government securities trading, for which the telephone market is widely used world over. Trading is not a mechanical process and, more often than not, involves negotiation, particularly at the wholesale level. Telephones, and other sophisticated communication equipment that are integral features of a modern day dealing room, facilitate the deal making process. While the screen is certainly useful for price displays, traders will still need to interact using telephones in a SGL-DVP environment. Information transparency supplied by several screen services is completely different from the telephone market that existed in India in 1991-92 which was based primarily on bank receipts.

Measures to Improve the Government Securities Market

- We need to widen the investor base by bringing in retail and non-bank investors – this can be a key measure for adding depth to the gilts market. To this end, satellite dealers, when they become operational, and banks, with their retail branch network, have important roles to play. It is also hoped that the Mutual Fund industry will soon step in with pure gilts funds. To extend the facility of book-entry based custodial services to general investors, NSDL could begin accepting Government

Securities for dematerialisation without delay, as stamp duty is not an issue here. Likewise, SHCIL can act in respect of physicals in gilts for the benefit of retail and non-bank investors.

- The tax disadvantage attached to Government Securities, vis-a-vis various other saving instruments under Income Tax Act provisions, needs to be removed, and replaced by clear tax incentives.
- We need a larger community of Primary Dealers and other market makers including those at a retail level, e.g. banks, satellite dealers and other finance companies.
- We need to open up the repo market to a wider range of participants – that will greatly add to the liquidity in the market.

Bonds

Let me now turn to Corporate Bonds, including public Sector Bonds. In recent years, the demand side has been strong – both at retail and institutional levels—despite an inactive secondary market. With an active secondary market, demand could receive further stimulus, leading in turn, to lower cost of issue, and permitting a lengthening of maturities which presently tend to remain restricted to 5-7 years. For this we need :

1. Well capitalised market makers in Corporate Bonds like the Primary Dealers in Government Securities market,
2. The settlement and custodial system needs to be radically changed as has been done for Government securities. Under current conditions, the operational risks and procedural delays in transfers would deter firms from becoming market makers. In case of PSU Bonds, this can be easily done as there is no impediment on grounds of stamp duty. NSDL can provide book-entry based custodial service, for transfers of PSU Bonds as they do not attract stamp duty. The other alternative for active, bond issuing PSUs, is to set up a depository organisation which can hold, in custody, all PSU Bonds in a dematerialised form. I am sure there will be enough commercial justification for such an enterprise.

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3. Most importantly, issuers need to take greater interest the creation of an active secondary market for their bonds as it will help in:
 - reaching a wider investor base
 - reducing borrowing costs
 - lengthening maturities
4. The following technical issues need to be resolved before market making in bonds can take off :
 - transfer procedure for non PSU bonds
 - mitigating risks in holding bonds in street names
 - funding of market makers for which initiatives are needed from :
 - issuers – where market makers are not well capitalised
 - commercial banks – who need to change their mid-set with regard to financing capital market intermediaries
 - Reserve Bank of India – relaxing the requirement of bank financing being made through demand loans up to 75%

But these can be addressed without much difficulty (except the transfers of non-PSU Bonds) if suitably pursued by issuers and market makers. We have seen how reforms in Government securities markets have helped creating an active secondary market. There is much to learn from this experience in reforming the corporate debt market.

One obstacle to market makers is the inability to hedge interest rate risks in the absence of an interest rate futures market. The L.C. Gupta Committee has recommended creation of such a market.

Infrastructure Bonds

The challenge of floating infrastructure bonds has, in recent times, been driving the concerns about the strength and depth of our bond market. Infrastructure bonds will involve long maturities and unfamiliar risks. For assessing the credit risks, the role of the rating agencies will be crucial, not only for the purposes of primary placement, but also for secondary market pricing. The other aspect worth noting, is that insurance companies, provident and pension funds, and commercial banks are the appropriate

investors in long term bonds, particularly those issued by infrastructure companies. This is so, not only because this category of investors have long term funds but also because they are best equipped with professional competence to assess the various risks associated with infrastructure projects. Retail and non-bank investors are not so equipped and, therefore, they should be encouraged to invest in risk-free Government Securities.

In this manner, the responsibility for supporting the Government market shifts away from insurance companies, provident and pension funds, and banks, thus making adequate room in their investment portfolios for investment in infrastructure and other projects whose appraisal requires high professional skills. Currently, we see an intermediation system under which these institutional investors are the dominant investors in Government Securities which are risk-free. On the other hand, individuals and other non-bank investors, with very little credit appraisal skills of their own, are investing in relatively risky assets such as corporate bonds and equities.

This pattern needs a significant change, which once again underscores the need to bring about diversification of the investor-base in respect of Government Securities.