

Problems with the Secondary Debt Market

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Background

Though the Indian debt market is the third largest in Asia, volumes are abysmally low. We witness an average turnover of 0.25% of the market capitalisation as against 6.2% in the US bond market. This may be due to the low levels of liquidity, inadequate depth or lack of instruments. This chapter will take a micro view of all problems from two or three different perspectives. The classifications may not be watertight, and there will be instances of overlap. The idea of classifying, as has been done, is to isolate each problem so as to arrive at solutions easily.

Problems Related to Settlement and Transfer

Government Securities

- In the settlement and transfer of wholesale trades, though DVP settlement has been introduced, inter-city settlement continues to be a problem. There is also no prescribed redressal for non-lodgement of an SGL transfer form. In the event that an SGL transfer form is not lodged, the seller would have

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no funds for that day. Hence norms relating to payment of interest, or penalty, in order to discourage non-lodgement, need to be prescribed.

- As far as semi-wholesale or retail trades are concerned, due to the non-existence of low cost custodial facilities, settlement is still largely by way of physical delivery with all its associated risks.

PSU Bonds/Corporate Debentures

- Since these securities are yet to be dematerialised, problems relating to physical settlement and non-standardised settlement practices persist. These include problems of directors' signatures, banker's attestation of signatures, separate resolution for selling and buying, insistence on rubber stamp of issuer company or transfer agents for previous transfers, etc.
- Banks are allowed to buy these securities only from registered holders and not if these are in "street names". Transfer of bonds and debentures is further constrained due to some sellers insisting on endorsing the instruments specifically in favour of the buyer.
- Finally, the status on purchase of bonds/debentures by way of Letter of Allotment by banks is not clear, again hampering transfer.

Other Problems

- Stamp duty continues to inhibit secondary market trades. Differing stamp duties in different states pose a hindrance to dematerialising securities.
- Funds transfer, in respect of secondary market trades, is a major issue, particularly for non-bank entities. Same day purchase or sale, on constituent SGL accounts, is not possible as these non bank entities do not have current accounts with the Reserve Bank of India, and are hence, unable to ensure against bouncing of SGL.
- High-value settlement, even intra-city is very restrictive. Geographical restrictions on high-value clearing increases the lead time for effecting payment. Even though several banks are now linked via satellite, inter-city funds transfer on the same day is still a distant reality.

Problems by Investor Profile

Retail Investors

The problems of retail investors can be best understood by first examining their principal needs viz. safety, liquidity, yield and ease of operation. The one instrument which meets all these requirements is a bank deposit. The fact that up to Rs.1,00,000 of a bank deposit is insured with DICGC, imparts it with additional safety.

- Retail investors have low interest in Government securities due to settlement related problems as well as the lack of direct or indirect access to the electronic clearing and settlement system at the RBI. But the most important reason which keeps retail investors away from the gilts market, is lack of awareness regarding the yields prevailing in Government securities and the procedures for investment. As a result, while yields on T-bills for the first half of 1996 were consistently higher than those offered by bank deposits, they did not elicit any retail interest.
- At most times however, yields on Government securities are lower than those on other available investment options due to higher liquidity and statutory demand from banks in the wholesale market. Low liquidity in the retail secondary market for Government securities keeps retail investors away from them.
- After the crash of the equity markets, the traditional retail investor has moved to bonds of PSUs and corporate debentures in a bid to get higher yields and greater safety. However, he continues to be plagued by the problems related to settlement, shallow secondary markets, relatively lower safety than those offered by bank deposits or Government securities and extremely cumbersome operational procedures. To invest in debentures, he still needs to find a broker, take delivery, make payment, affix transfer stamps, lodge for transfer, follow up with issuer company and collect interest payment. In addition, he has to repeat much of this process at the time of sale.
- Larger players, particularly banks, have been reluctant to market debt instruments to retail investors, under the apprehension of creating an adverse impact on their own deposits.
- Finally, the absence of market makers, and hence liquidity in the secondary market, further dampens retail interest. The importance of liquidity is best

demonstrated by the UTI, which has been singularly successful in attracting retail funds over the last thirty years. This can be largely attributed to their offering liquidity to this instrument by quoting two way prices at all times. To a certain extent, factors such as perceived safety and tax benefits, have also played a role.

Semi Wholesale Investors

Semi-wholesale investors consist of provident funds, NBFCs, co-operative banks and charitable trusts. They form an important category by themselves, with most issuers trying to tap this segment in order to ensure success of their issue. The problems faced by this category include :

- A number of regulations prevent provident funds from selling their large corpus of investments in the secondary markets, thereby limiting their secondary market participation. They need to seek the Commissioner's permission to sell their investment for any reason other than for meeting retirement or retrenchment compensation payment commitments. In case a sale implies a loss, the permission of the Board of Trustees is required.
- Provident funds are required to distribute a minimum of 12% to their constituents. In times of high yields, this tends to reduce incentive to earn better returns, and in times of low yields, the shortfall in generating 12% has to be borne by the parent company itself. This discourages companies from setting up their own Provident Fund Trusts, and instead, prompts them to opt for the Provident Fund Commissioner. In addition, provident funds are not allowed to purchase private sector corporate paper. Co-operative banks and charitable trusts, on the other hand, may be permitted to invest in corporate paper. However, such permissions are granted only on a case-to-case basis for each specific issue, rather than on the basis of broad investment guidelines.
- The constituent SGL facility, provided by banks to provident funds and NBFCs, is either very expensive or provided with reluctance and inefficiency. Since the RBI has directed the closure of all non-bank SGL accounts being operated by it, an increasing number of PFs and NBFCs are seeking this facility. Things may however change now that some private sector and foreign banks are offering this service efficiently and at reasonable cost.

SECONDARY DEBT MARKET

Wholesale Investors

Wholesale investors include banks, insurance companies, mutual funds, financial institutions and FIIs. Since the secondary market is dominated by banks, most of the problems enumerated, relate primarily to banks. Some of these problems are attitudinal:

- Treasury is considered a compliance centre instead of a profit centre in most public sector banks.
- The shadow of the securities scam continues to hinder active trading not only in public sector banks but also in several private sector and foreign banks. Trading limits are not delegated to the dealer level but continue to vest with levels as high as general and deputy general managers. These managers also bear varied other responsibilities, and are in no way equipped to trade in the secondary market.
- A number of public sector banks do not yet have a policy in place for secondary market purchases, particularly for non-SLR securities.

Other problems of the wholesale investor category include :

- Evaluation of investment performance continues to be based on profit or loss on sale, and the concept of holding period returns is still alien.
- The market is highly segmented as certain segments invest only for statutory requirements.
- Risk weightage for banks is based on statutory regulations rather than rating assigned to the issue. As a result, a AAA corporate debenture may sell at yields higher than a AA- PSU paper, reflecting an anomaly in pricing.
- Money market mutual funds are virtually non-existent, since their efforts to mobilise funds have not been too successful. Till such time as minimum lock-in period and the prohibition on provision of checking facility by these funds continues, their popularity with retail investors will remain low.
- There are several restrictions on investment of surplus funds by public sector enterprises viz.: AAA bonds with a maximum tenure of one year, and government securities with maximum residual maturity of three years. PSEs therefore, take the easy way out and place their funds out in Certificates of Deposit of approved banks. As a result, a large corpus of funds is prevented from entering the debt market.

- Intermediary still continues to be a dirty word in the lexicon of many secondary market players. This restricts the ability of such players to participate in the secondary market. It also prevents intermediaries from enhancing their levels of activity and acts as a constraint on the depth and liquidity of the market.

Market Related Problems

Some of the problems that confront the debt market may be attributed to the existing state of the market after years of inactivity. The Secondary Debt Market of today has evolved over the last so many years, during which it was in a deep slumber as a result of regulatory fetters. It took a knock on the chin in the form of the securities scam of 1992 and is only now trying to get back on its feet, hesitantly, helped along in recent times by enthusiastic regulatory authorities. The following factors may merit attention :

- Holdings of debt securities are concentrated with institutional investors, who invest for statutory purposes, typically hold securities to maturity, and are one investor class i.e. they all tend to be on the same side of the market. This makes the market extremely illiquid. Since banks, institutions and investment companies are the major holders, they are equally exposed to the vagaries of the money market. Hence when money is tight, they emerge as sellers, and they all turn buyers when money is easy.
- No hedging mechanism is available to permit participants to hedge their positions. As a result, the trading activity is high only when interest rates are headed southwards. In fact, traders can make money only at such times.
- The lack of a futures and derivatives market, precludes primary dealers from effective market making. This is because they can neither hedge positions, nor take opposite views in one-way markets. This impacts adversely on the spreads of their buying and selling quotes. Repos are restricted only to Government securities, that too for a few defined investors and for a maximum period of 14 days, in case they are transacted on an exchange. Even though the last Credit Policy permitted repos on Government securities and allowed non-bank SGL Account holders to transact reserve repos, a notification permitting the above is still awaited – a full six months after the Credit Policy.

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- Even real time short selling is not permitted. If a participant sold a security so as to cover it back in the next two minutes, he would still be violating the law of the land. Complete absence of a term money market, which can be attributed to SLR still being levied on inter bank borrowings, non evolution of a suitable reference rate and credit exposure related problems, make hedging impossible.
- Non-integration of various markets such as foreign exchange, money, securities, equity etc., which permit the free flow of funds from one area to another, thereby evening out sharp volatilities. Netting of trades is not permitted, implying settlement of each and every trade transacted between the same counterparties, thereby increasing paper work substantially.
- Market intermediaries like inter-dealer brokers and market makers have no access to credit at cost-effective rates. This comes in the way of warehousing and position-taking by intermediaries, which would otherwise have lent depth to the market.
- The 5% limit specification on business distributed by banks to brokers, non-adherence to which finds place in every inspection report, results in banks complying with this limit completely. With few players and brokers active in the first place, this limit serves as a disincentive to efficient brokers to provide value-added services as well as serves as a reward for inefficient brokers. It also gives rise to unhealthy practices such as routing business through dummy brokers, once limits of efficient brokers are exhausted.
- The Government loan issuance programme is not very structured and lacks transparency to a certain extent. It has, however, improved over the last year or so. Repo calendars are now announced a month in advance and Treasury Bills auctions follow a regular schedule. However, Government securities continue to be issued without much advance notice. This factor, along with the absence of a 'when issued market', does not enable issues of government securities to be used as benchmarks for related markets such as the corporate debt market. An unstructured issuance programme also leads to an illiquid market.
- The terms of issue in the private placement market are not standardised which brings us to the more important point of non-regulation of this market. As such, you may find allotment letters getting converted into certificates even as late as one year after the issue. Again, the ambiguity of trading in allotment letters, severely hampers liquidity in the market place.

- Finally, the absence of a central data base, containing information on issues of corporate debt, offer documents, etc., makes it difficult to trade in the secondary market.

Conclusion

The above exercise is not one in fault finding. The problems that I have raised here have been harped upon time and again at various forums. I am happy to see that our regulatory authorities, particularly the Reserve Bank of India, have realised the severity of these problems and are actually doing something to resolve them. There are three committees on the debt and money markets working simultaneously and, as a member of one of these, I am convinced that the regulatory authorities are indeed very sincere in this regard. I assure you that all these efforts should start yielding results soon. We have all hung in there in good times and bad. And it may not be too long a wait before the Indian debt market takes on all the proportions of an international debt market.