

Widening the Debt Market: Future Directions

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Background

Prior to 1991, interest rates were essentially controlled by the Central Bank, investments were directed, and the debt markets – the secondary market as well as the primary market for corporate debentures – were dormant. However, the primary market for Government securities was very active, so as to bridge the fiscal deficit. Debt was predominantly in the form of credit extended by banks and institutions for financing private and public sector projects. The debt market had few players and offered little attraction for the public at large on account of :

1. Flow of investor money heavily in favour of the equity markets. This was during and due to the CCI regime which facilitated attractive returns on equity as the entry price dictated by the CCI formula was always substantially lower than the exit price on the secondary market (on listing). This commanded a much higher price earnings multiple.
2. Investors satisfied their need for debt investments through safe and sovereign term deposits with nationalised banks.

Post 1991, we had a complete change from the earlier watertight situation and the markets witnessed some fluidity. The Government

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instituted various macro-economic reforms in order to put the country on the path of liberalisation. The Central Bank also engineered for change in the financial system – the bidding process was introduced for pricing of Government securities. This induced market related pricing as opposed to the earlier directed pricing. Further development of infrastructure was given an impetus and the concept of market making emerged for activating the secondary market. The RBI initiated the process of removing the shackles on a bank's ability to get greater flow of discretionary funds. Therefore, CRR and SLR were reduced for greater discretionary lending and investments at higher interest rates. Removal of legal impediments like the TDS on Government securities, allowed genuine trading at clean prices. The RBI also decided to look at indirect tools through open market operations for the management and conduct of the Monetary Policy. It also facilitated greater dissemination of information and prescribed valuation of Government securities on a mark to market basis. This was a very important step as this enabled the holders of such securities – i.e. the banks – to easily bring these to a tradable form for secondary market operations. This has resulted in an increase in the volumes of both in the primary and the secondary markets.

The Present and Potential Size of the Debt Market

Significantly, the private placement market has raised 50% – up from 39% in the previous year – of the Rs.30,674 crore raised from the domestic capital markets in 1996-97. Of this, a substantial portion – nearly 83% of the Rs.15,066 crore – was raised in the form of public sector bonds. The size of the debt market is increasing and the expectations from the coming year will be higher. Funds being raised in the form of debt, particularly for PSU debt, may also adopt the private placement route. This route is being preferred over the public issue route, on account of time and cost efficiency.

Since issuers will continue to raise money, the growth potential will always exist for primary fund raising. As per the Rakesh Mohan Committee Report, approximately Rs. 4,20,000 crore is required for infrastructure over the next five years. Of this, an estimated Rs. 30,000 crore will have to be raised from the domestic capital markets per year, for the next five years, to

meet the private and the public sector infrastructure needs. The domestic debt market is going to play a critical role in the mobilisation of these resources. Besides, the debt market is likely to follow the international trend of growing larger than the equity markets in the years to come.

Capitalising on the Potential: Future Directions

As a first step, we need to focus on the development and growth of the secondary market, since the secondary market provides liquidity and makes maturity irrelevant. Besides, the secondary market trading in debt paper will provide the much needed benchmark for deciding primary market yields. If this happens, the primary markets will get activated even further, and this will, in turn, snowball into further growth in the secondary market. This will enable us to achieve the potential needs of infrastructure. We also need the development of risk management tools, as well as, participation by more pro-active players in the market with divergent views. In other words, we need to widen the debt market.

Towards this objective of facilitating the development and growth of a vibrant secondary and primary market, we need to focus on the five I's of the debt market. These are: the *issuers* who need funds; *investors* who supply these funds; properly structured *instruments*; *intermediaries* for marketing these instruments; and, an effective *infrastructure*.

Investors

Though investors are probably the most important segment of the debt market, they have also been the most neglected in the Indian context. The following measures may develop this segment :

- We need to create different classes or segments of investors, to prompt divergent views, which, in turn, will facilitate deeper trading on the secondary market and thus aid greater primary market issuance. Restrictive allocation norms that were set for various wholesale investors need to be reviewed, enabling them to decide on investments based on their own internal guidelines. This is true for investments in both Government and non-Government paper. Wholesale investors including provident funds and insurance companies, which have access to long term funds, will therefore be able to invest in infrastructure bonds with long term maturities.

- It is essential to attract and allow retail investors into the market. Retail investors are debt conscious as they have, at some point in time, either lent or borrowed funds and are therefore familiar with paying and earning interest. They have also been very active in the equity markets. Their entry will further deepen the debt markets. However, a pre-requisite to attracting retail interest is investor education regarding the concepts of risk-return. Thereafter, the industry has to build a long term relationship with the retail segment by providing efficient services and a sound infrastructure.
- In order to attract retail investors, a fiscal stimulus may be provided to them by offering them the benefits and exemptions currently available under Section 10(23G) of the Income Tax Act. This presently applies to all companies investing in the infrastructure facilities of the country. Though it is encouraging that the central Government had introduced this Section, there is little rationale for excluding retail investors from enjoying similar tax benefits for investments made in infrastructure facilities. The Government should also consider increasing the limit under Section 88, from the present Rs.10,000 to Rs.50,000 for investment in infrastructure. In addition, Pass Through Vehicles (SPVs) – dedicated infrastructure funds that collect small savings – should qualify as eligible infrastructure enterprises under Section 10(23G). As a further benefit, Government securities can be included as a part of Section 88, as this section already includes a number of securities issued by the Central and State Governments – PPF, NSC, Indira Vikas Patra, etc.
- Another measure that may be considered, is a complete removal of TDS on interest payments for all types of securities. In this case, to overcome potential tax compliance problems, a flat rate of tax may be adopted for interest payments – to be paid by the issuer as in the case of dividend. This will also help in building a better and more vibrant secondary market.
- We must concentrate on creating dedicated investors, and the RBI has already paved the way for promoting gilt-edged funds. This should now be expanded by permitting dedicated infrastructure funds, with similar benefits. We also need to boost FII debt funds by removing the withholding tax, considering the over Rs. 24,000 crore that has already been invested by them in the Indian stock markets within a span of 3½ years. We need to encourage such players which are aggressive, have risk management

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expertise, and are prepared to take positions on different maturity profiles, thereby providing a platform for divergent views. Besides, these investors have deep pockets.

- A related issue which needs to be reviewed, is the minimum guaranteed return to provident funds which pay interest at 12% per annum. They need investment avenues that will yield a minimum 12% return. We need to reconsider this while promoting market related reforms in light of the present situation, when interest rates and inflation are down. Therefore, fixed returns should be brought down in line with the market rates. This will also remove the distortions that exist in the markets (for example, the higher yields fixed by the RBI for State Government paper after effecting lower yields on similar maturity Central Government paper within a span of 2 to 3 weeks). Linking returns to the bank rate, may be a solution for provident funds.

Issuers

New classes of issuers are expected to come to the market, including long term issuers like municipal authorities, local authorities, securitised asset SPV companies, etc. The Tarapore Committee Report on Capital Account Convertibility has recommended that the RBI, divests from itself, the function of borrowing money on behalf of the Government. This will prompt the Central and State Governments to access the markets directly. However, whether the various State Governments will be identically priced, despite differing individual credit risks, is debatable, though the better States will get the money at competitive rates while the low performers will have to pay a premium.

- In order to facilitate the entry of this new class of issuers, and benefit the existing issuers, a guarantee company should be established. This proposed guarantee company will provide the necessary credit enhancement mechanism and help in the issuance of long term paper for the infrastructure company issuers. With the provision of credit enhancement, or some form of insurance, banks will be ready to provide initial funds till the gestation is completed with investors coming in thereafter. Moreover, since the credit enhancement mechanism will provide safety to investors, they may also come in as long term players. Steps in this direction have already been taken, and they should now be further implemented to make the credit guarantee company operational.

- The definition of “security” under SCRA should be widened to include the issuance of securities by unincorporated bodies. A lot of trusts that are likely to access the market to issue securitised debt should be allowed to issue securities and get listed. The present listing guidelines, which do not permit the issuance of securities by unincorporated bodies need to be modified immediately.
- The primary market issuance guidelines of SEBI contain a clause of 90% minimum subscription which should be removed for debt issues. Debt issues should have the flexibility of raising funds from different sources, at different points in time, so as to be able to raise debt more easily. A similar flexibility already exists in the private placement market, where the target amount can either be enhanced suitably through the green shoe option, or a lesser than target amount can be retained.
- The currently defined issuers which are permitted the issuance of a shelf-prospectus (which has already been provided in the Companies Bill – Clause 59) should be widened to include infrastructure companies. This will enable infrastructure projects, which have long gestation periods and huge fund requirements, to enter the market time and again.
- The issuer must work towards developing a long-term relationship with investors by providing them authentic and timely information, as well as value-added services. Market making, which is being introduced in the Government securities through primary dealers and satellite dealers – should also be made similarly operational for PSU bonds and corporate debentures. This has yet to be implemented due to the lack of funds support from the issuers and banks. Considering the large size of issues and the volumes of trading to be built up over a period of time, intermediaries acting as market makers can provide liquidity support and assume associated risk only if they have necessary fund support.

Instruments

Innovative instruments play a vital role in attracting funds from investors, particularly in the form of small savings. The deep discount bonds introduced by the IDBI in 1992, were extremely successful in attracting retail investor funds by appealing to the target segment's needs and aspirations. This is only one among many such instruments which have helped channel small savings into debt instruments.

- Issuance of longer term instruments or bonds, with 15 to 30 years maturity should now be considered. This will aid in creating a long term yield curve, which is necessary for the development of an active secondary and primary market. These long term bonds, in addition to being introduced in the Government securities segment, should also be floated for private and public sector bond issues targeting funds for infrastructure projects, which have long gestation periods and require longer term funds.
- Tradable stock of approved SLR investments is lying in the vaults of various PSUs and Private Sector Banks. Today, these banks have Rs.47,000 crore of Government securities, issued at interest rates between 7 to 11%, with a remaining minimum life of around 15 years. These have obviously been put in the permanent category on account of the low yielding interest rates so that the banks need not mark to market the same and suffer losses in the P&L Account. A simple solution can be considered here – to convert these taxable, interest bearing bonds, into tax-free bonds. This will reduce the loss to be suffered by the banks on account of marking them to market, since the mark to market can now be compared to the tax-free yields, which are much lower. Through this route, banks will be encouraged to accelerate the process of marking to market these investments, with lower losses being debited to their P&L accounts. Consequently, banks will bring these investments out of the permanent category and into the current category. Therefore, fresh issuance of long term paper by the Government will not be necessary and we will have a readily available and tradable stock of long term paper. This will consequently enable the immediate emergence of the urgently required long term yield curve. Importantly, this will not result in any loss to the exchequer. Today, when investment of banks are marked to market, the loss lowers the taxable income of the bank – in other words, the loss on account of marking to market is a legitimate tax shield. The exchequer never really loses any revenue by this action. On the contrary, marking to market the converted tax- free bonds will result in lower loss

being debited to the P&L account. In this case, the taxable income is not reduced, as it would have been in the case of marking taxable bonds to higher market yields. Therefore, this can, and should be immediately done, in order to provide depth to the tradable stock of long term Government security paper.

- Interest rates in the fixed deposit and tax-free bond segments should be freed, in keeping with the move towards market related rates. Until we have an inter-bank term rate, Government securities rates of varying maturities should act as a reference point for pricing the primary issues of PSUs and Private Sector paper. In America, the US treasury rates act as a reference point for pricing the primary issuances of corporate bonds. These issuances are obviously at a premium to the treasury rates. A similar situation can emerge in India where the Government paper acts as reference rate till you have the emergence of a widely used inter-bank term rate.
- We must also consider the securitisation of loan portfolios. There are certain legal constraints which have hampered the development of securitisation in India. Take the case of double incidence of tax where the issuer has already paid tax on the interest income, which has been discounted, and the tax is also to be paid on the same interest income by the investor. This is similar to the double taxation argument advanced on dividend, an anomaly which has been set right in the last budget. Therefore, the SPV should be exempt from paying tax. In addition, TDS should be done away with and replaced with a flat rate of tax on all interest payments – whether made and to be paid by the issuers.

Infrastructure

Efficient and sound infrastructure facilities form the base of any debt market. Since other chapters will discuss this aspect in detail, I will only mention that in order to promote dematerialisation of all securities, it is essential to abolish stamp duty on transfers immediately. This will remove the current bottlenecks in transfer of securities and promote the growth of a very active secondary market. Once this is effected, corporate debentures will also be actively traded in the market as the risks of transfer and settlement will be greatly reduced. A similar situation already prevails in

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Government securities which are transferred and settled in a dematerialised form.

Intermediaries

They drive the market and thus have to play a pro-active role. However, we are yet to see intermediaries acting for the development of the debt market. They need to view marketing as an essential tool. As Peter Drucker once said, “Business has only two functions – marketing and innovation.” Innovation and marketing orientation is therefore important for the success of any product. But even innovations require to be marketed. Intermediaries have to play a very active role in marketing PSU and corporate debt to retail investors. To reach and service retail investors, they need to set up a strong, wide-spread distribution network. However, to set up an efficient distribution infrastructure, they should have access to low-cost funds as there is a gestation period for development of a network.

Conclusion

A vibrant debt market is essential for developing the primary market which will, in turn, develop the debt culture in India. Removal of restrictive allocation norms for qualified institutional investors; providing fiscal stimuli for attracting small savings; setting up of an institutional infrastructure; lengthening of the liability profile; inculcating an orientation towards risk management; and, marketing of debt products, will be instrumental in moving towards a more mature debt market.