

# *Debt Market : The Regulator's Perspective*

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## **Introduction**

This Conference gives me an opportunity to sharpen my thoughts, and gain insights from the deliberations. The subject has gained importance over the years, and in particular, more recently after the Monetary and Credit Policy of April 1997.

I understand that the objective of this national conference, is to assess recent changes and examine issues which merit urgent consideration in order to achieve an efficient and vibrant debt market. In the Seminar organised by the SBICAP, Governor of the Reserve Bank of India, Dr. C. Rangarajan had flagged some specific issues which would help in formulating an agenda for further reforms in the debt markets. I would urge upon this audience to give serious consideration to these issues.

Let me, therefore, begin by highlighting the reforms initiated by the Reserve Bank of India and Government of India in the debt market in the recent period. These include:

- Setting up of a comprehensive system of Primary Dealers

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- Adoption of DVP system for settlement of Government Securities transactions
- Abolition of tax deduction at source on Government Securities
- Permitting FIIs to invest in debt instruments including Government stock and allowing them to hedge their foreign currency risk in the forward market
- Introduction of Treasury Bills of varying maturities, and,
- Placing investments of banks in preference shares / debentures / bonds of corporates outside the five per cent limit.

In a bid to increase transparency in operations, the Reserve Bank of India (RBI) has been disseminating information on its transactions in Gilts and publishing the calendar of auctions in respect of Treasury Bills and Repos. Soon, the RBI proposes to publish data on banks' investments in corporate and PSU debt in the Weekly Statistical Supplement to the RBI Bulletin.

To foster inter-institutional co-ordination, a Technical Advisory Committee for Government Securities and a Standing Committee on Money Market have been set up. Major issues confronting the debt and money markets are discussed in these committees. These committees have been found to be useful to all participants.

As I observe, the discussions in this conference are structured around five sessions, viz., primary market, secondary market, legal issues, risk management and future directions. For the sake of convenience, I will follow broadly the same structure and pose issues for further deliberations.

### **Primary Market**

Lack of market clearing yields at primary auctions of Government debt is often being cited as a significant factor slowing the development of the secondary market. The arguments run as follows:

- It hampers efforts to broaden the investor base
- At times, when cut-off yields in the primary market are lower than prevailing secondary market yields, it curbs secondary market trading

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- To the extent the cut-off yields are lower than secondary market yields, it constrains inventory build-up by primary dealers. Finally, to the extent volumes of pick-up in primary auctions are reduced due to interest rate considerations, it reduces the availability of floating stock in the secondary market.

What are the factors that inhibit market clearing mechanisms? There are four important issues, viz., notifying auction size, type of auction, element of non-competitive bids and frequency of auctions of Treasury Bills. Another issue of concern relates to large private placements of corporate debt.

### Notifying Auction Size

At present, there is no pre-announced notified amount in 364-Day and 14-Day auctions. This procedure enables the RBI to determine either the cut-off price or the amounts to be accepted in a flexible manner. Notifying amounts in auctions will bring more transparency in the auction procedure by removing the uncertainty about volumes in auctions. In this context, it needs to be emphasised that the capacity of primary dealers to absorb auction supply as an underwriter is limited. Currently, primary dealers underwrite to the extent of 50 per cent of the amounts in auctions with notified amounts. In this scenario, there is a danger of devolvement on the RBI, if there is a pre-announced notified amount. The extent of the devolvement on the RBI can be minimised by increasing the underwriting amounts to primary dealers. The RBI could also change the notified amounts between each auction, depending on prevailing market conditions, in order to minimise the devolvement risk on itself.

Presently, there are six primary dealers. The institution of primary dealers has partly contributed to a significant increase in secondary market transactions in Government Securities. Authorising primary dealers is an on-going process. All eligible applicants will be considered by the RBI for primary dealership. While on this subject, an issue that needs to be considered relates to the when-issued market. At present, the Securities Contracts (Regulation) Act, 1956 prohibits short-selling of securities. Two options could be considered. First, whether to give exclusive access of primary auctions to primary dealers and simultaneously permit them to

engage in short sales of Government Securities. Second, whether to continue with the existing system of access to primary auctions and allow all participants to engage in short sales of Government Securities. The timing and sequencing of this reform - whether to introduce it now or wait until the number of primary dealers have enlarged are aspects that need to be carefully considered. I would urge upon the participants to discuss the pros and cons of these options and the international practices in this regard.

### Type of Auction

There is some debate over the type of auction that is most suitable for selling Treasury Bills and Dated Government Securities in India. There are advocates for both the discriminatory and uniform price auctions. But, international practices seem to be in favour of discriminatory price auctions. In a switch over from one auction system to another, a number of considerations arise such as easy entry, cost to issuer, return to investor, role of primary dealers, incentive to gather information, etc. This is another area fit for a careful assessment.

### Non-competitive Bids

As you are aware, non-competitive bids are allowed in 91-Day and 14-Day Treasury Bills auctions. Major issue relates to the treatment of non-competitive bids. Country practices show that non-competitive bidders are made allocation within the notified amount. However, the non-competitive bidders in other countries consist essentially of the small, retail and inexperienced investors. Since the maximum bid is restricted to a small value, the competitive bid prices do not get distorted. There is a view in the Indian market that non-competitive bidders should also be allowed as competitive bidders. However, in our country, since State Governments are major non-competitive bidders, their volatile surplus funds position could make their participation in Treasury Bills auctions very uncertain. Thus, there could be large swings in terms of volumes in auctions. Another view is to make allocation for non-competitive bidders outside the notified amount.

### Frequency of Auctions of Treasury Bills

There is a view in the market that the high frequency of auctions recently brought about by introducing 14-Day Treasury Bills auctions (along with frequent repos) tends to hinder secondary market activities by reducing investor participation in the secondary market in favour of waiting for a few days for primary issues. Also, the staggered settlement dates for Treasury Bills falling on different days in a week make secondary market trading across different maturities of Treasury Bills less efficient. Perhaps, it would be useful for this Conference to discuss the need, if any, to reduce the auction frequency and adjust settlement dates of different maturity Treasury Bills to fall on the same day in a week so as to improve fungibility and thereby price discovery and market efficiency.

### Large Private Placements of Corporate Debt

Finally, an increasingly important concern relates to the issuance of PSU bonds and corporate debentures through private placements. Although, the private placement market is playing a crucial role in enabling corporates to raise resources, certain vital issues need to be considered for a well-directed and efficient functioning of the market. At present, there is no transparency in this market and virtually little information. In developed markets, the regulatory authorities indicate the framework within which the private placement has to function, like number of persons per placement, arrangements with only qualified investors and strict regulations to access certain qualified investors. We have to assess the adequacy of regulatory framework to protect the interest of investors from risks associated with subscriptions in the private placement market. With a proper regulatory framework and more transparency, the private placement market can develop further as an integral and important constituent of the primary market for raising of resources by the corporates; hence, the need to deliberate on the status of regulatory framework.

### Secondary Market

As part of reform process, a number of technical impediments that prevented more active secondary market trading in Government Securities and Treasury Bills have been progressively removed. Let me briefly recall these:

- abolition of the system of TDS
- issuance of benchmark securities, and,
- operationalising the DVP system at all centres.

The RBI is encouraging banks to open SGL II accounts for constituents, thereby enlarging the coverage of book-entry holding of Government securities. Recently, the National Stock Exchange has been authorised to open a SGL II account and current account with the RBI. A decision has been taken to extend a similar facility to Stock Holding Corporation of India. These steps would further streamline transfer and settlement procedures in the Government securities market.

In respect of PSU bonds and corporate debentures, which are held mostly in scrip form, a proper settlement system is yet to be put in place. The National Securities Depository Limited (NSDL) was expected to dematerialise a sizeable stock of non-Government debt. But, at present, NSDL has been able to dematerialise only those securities which are exempt from stamp duty. Suitable amendments to stamp duty regime appear, therefore, necessary to avoid transaction costs and enable active use of the facility. An appropriate solution is needed since an efficient transfer and settlement system in the PSU bonds and corporate debt segments could usher in the resumption of repos in these instruments. Once it is assured that risk free and transparent payment and settlement systems are put in place through a depository like NSDL in dematerialised form, it should be possible to permit such repos.

Another issue that has been raised frequently relates to permission to financial institutions to borrow through repos in eligible securities. While there is a risk of generating asset-liability mismatches among non-bank

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participants, the conference could discuss the operational feasibility of allowing such participants in the repo market under suitable safeguards.

The Reserve Bank of India is considering a range of options to increase the interest of individual investors in Government securities. There is an inherent potential for households to diversify their investment portfolio encompassing Government securities. It would be useful to quickly review marketing and distribution strategies adopted in other countries for reaching Government Securities to households. Australia, Ireland, Netherlands and Sweden adopt direct sales of Government Securities to the retail sector through special registration facilities. Hungary and Switzerland, the UK and the USA retail through non-competitive bidding arrangements. France and Norway use the primary dealers network. Germany, Spain and Turkey have retailing arrangements through the banking system while Denmark, Ireland, and Poland retail Government Securities through the stock exchanges. Italy uses both the banking and stock exchange network. The conference can do well to consider strategic options for this important phase of market development.

### **Legal Issues**

#### **The Public Debt Act, 1944**

The most important segment of the debt market being Government securities, let me start with the relevant law on this. The law relating to Government Securities and their management by the Reserve Bank of India is the Public Debt Act, 1944. The present act dates to pre-independence days when marketable debt comprised almost the entire borrowing of the Government. This is no longer valid with almost over Rs.300,000 crore worth of other liabilities of Government comprising inter alia instruments like NSS, Indira Vikas Patra, etc. falling outside the purview of this Act. Further, provisions of the Public Debt Act relate to issue, servicing and repayment of Government securities and do not provide regulation of trading/marketing of Government securities. For instance, under the present Act, the Reserve Bank has no substantive powers to design and introduce an instrument of transfer suited to computer environment. There are other constraints such as those which preclude the RBI from issuing Government Securities in the form of promissory notes in the name of Trusts,

nonavailability of nomination facility in respect of Government Securities, barring a minor from holding Government Security, etc. A new Act on Government Securities is proposed to take care of these issues. Any suggestions on this reform are welcome.

### The Depositories Act

It seems appropriate to consider extending the use of Depositories established under the Depositories Act to Government Securities. The Depositories Act came into force in 1996 providing for a legal framework for holding of equities, bonds, debentures, units and other market instruments in dematerialised form in a Depository. Such deposits come under the regulatory framework of SEBI. Since the RBI manages the public debt of Central and State Governments, Public Debt Offices (PDOs) of the RBI are in effect depositories under the Public Debt Act. Thus, giving permission to Depositories to hold Government Securities in dematerialised form would make the provisions of the Depositories Act applicable to the Reserve Bank as an issuer, bringing into focus the respective regulatory roles of the Reserve Bank and SEBI in Government Securities. One of the suggestions to resolve this is by way of incorporating a provision in the proposed Government Securities Act, excluding the provisions of Depositories Act being applicable to Government Securities.

It would certainly be useful to survey the international experience in this regard. In Canada, Germany and Switzerland, there is Central Government prudential regulation of depository institutions and provincial or state supervision of securities trading. The Bank of England used to provide regulation of depository institutions, although after the passage of the Bank of England Bill, responsibility for banking supervision will be transferred to the new and strengthened Securities and Investments Board (SIB). SIB will also take direct responsibility for the regulatory regime covered by the Financial Services Act. In Australia and New Zealand, the central banks provide prudential regulation of depository institutions, but there is no specific regulation of Government securities market. The Japanese Ministry of Finance and the Danish Supervisory Authority for financial affairs provide centralised regulation of the Government Securities. As you would have observed, the international experience is varied.

### Forward Contracts

Another legal issue which is often alluded to relates to forward contracts. This forum would do well to discuss the advantages and disadvantages of the repeal of the Government notification issued in 1969 prohibiting forward contracts in securities.

### Risk Management

Investors in debt instruments face three major components of risk, viz., credit risk, interest rate risk and foreign currency risk. In case of Government bonds, credit risk is zero. The foreign currency risk is relevant only to non-resident investors like FIIs who are investing in debt instruments. Recently, the 100 per cent debt funds dedicated to the debt market were allowed to take forward cover to enable them to hedge their exchange rate risk. Investments in all debt instruments are exposed to interest rate risk. This risk can be better hedged if a futures market in interest rate exists or if short-selling in securities is allowed. However, the futures market will be meaningful only in an environment of totally deregulated interest rates and the existence of a term money market which itself is dependent on a credible yield curve. Thus, while eventually introduction of interest rate futures and permission for short-selling are inevitable, the real issue is one of timing of these reforms, so that it does not entail any systemic risks.

### Future Direction

- Consistent with the spirit of financial sector reforms, the RBI is in the process of divestment of part of its share holding of DFHI and STCI so that the RBI does not have majority of share holding. As you aware, the RBI had taken initiative to promote STCI and DFHI. The RBI is now a minority share holder in DFHI and after the second round of disinvestment in 1995, its share is only 10.5 per cent. It has also been decided to disinvest shares of STCI so that after the first phase of disinvestment, the RBI's share holding will be less than fifty per cent.
- Second, Non-Banking Financial Companies are now required to maintain a higher level of liquid assets in the form of Government securities and Government Guaranteed Bonds. This will increase the demand for

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Government Paper in the market. This will be in addition to the demand generated due to opening up of provident funds to debt market instruments, emergence of MMMFs and investments by 100 per cent FII debt funds.

- Third, I would like to flag the vital issue of the role of market participants. Standard practices have to be evolved by the market with regard to the manner of quotes, the conclusion of deals, the manner of pricing and accounting standards. Code of best practices has to be evolved also for repo transactions in eligible securities. In the context of moving towards a liberalised and market oriented environment in the financial sector, it will be desirable if such standard practices are evolved and accepted in a common forum of a self regulatory body. At present, I understand that there are moves to create such self regulatory body/bodies among the PDs and among banks and financial institutions covering transactions in money and fixed income securities markets. This is a welcome trend and the RBI would be willing to nurture such developments in the market.
- Finally, the time has come to accord priority for establishing electronic links between Deposit Accounts Department and Public Accounts Department / Public Debt Office of the RBI for achieving synchronisation of funds and securities transfers. We should also begin planning electronic links between banks, primary dealers and others who have access to the system so as to pave way for a more information-efficient and transparent securities market.

These plans can succeed only with the concerted efforts of all - the Government, the Reserve Bank of India and the market participants. I would appreciate your detailed suggestions. I would be interested to learn about the outcome of the deliberations.