

Promoting Debt Funds

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Introduction

Debt instruments and, consequently, debt investing products floated by Mutual Funds, are rapidly gaining popularity. The investing public is understandably wary of equity in the light of recent history, and has turned to bonds. Significant structural changes have also made the debt market more efficient. Largely as a result of these factors, the last two years have seen a dramatic increase in the number of debt issues, as also the amount mobilised by mutual funds in debt products. Table 1 indicates the increase in the share of debt funds, in the total funds mobilised by mutual funds in the last few years.

Table 1

Period	Funds Raised	Income Funds	Growth
	<i>(Rs. in crores)</i>		
July 93 - June 94	8050	60%	40%
July 94 - June 95	6705	55%	45%
July 95 - June 96	4353	83%	17%
July 96 - March 97	3077	90%	10%

Source: Unit Trust of India

Total does not include amounts raised in balanced funds

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Background

The size of the bond market has nearly doubled over the last five years – from around Rs.175,000 crore in 1992 to about Rs.325,000 crore in 1997. Of this, Government securities form approximately 78% of the debt market, Public Sector Undertaking (PSU) Bonds about 16%, and the balance 6% are corporate Bonds. In the past, the debt market in India was rigidly regulated, dominated by the Government as the principal issuer, and largely avoided by the private sector. Significant changes have however taken place in the debt market since 1994, and particularly since early 1996. These include :

Structural Changes

- There has been a relaxation of control on asset allocation by institutional investors. For example, since April 1997, the Reserve Bank of India (RBI) has removed the ceiling of 5% of incremental deposits by banks for investment, inter alia, in corporate debentures.
- Almost all interest rates have been deregulated, and RBI is largely relying on market operations to implement its monetary policy. It has established the "Bank rate" as an effective signal and benchmark rate, by linking this rate to several accommodations granted by it. This has been announced in its Credit Policy of April 1997.
- The Government is increasingly resorting to borrowing at market driven interest rates.
- The Wholesale Debt Segment on the National Stock Exchange (NSE) has created an effective secondary market in debt instruments. The Stock Exchange, Mumbai (BSE) has also activated trading in debt.
- The Securities and Exchange Board of India (SEBI) has allowed several Foreign Institutional Investors (FIIs) to set up India dedicated 100% debt funds, from November 1996.
- RBI appointed primary dealers have begun to make a market in several Government securities.
- Removal of reserve requirements on inter-bank liabilities, has paved the way for the creation of a continuous yield curve over the spectrum of maturities.

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This should lead to greater integration of the Government securities market, the rest of the bond market and the currency market.

Increased Supply of Corporate Debt Paper

- The high real interest rates over financial year 1997 (April 1996 – March 1997), coupled with the slump in the primary equity market had caused many corporates to cut back on fresh investments. This led to a decrease in borrowings, and consequently in new corporate debt paper. In an effort to increase liquidity, RBI made several cuts in reserve requirements and removed certain restrictions on banks investing in corporate bonds. The trend continued with RBI lowering the bank rate in mid-1997 by 100 basis points. This resulted in a downward shift in yields across all maturities. Consequently, there has been a sudden rush by corporates to raise money, specially those who had shelved earlier plans.
- The first half of the financial year 1997 witnessed over 50 primary issuances, at steadily decreasing yields. Top credits have now started issuing paper for 5 to 7 year maturities, and further, began using the book building process. Even corporates at the upper end of the risk spectrum, are resorting to 2 to 3 year paper, though they were earlier able to borrow only for short maturities.
- Moreover, the increasing focus on infrastructure development and private sector participation in such ventures, should result in private sector funding patterns shifting to issuance of fixed income paper.

As a result, pure debt funds are now coming into their own. The reasons for this are discussed below.

Why Debt Funds - Macro Issues

Falling Spread between Yields

Reductions in the Statutory Liquidity Ratio (SLR) and the Cash Reserve Ratio (CRR) have infused liquidity in the system. Sluggish industrial growth, lower inflation rate, and a downward revision in the recently revived benchmark – bank rate – by the RBI, have, however, brought about a significant decline in interest rates across the maturity spectrum. The gradual phasing out of the system of ad hoc monetization (issuance of ad hoc treasury bills) has forced the Government to increasingly borrow at

market related rates. This has led to an increase in the average cost of Government borrowing. Though the marginal cost of the Government's market borrowing has been showing a declining trend in the recent past, there has been a steeper fall in the marginal borrowing rates for corporates with a high credit rating. This has led to a fall in the spread between yields from sovereign and corporate paper. This, in turn, has created a benign environment for corporates to float new paper, that can be subscribed by banks as well as mutual funds.

Efficiency of Intermediation

The primary issue in the saver (or investor) and issuer match-making, is the cost and efficiency of intermediation. Traditionally, banks have been the most important intermediaries, and the spreads between the lending rate and the deposit rate is the cost of their service. This spread, though thinning down, is rather high at around 3%. This is based on the minimum lending rate and the maximum deposit rate. The spread would be higher, if averages are considered instead of minima and maxima.

Debt funds offer a significantly more efficient intermediation service, since the recurring costs of a mutual fund for a debt product is regulated at a maximum of 2.25%, and can fall to as low as 1.50%, as the size of the corpus increases. Despite the fact that debt funds, unlike banks, usually do not guarantee principal or returns on unit holders' funds, they provide a valuable service to the investors. This is because debt funds reduce costs and risks associated with the debt market, by diversification and through superior evaluation skills.

Low Risk Profile

The main reason for the current retail preference of debt over equity, is that the retail investors are assured of consistent returns with minimum volatility. In essence, a debt fund is an important part of a balanced investment portfolio for an investor and an important investment choice.

Professional Expertise

The same advantages that professionally managed assets have, over assets managed by individuals, naturally apply to debt funds. Hence an individual gets the advantage of superior investment management skills and an efficient back office.

Why Debt Funds - The Layman's Point of View

Better Liquidity vis-à-vis Fixed Income Securities

Many of the new mutual funds schemes today are open ended. This implies better liquidity for retail investors as they can easily sell back the units to the mutual funds. In case of fixed income securities, they would have to depend on the secondary market, with the associated vagaries of either not finding buyers for relatively small lots or not receiving the right price. Today, mutual fund schemes have the additional advantages of a marginal or nil front-end load or exit load.

Systematic withdrawal plans allow investors to determine their needs for cash inflows and plan their exit. Similarly, systematic investment plans allow them to phase their entry into the debt market, to match income accretions.

Tax Efficiency

Debt Funds usually provide a 'growth' option, whereby, earnings on the investment are re-invested instead of being regularly paid out. This allows the investor to better plan his tax incidence, by paying a lower level of tax on capital gains. There is also an additional benefit of reducing capital gains by indexing the cost of acquisition. There are some ambiguities regarding the treatment of such earning as capital gains, which warrant a clarification from the authorities.

Pooled Funds and Diversified Exposure

The market favours large players, with finer spreads and lower transaction costs. Retail investors can avail the benefits of the larger fund size of the pool, as opposed to his individual investment. This also makes sovereign bonds, privately placed bonds and earnings from the short term money

market instruments, available to retail investors. Above all, Mutual funds invest in a diverse portfolio of securities, thereby reducing unsystematic risks.

Augmenting Resources

Market Segments which Favour Debt as a Tax Shelter

Capital gains from the sale of long term capital assets can be invested in mutual funds schemes which offer this option. Those who do not need current income, can invest in the growth option which is normally offered by debt funds, where, on redemption, the capital gains get a more favourable tax treatment.

- *Retirees*: Superannuated employees can allocate their assets across mutual fund schemes offering assured returns and security of capital. Typically, such investors favour monthly income schemes for the major portion of their investments as they are largely risk-free and offer a sound avenue for their investments.
- *Money market investors*: Investors looking for easy liquidity, combined with a return better than what is obtainable from a savings account or short term bank deposits, could look at open ended debt products of mutual funds. These investors would typically not be able to access other money market instruments. Debt funds give them an access to this avenue.
- *Corporates*: Quite a few corporates have come to grief by participating in the unregulated inter-corporate deposit (ICD) market. To effectively utilise short term surpluses, debt funds can be positioned as a good investment vehicle.

Institutional Segments

- *Banks*: Banks have always been viewed as direct competitors to debt funds. However, they too could benefit by using the specific expertise which mutual fund managers have in managing corporate bond portfolios, including the handling of cumbersome back office work. They could therefore choose to route their investments in these sectors through debt funds.

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- *Provident Funds*: As of now, PFs are prohibited from investing in mutual funds, but with increasing liberalisation, this restriction may be relaxed. Specific products, tailored to meet the long term needs of such investments, coupled with a fairly predictable pay-out, can be designed. This segment is very risk averse and the investment strategy of such funds would also vary accordingly.
- *Charitable and Religious Trusts*: Presently, such trusts can only invest in UTI or in other instruments with the express approval – on a case-to-case basis, from the Government. If the parameters for approval by the Government are specified, other funds can tap the investments of such trusts, with appropriate products.
- *Insurance companies*: Currently, insurance companies are hesitant to invest in debt funds. As in the case of banks, they too would benefit from investing in debt funds.

Reaching the Investor

Promoting Informed Investment

This has now become pretty trite, since much has been said – and little done – about investor education. Nevertheless, this is the key to developing healthy investment behaviour in the investing public. The feast and famine approach to investing – investing wildly when the market booms, often on the basis of little or no knowledge, and, total abstinence when the markets catch a cold – is the main reason for the present disillusionment among investors. The solution is organised intermediation with well informed intermediaries assisting investors match their investment behaviour to their risk profile. For debt funds, this is particularly essential, since the schemes have many subtle variations in investment patterns, lock-ins, and income pay-outs. Instead of opting for a widely distributed proprietary network, it may be advisable for mutual funds to focus on selecting sound institutional intermediaries who have a well trained sales force.

Under-explored Channels

- *Banks*

The role of bankers as financial advisors has not been well developed in the country though a few bankers – notably the private sector and foreign banks – do provide these services. With an extensive branch network, and the high level of customer confidence that branch managers enjoy in semi-urban areas, banks have an immense potential to provide intelligent and knowledgeable intermediation.

- *Payroll contribution*

Defined contribution plans (DCP) are not currently prevalent in India. However, marketing schemes along the lines of DCPs, with pay-roll deduction facilities, could offer a steady and cheap source of fund mobilisation. It would make systematic investment plans truly effective.

- *Direct selling through professionals*

Professionals are the key investment advisors for high net-worth individuals in India. Instead of diffusing focus and spreading budgets thin in large-scale investor and intermediary education programs, this may be a good target audience for a focused investment education campaign.

- *Tele-marketing*

Given that the typical mutual fund investor is likely to be accessible through this medium, its true potential is yet to be tapped.

Innovation

In the final analysis, no product can sustain the interest of investors unless they get a fair return – from their point of view. As professionals, we must focus on offering a variety of products and tailoring investment vehicles that can cater to their various needs.

- A range of products catering to niche segments can offer investors a variety of plans to distribute their savings.
- *Simplifying decision making*: Umbrella funds can attract the undecided investor, if cheap switching options can be provided. Umbrella funds, with

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sub-accounts, can make it easier for investors to plan their investments according with their individual (changing) investment goals, availability of funds, and with changes in their own perception of investment opportunities.

- *Credit rating*: A sense of security can be provided by getting debt funds credit rated. Regular audits can ensure that there are no deviations from the scheme objectives.
- *Liquidity*: The past few years have seen a remarkable improvement in service levels, as well as a dramatic increase in consciousness about the importance of liquidity. Simplified procedures and efficient services can perhaps give mutual funds an important edge over the banking system, in attracting investors.

The Road to Greater Efficiency

With the Government encouraging the development of a strong debt market, debt funds are bound to grow from strength to strength. However, some major structural changes are still required, to make such products (and the entire system) more effective.

Improve the Payment Mechanism

The present payment mechanism makes it virtually impossible to clear funds on the day a cheque is received. A same-day-clearance system, at least for high-value bank pay-orders, with a cut-off time of (say) 13:00 hours, is essential to facilitate quick completion of debt market deals.

Lower the Cost of Trading

At present, the cost of trading in debt is too high to facilitate any meaningful level of trading. This needs to be rationalised to build a healthy secondary market for debt. The stamp duty on the transfer of securities is also too high and restricts trading in debt, since short-term deals become unviable. These laws need to be restructured and made uniform across states, or a one time levy on the issuer, could substitute repeated stamp duty payable on each transfer.

Introduce Depository for Corporate Debt

This would facilitate settlement, reduce costs and eliminate bad deliveries. Immediate steps need to be taken to encourage dematerialised debt holding.

Widen the Repo Market with Suitable Controls

Liquidity in the debt market can also be increased by the introduction of repos, enabling dealers to make markets and hedge positions. More players should be allowed to conduct repos as their participation will create a liquid debt market. There is a need to widen the repo market to include corporate bonds with suitable checks and balances.

Make 100% Marking to Market Compulsory

There is a low floating stock of securities, compared to the stock on issue. This is because a few large participants hold securities at historical costs, not marking them to market. Since trading in such securities would entail booking a loss, they are usually held to maturity. If 100% mark to market is made obligatory, there would be a definite impetus to trade in these securities.

Promoting an Active Secondary Market

Increase Floating Stock

The requirement of obtaining a credit rating for listing of a security has effectively meant that most privately placed debt securities cannot be listed. Moreover, rated privately placed debt can be listed only if equity shares of the issuer are also listed. To increase floating stock and thus to facilitate trading, it is essential that these criteria be reviewed.

Usher in Attitudinal Changes

A herd mentality results in an unidirectional market and restricts volumes in most situations. Secondly, regulations still do not allow institutions which invest in debt, to fully integrate with market practices. For instance, banks cannot invest in paper held in street names. Thirdly, institutions continue to

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function in the old traditional manner, partly due to cost considerations, and also as a result of the strong ‘hold to maturity’ syndrome in their investment attitude.

Develop Trading Systems

The market infrastructure continues to treat debt as a poor cousin. There are no guarantees against bad deliveries, netting of transaction is not allowed, and there are no lines of credit to market makers. It is about time these issues are given the importance they deserve.

Facilitate Borrowing

The difference in yields on corporate debt paper and interest on borrowings may provide a significant arbitrage opportunity for the fund manager. Presently, fund managers cannot borrow against the security of assets to improve returns, except for bunched redemptions.

Review Restrictive Guidelines

The fund manager is restricted from distributing business as per his own assessment of the broker in terms of his services, market access and the deals he can bring to the table. This is an artificial barrier on the fund manager, which curtails his freedom, without achieving much in terms of quality of fund management. Returns can be directly affected, if the fund manager is compelled to choose relatively less efficient brokers. The requirement of distribution of business may be best left to the trustees to monitor and advise.

Reduce Restrictions on FII

There is a need to review the present restrictions on FII, on purchase of Sovereign paper by non-100% debt funds. Similarly, the restriction on short term money market investments, limits their option for earning on temporary liquidity. The present system requires that an income tax clearance be obtained for repatriation of realised sales proceeds, resulting in idle balance being left with the custodians, with no returns. This skews all yield calculations, since the timing of the ‘no objection certificate’ (NOC) is indeterminate. This system needs to be streamlined.

Conclusion

There is no gainsaying the fact debt funds offer certain distinct advantages for investors, over their nearest rivals i.e. fixed deposits and direct investment in corporate debt.

The debt market has still to undergo a number of structural changes to make it truly effective. In addition, debt funds will need to be designed in an innovative manner and marketed creatively. Much of this product's popularity will depend upon how effectively fund managers deliver results, in tune with the investors' objectives.

This is an interesting new area of business for all of us, and progress needs to be made structurally by the regulators, and in terms of product design and returns by Asset Management Companies. Debt Funds have unique advantages to offer and our collective success will be demonstrated by the future popularity of this vehicle with investors.