

Depository in the Debt Market: The Unfinished Agenda

*T. Koshy*¹

Background

Though the Indian capital market is over 100 years old, it continues mainly as a market for equity related products. Debt is more or less financed through banks and financial institutions, although in the recent past, financial markets are playing an increasingly significant role. Even the Government securities market essentially consists of primary issues and inter-institutional trades. This is also mainly influenced by ‘demand management’ by the Government through SLR and PLR ratios which inhibit true price discovery.

World over, the size and scope of debt markets is at least five to ten times larger than the equity markets – both in cash and in derivatives markets. This is because while equity related products originate primarily from the corporate sector, debt instruments could originate from various areas including corporate and governments sectors. Moreover, the scope of product development, by way of securitisation of debt etc., also enlarges the potential for the market for debt instruments. In fact, the debt financing

¹ Vice President, National Securities Depository Limited, India
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route takes precedence over equity finance to meet the current demands of the infrastructure sector.

However, due to a variety of institutional and regulatory reasons, the Indian debt market has not been able to achieve even a fraction of its true potential. This is especially true for the secondary market, as illustrated by the following table. As on 31 March, 1997, the total outstanding debt instruments, including corporate debt and government securities, was only about Rs.4600 billion which is about 80% of the stock market capitalisation.

Table 1. India – Indicators of financial sector development (value Rs. billion)

Item	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
<i>Stock Market Capitalisation</i>	1,103	3,541	1,771	3,984	4,688	5603	5832
<i>Bank Deposits Outstanding</i>	1,925	2,308	2,686	3,151	3,869	4323	5036
<i>Bonds</i>	1,590	1,825	1,978	2,357	2,614	3600(e)	4600(e)
<i>GDP (at current prices)</i>	4,727	5,516	6,279	7,090	9,456	10986	12600
<i>1 as % of 4</i>	23.3	64.1	28.2	56.1	49.6	51.0	46.28
<i>2 as % of 4</i>	40.7	41.8	41.8	44.5	40.9	39.4	39.97
<i>3 as % of 4</i>	33.6	33.1	31.5	33.2	27.6	34.5	36.51

Source : *The Indian Bond Market, June 1995, CMIE(EIS)*

e - estimate

Institutional Developments

The last three years have witnessed revolutionary changes in the institutional framework in the equity market. These include :

- Establishment of an anonymous trading mechanism with national reach which has removed the potential abuse by the 'club market' and provided equal opportunity to a large number of investors, irrespective of their geographical location.
- Establishment of a clearing corporation which act as a counterparty to each leg of the trade has eliminated the risk of default.

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- CM level netting along with risk management measures instituted by the clearing corporation by means of exposure limits, and marked to market margins, has provided considerably safer leverage to market participants.

These institutional developments have helped the daily trading volumes to soar from about Rs.300 crore in 1993 in BSE to about Rs.2500 – 3000 crore today in BSE and NSE together. All these factors are equally relevant to the debt market which also needs a healthy clearing and settlement system. Many of the regulatory shackles which act as a hindrance to the growth of the debt market, are probably attempts to limit the potential abuse of inefficiencies of the paper market. Unfortunately they not only limit the abuse but also kill the market.

Relevance of the Depository

It is in this context that a well functioning depository becomes relevant. The potential benefits of the of this system include :

Qualitative Factors

The introduction of scripless trading may result in a number of qualitative improvements in the market.

- Elimination of bad delivery and transfer of the title of security at the time of exchange of assets, eliminates the buyer's disadvantages with respect to the genuineness and title of the asset received, compared to a seller.
- The market opportunities for a broker are substantially increased due to the elimination of the possibility of forged documents. His exposure with the person who delivers the security is over once he receives the securities in his account. This is unlike in the case of physical securities where the broker is exposed over a substantially longer time.
- In the physical market, speed of movement of transfer documents is restricted due to its form, whereas in the dematerialised environment, the transaction processing can be instantaneous. This substantially reduces the carrying cost.

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- Instant transfer, independent of the geographic location, brings about equality between investors in Mumbai and investors in other far away locations. This is not possible in the physical environment.
- In the debt market, due to the non standard nature of instruments, there is no concept of a market lot. Therefore, in the physical market, asset holders often face problems of liquidity due to the time taken in splitting or consolidation. This is a non-issue in a dematerialised environment.
- In the absence of a clearing corporation and netting in the debt market, each transaction has to be settled on a trade-to-trade basis. As a result, back office activities may be much higher than in equity markets. This could substantially restrict the number of trades a dealer could handle per day which will not be the case with electronic holdings.
- The issue in electronic form could be more economical and efficient and could help development of many innovative products subject, to regulatory restrictions.
- Such state-of-the art clearing and settlement system will be essential for integration with the international markets once the Indian currency becomes convertible on capital account.
- Improvements in clearing and settlement infrastructure would also give confidence to many international investors who are very wary of the existing weaknesses in the physical market. This is of special significance in light of the recent permission to FIIs for investing in the debt market.
- These reductions in transaction time, cost and risks would boost the development of a healthy secondary market with a wider participation from retail investors. This is an essential requirement for setting a benchmark for risk-return and for providing liquidity which are pre-requisites for development of the debt market. This would further contribute to the development of hedging products like options and futures.

Cost

Capital cost (building, vaults, computers, etc.) and revenue cost (people, utilities, administration, etc.) of handling shares in the electronic book entry

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form is much lower than the corresponding cost for physical shares. These benefits definitely translate to reduction in custody and transaction cost.

The magnitude of savings in transaction costs in both equity and debt markets is provided in Table 2.

Table 2

Parameter	Equities		Debt	
	<i>Physical</i>	<i>Electronic</i> ²	<i>Physical</i> ³	<i>Electronic</i>
<i>Custody</i>	20-30	3.5	10-15	0.50
<i>Transaction</i>				
♦ Buy 30-40	5.0		15-20	0 ⁴
♦ Sell 30-40	0		15-20	0
<i>Stamp Duty</i>	50	0	Present ⁵	0 ⁶

Adoption of the Depository

As the debt market is still the process of development in India, it may be the best time for establishment of such modern institutions.

Debt instruments are not presently available in the depository since there is no exemption of stamp duty for debt instruments, unlike in case of equity and units of mutual funds. This is because stamp duty on debt instruments is a State subject and no states have yet announced any concessions. In equity and mutual fund units however, it was removed by the Central Government.

² NSDL Charges to the DP who will have their markup on this

³ The charges by Custodians for non government debt instruments is widely varying and are in the process of evolving as this service was started by many custodians only recently. Moreover in most cases as the transactions are presently of very high value there is upper cap on each transaction. For a comparative indication it is shown as half that of equity instruments as the average size of debt instruments are generally large due to the institutional nature of the market although there is no major difference in handling of debt instrument compared to an equity instrument. NSDL charges for Debt instruments has been priced much lower as a support to the growth of the debt market.

⁴ Till March 31, 1999

⁵ Different in each state

⁶ There is no stamp duty exemption on all debt instruments. But only instruments, where there is such an exemption, will be admitted in the depository.

Although an exemption in stamp duty may appear to be against the interests of State Governments – owing to a loss in revenue – the resultant increase in liquidity will go a long way in improving their fund raising efforts as also of their state financial institutions and municipalities for infrastructure projects. The National Securities Depository Limited (NSDL) has already taken up this matter with the State Governments. NSDL has requested for a revenue- neutral policy change which will imply the levying of a one-time charge at the time of issue and eliminating duty at the time of transfer.

I trust the debt market participants will join the NSDL in representing with the State Governments for such a uniform policy, in addition to supporting us in the establishment of a world class depository.