

# *Issues in Distribution and Placement of Debt*

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## **Introduction**

In the present stage of financial reforms, the issues relating to development of the debt market assumes great significance. The cornerstone of the reforms process launched since 1991, is the reliance on market forces for effective distribution of resources rather than the command method followed in the centralised planning model of the mixed economy. Capital market reforms were inaugurated with the abolition of the office of the Controller of Capital Issues which introduced free pricing of equity and debt. This sounded the death-knell of the *khoka* market which thrived on under-pricing of equity and over-pricing of debt. The command model had segregated the financing function between banks and financial institutions, as commercial lending and development finance, respectively. Financing of public sector came mainly through budgetary support. The Government had a major claim on the national resources for funding its undertakings, as well as financing its deficit. The banking system was fraught with a multitude of regulated interest rates to subsidise and subserve the socio-political imperatives of the socialist model. All that is sought to be changed, and, indeed, it is changing.

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### **A Fragmented System**

#### **Issuers**

The financial system continues to be deeply fragmented. This fragmentation is responsible for the glaring inequities in the debt market. The risk-reward relationship of a debt offering is incoherent. The highest rating from a rating agency should signify the same safety of principal and interest for different classes of issuers. Yet different issuers pay different prices for instruments with same features, even if the rating and timing of an issue is the same. This is a result of the regulatory impact on the cost of funds for different issuers as also the divergent yields on their assets side.

The impact of statutory reserves is different for different issuers. Banks are subject to the highest reserve requirements, leading to higher impact on reserve-adjusted cost of funds. Financial institutions have no reserve requirements. Non-banking finance companies have SLR lower than that of banks and no CRR. Manufacturing companies have no reserve requirements except for their fixed deposit programs. So the same nominal cost of funds (issue price) would translate to different cost of funds for these issuers. The problem is compounded when you look at the assets side.

Commercial banks are mainly in the business of gathering short term commercial assets. The financial institutions have project loans as the bulk of their assets. NBFCs have different kinds of assets such as hire, lease or auto finance. The yields on these assets are different. Auto finance assets are considered to be the safest asset-class by rating agencies. Funnily, the yield on these assets is the highest today. So the rates offered in the market are based on what you can afford to pay after taking into account the cost of funds and yields on assets. When manufacturing companies issue debentures, the cost or advantage does not reflect appropriate disintermediation benefits or sharing of the same with the investors. This happens because there is fragmentation on the investor side as well.

#### **Investors**

Fixed income class of investments constitute a huge market if one includes the bank deposit market as a part of it. The size of the Indian debt market is

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estimated to be around Rs.4,00,800 crore (outstanding as on 31 March, 1997). Outstanding deposits with scheduled commercial banks alone amounted to about Rs.5,05,000 crore as on 31 March, 1997.

Bank depositors are investors in the Government securities market by proxy i.e. through the medium of banks. The nationalisation of banks in 1969 was intended to mobilise and channelise savings of the Indian population to the targeted credit groups and for the Government's own funding. The banking sector's Government securities portfolio today is over 35% of the total assets in the banking system. If one takes into account the non-performing assets of Indian banks, the Government securities portfolio will be larger than the commercial credit portfolio. Moreover, the biggest asset-liability mismatch for banks will be found in this portfolio. Now that securities portfolio of banks needs to be increasingly marked to market, one sees wild swings in bank profits. It is true that the removal of the 5% ceiling on investments in shares and debentures by banks, removed in the credit policy announced in April 1997, has begun to ease tightness in medium and long term funds need of borrowers. But the income volatility should make banks wary of adding further to the mismatches through investing more in fixed rate bonds and debentures. Banks should increasingly look at floating rate debentures as a safer avenue for asset-gathering. Albeit, banks are a major investor base for fixed income securities market today.

Investments by provident, gratuity and other superannuation funds is another reason for the investor base to be fragmented. All debenture issues by PSUs qualify for investments by these funds whereas private sector papers are denied that benefit. Ironically, unrated or low-rated PSUs are able to place their issues with these funds without much difficulty. Not only is the corpus of these funds large, the accruals by way of interest and monthly contributions by members are also substantial. This results not only in a premium the private sector issuers have to pay, but it also leads to a drastic reduction in their investor base. Some of the state guaranteed bonds also qualify as reserve investments for NBFCs (but not for banks!). Adding to the confusion is the trustee security status of some securities, regional bias for making certain issues eligible for investments by charitable and religious trusts. The insurance companies which are hitherto untouched by reforms and competition are heavily weighted towards investments in Government securities.

The mutual funds are in many ways non-starters, except for the Unit Trust of India, and are yet to emerge as a major investor base for fixed income securities. Some of the schemes which guarantee minimum return have difficulties in a falling interest rate scenario – during the offer period.

The Foreign Institutional Investors (FIIs) are a new entrant to this market and perhaps, most missed the bus when the interest rates dramatically fell during this year. The currency risk, the erratic and expensive non-deliverable forward market for Rupee abroad, thin and unrelated domestic forward market make it difficult for the FIIs to enter the market in a big way. The arbitrages which lured them to other emerging markets are not readily available in India.

Lastly, the retail investors in debt are a newly emerging mass of investors. Prior to the advent of reforms, only equity investors were the investors in the debenture market. They were generally lured into debentures through the sweetener of equities. Pure debt offerings used to be far and few in between. It is only since 1994 that some large issuers, especially the all-India financial institutions (FIs) like IDBI, ICICI and IFCI have taken keen interest in developing this investor base. For the first time, debentures and bonds are emerging as a viable alternative to bank fixed deposits. The issuers also have been pro-active in providing a wide range of liquidity options to small investors. Few private sector companies have tried to tap this market but the enthusiasm seems to be waning because the public offering route is not only expensive, but interest rate volatility makes the timing logistics tough as well.

### **Search for a Benchmark**

Within this fragmented system, searching or setting a benchmark is no easy task. The efforts to streamline the processes has yet to bear fruits. The abolition of reserve requirement on interbank liabilities was expected to lay the ground for emergence of a MIBOR rate. The facility of investing up to US\$10 million given to banks, expected to align implied interest rates through the forward foreign exchange market with the short term rates, has not succeeded in eliminating arbitrage situations. The banks do not seem to

have realised the importance of floaters or have cause for concern with the suitability of volatile Treasury Bills as a benchmark. The sovereign yield curve, now and then, appears to be erratic (witness the coupon of 12.30% announced for 10 year state loans on October 6, 1997 when the secondary market was trading under 12% for 10 year maturity! To confound all, the announcement of the issue was made 3 weeks ahead of the issue date!). The primary and secondary market, many a time appear to be diverging. This not only makes pricing a tough proposition, but also creates uncertainty with regard to successful completion of an offering. In such circumstances, it becomes difficult both for issuers and investors to define the basis risk. With the revival of the Bank Rate (BR) as the RBI's signalling device for the interest rate markets, there is the likelihood of the BR being used as a benchmark for new debt offerings. The BR is relevant today as the short term deposit rates and refinance rates of RBI for banks are linked to the BR. Should this link be altered or abandoned, the utility of BR as the benchmark may be in doubt.

### **Private Placement vs. Public Offering**

Only time will decide if the way of the debt market in India is going to be retail, or wholesale, or both the modes of offering will coexist. For the present, at least, the retail segment should form a significant part of the debt market. The simple reason for this is that the bulk of the fixed income market exists today as a vast deposit market, which is essentially retail. The success of several schemes of the UTI, offering guaranteed and regular return, as well as the success of the recent issues by the FIs, are a pointer to this fact. (The US-64 scheme earlier had the status of a quasi-debt or a money market instrument). The initial success of the FIs could be attributed to the novelty as well as relatively higher returns offered. What the exercise has definitively demonstrated is that the retail market can supply a significant portion of the total funds requirement of the FIs. The defragmentation of the financial system would mean that the FIs would compete with the banks in gathering retail resources. Some have already articulated this concept as a "universal banking" proposition.

Retail resource gathering is a labour intensive, and relatively expensive proposition. Also, it is subject to rules and regulations of the SEBI governing all public offers. The concept of shelf offering is yet to

materialise, though 'on-tap bonds' have been offered by the FIs on a private placement basis. For retail offering to be economically viable, the size has to be over Rs.350 crore. The larger the number of investors, the more important is post-issue customer service. The network required for placing such an issue with hundreds and thousands of investors is a first class marketing problem in the financial products market in India. Obviously the retail route is not available to each issuer. The private placement route is simpler and used increasingly by many.

Private placement by definition is an invitation to invest, made to specific investors who are qualified to invest. Qualified investors are not defined in our market. It is understood that such investors are fewer in number, compared to a public issue. A typical investor is expected to ascertain the risk profile of an investment on his own, based on the information supplied by the issuer and his own knowledge of the market. He may seek additional information from the issuer if he so requires. In India, investment managers do not work within the framework of a well defined investment policy. The policy prescriptions, where they exist, are mainly driven by regulatory requirements, influenced by 'credit' bend of mind as against a 'market' bend of mind. Most of the portfolios are immobile and the scrips are dusted only when it is time to redeem.

A private placement also takes minimum 15 to 21 days to complete in the Indian market. Any interest rate volatility can affect the success of an issue, not because the pricing is not reflective of the overall interest rate situation, but because the short term call money market drives investor sentiment or clouds investor judgement. In recent times therefore, the book-building method, including a price-discovery mechanism, has proved to be more reliable. The present market conditions are also favourable for this methodology as it works in favour of both issuers and investors. Since 1992, the Indian money market has seen liquidity swings between buyers' market and sellers' market. With the investor base widening and issue sizes usually small (about Rupees 100 crores), the impact of swings is less severe now than it was during the early period of reforms. The price discovery has been restricted to vanilla instruments and, it has not been possible to price puts and calls yet. There were some attempts to price the puts through a

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step-up coupon structure where a put is available at each step-up and redemption is done at par. Indian investors are perceived not to be ready to pay a price for a put by way of a discount to face value on a fixed coupon instrument. Likewise issuers have been reluctant to price calls. One simplistic assumption people have made is to attach an equal and opposite price to a put and a call.

1996-97 was a year for debt when the primary debt market witnessed considerable activity. The number of primary issuances of debt instruments by Public Sector Undertakings (PSUs) and all India Financial Institutions (FIs) was on the rise. It is estimated that PSUs raised Rs.8,080 crores in the whole of 1996-97 while FIs raised around Rs.11,000 crores. These amounts were significantly higher than those raised in 1995-96. In the first half of 1997-98, the primary debt market witnessed hectic activity. While the primary equity market continued to remain dull, at least 80 debt issues, raising over Rs.11,000 crore, hit the market during April-September, 1997.

### **Role of Intermediaries**

The role of intermediaries in the primary market, to say the least, is still evolving and is not fully understood by issuers, investors, and also by merchant bankers themselves. Any transaction has to take into account issuers needs, investors needs, legal imperatives as also market conditions. Where aspirations of all parties to a transaction cannot be matched, innovation has to be the solution. The markets in India are shallow. We are at the beginning of the learning curve and still away from the derivative market where both issuers and investors can hedge interest rate risk. The intermediary – typically an investment banker – has to bring to the table his expertise, knowledge of the market, and ability to conclude transactions. He has to ensure that the quality and authenticity of the information memorandum for an invitation to invest, is of a very high order. As we head towards capital account convertibility of the Rupee, the services provided by the intermediary will have to meet international standards.

## Conclusion

India is entering into a bond era. The debt market holds a promise of a very large market. The current phase of reforms includes de-fragmentation of the financial system. Both, the RBI and market participants, are seen to take the initiative for integrating the market into a level playing field, where participants should be able to source or use capital efficiently, and according to their risk-reward perceptions. The debt market of today is vastly different than what it was a few years ago.

**Fig. 1**

**Composition of the Indian Fixed Income Market  
March 31, 1997**

