

Primary Debt Market: Regulatory Aspects

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Background

Financial markets play an important role in allocating resources and enabling stakeholders to take and mitigate risks. The experience of developed economies shows that globally competitive facilities and infrastructure require access to a much larger pool of resources, including the traditional sources of equity and institutional debt. I am of the opinion that it is debt that is required in much larger volumes than equity, given the type of projects, especially the infrastructure projects with large costs and long-gestation periods. The need of Corporates to raise debt is also to generate shareholder wealth. In India, debt is particularly important because, till recently, India was largely an equity market where borrowing was not considered to be a desirable option. Traditional credit markets are no longer efficient and are unable to provide the required volume at the appropriate price. Therefore, there is a growing need for an efficient debt market.

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Regulation

World over, financial markets have been largely driven by two factors, viz. technology and regulation. At present, technology is freely available. We therefore need to focus on the critical role regulation plays in the development of a market. Regulation determines what can, and cannot, be done and provides the operating environment. However, in India, regulation has developed, as also restricted, the growth of the Indian debt market. In this chapter, I propose to highlight the important regulatory changes as well as their impact on the market. I will also present a 'desired state' scenario and outline some of the regulatory changes that may be required to move the market to this desired state.

A market progresses from 'controlled' to 'regulated' and then to a 'self-regulated' state. The Indian market is presently between the 'controlled to regulated' stage – though closer to the 'regulated' state. Earlier, India was a controlled market where rates were determined by the Government and investments were also largely Government directed. Though corporate bonds were almost non-existent, a sweetener was invariably attached, that of partly or fully convertible debentures. In short, instead of a market, there existed only a controlled, isolated system.

Recent Regulatory Changes

Some of the important regulatory changes in India's debt market include:

- Introduction of the auction system for Government securities.
- Introduction of DVP system for dated securities and T-bills.
- Introduction of Primary Dealers (PDs) in March 1996, with six PDs offering two—way quotes with bidding commitments in the auction of dated securities and T-bills. The RBI also issued guidelines for Satellite Dealers in December 1996, to impart greater momentum in terms of increased liquidity and turnover. However, they are yet to commence operations.
- Repo facility has been extended to all dated Government securities and Treasury bills. Non-bank entities – holders of SGL accounts with the RBI –

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are allowed to enter into reverse repo transactions with banks and primary dealers.

- Changes in asset allocation norms include:
 - Banks are allowed to invest in debentures, bonds and preference shares of private corporate bodies. They have been freed from the earlier ceiling of 5% of their incremental deposits in the previous year (primary and secondary market).
 - Banks are permitted to undertake the retailing of Government securities with non-bank clients, with effect from June 1996.
 - Provident Funds (PFs) are now free to invest up to 60% of their accretions into bonds issued by Public Sector Undertakings (PSUs) and Development Financial Institutions (DFIs). These were earlier being invested only in Government securities and bank deposits.
 - Investments by corporates and individuals in the fixed income mutual fund schemes have been increased.
 - FIIs have now been allowed in the category of 100% debt funds, to invest in corporate debt and in dated Government securities with the objective to encourage flow of foreign capital into India and to impart more depth and liquidity to the debt market. This investment is subject to the overall ceilings on sovereign commercial borrowings
- Freeing of interest rates.
- Abolition of TDS on interest income from Government securities, with effect from June 1997 under Section 193 of the Income Tax Act.
- SEBI has now allowed the book building mechanism for pricing.

Impact of Regulatory Changes

- Government borrowing at market rates.
- Greater market absorption of Government securities – lower devolvement on the Reserve Bank of India.
- Increase in the amounts being raised in the market at market determined rates.
- Increase in trading volumes.

- Greater transparency – RBI has started publishing SGL (Securities General Ledger) data.
- Availability of information and increased interest in the debt market – research reports, seminars, discussions, newspaper articles, etc.
- Introduction of auctions which have contributed to development of bidding skills among the investors. Banks are paying special attention to this sector as profit centres.
- Increased focus on treasury management and interest rate risk management.
- Possibility of a market responsive yield curve emerging.
- Larger amounts being raised by the corporate sector.

In short, regulations have had a positive impact on the market which has moved from a credit market to a securities market.

Revitalising the Primary Debt Market: The Tasks Ahead

The basic approach in this direction should primarily aim at:

1. Developing a deep and active institutional market in gilts and in other forms of debt.
2. Providing market determined benchmarks and exit routes.
3. A liquid market in gilts to enable the development of a reliable sovereign yield curve.
4. Appreciation of risk will enable pricing of other risk classes vis-à-vis the sovereign yield curve and, therefore, generate investor interest in other types of debt.

Perhaps the most essential step towards further development of India's debt market is investor education regarding debt instruments. Investors need to know how to appreciate and price 'associated risk'. The other important issues that need to be considered are :

Stamp Duty

The secondary market plays a critical role in the development of the market. The primary market therefore requires a rationalised stamp duty structure to facilitate securitisation deals and transactions for the following reasons:

- PSU bonds, Government securities and institutional bonds are exempt from stamp duty, both on issuance and on transfer. In addition, all bonds, transferable by endorsement and delivery, are exempt from duty. However, all other transactions for primary and secondary trading attract stamp duty, although the issuer bears the initial stamp duty.
- Stamp duty rates vary from state to state.
- Electronic transfer by depository cannot take place for transactions where stamp duty is payable, thus building a strong case to abolish transfer duty.

These factors ultimately discourage trading in the secondary market. Therefore, it may be desirable to consider either a one-time stamp duty on transfer, or an abolishment of this duty. This will also encourage securitisation of debt, which is yet to become popular in India – the exorbitant stamp being one of the reasons.

Repos

The RBI has recently permitted repo transactions in all Government securities and Treasury bills. Repos provide an opportunity to temporarily refinance portfolios, thereby enabling better cash management. However, despite all its advantages, the inter-bank repo market continues to be inactive.

- There are no standardised repo agreements and this exposes the parties to counterparty risk in the second leg of the transactions. The RBI should issue guidelines that detail the operational procedures for such transactions, to eliminate these risks.
- There is a restriction of a minimum duration of 3 days, and a maximum duration of 14 days, on repo transactions. The minimum duration was set when the inter-bank borrowings were subject to SLR/CRR requirements. In the absence of such requirements, such a restriction should be done away

with. On the other hand, the 14 day stipulation should also be relaxed, to activate the market and enable development of a term structure.

- Non-bank entities are permitted to participate only in reverse repo transactions. Their inclusion in the repos market would broad-base the market and promote active trading.

Private Placements

An important concern of investors is the lack of uniform disclosure requirements in the private placement market. Investors need complete information about the issuer to enable them to take informed decisions. There is, therefore, a need to (self) regulate this segment of the market. For example, in the US private placement, issuers use Rule 144A to privately place with Qualified Institutional Buyers. This is done to avoid compliance with stringent SEC Guidelines for an offer document. Similarly, there is a need to self-regulate this segment in India, the responsibility for which lies primarily with the arrangers. The RBI is also seriously looking into this in order to improve transparency and control.

Multiple Regulators

Often, there are instances when multiple regulators oversee the same segment of the market which leads to conflicting regulations. For instance, Government securities are subject to a number of regulations – Public Debt Act, RBI, SCRA, etc. – which leads to ambiguity regarding the provisions and rules governing transactions. Another example of this is Primary Dealers which are registered as NBFCs. However, the rules and regulations for NBFCs were framed much before the setting up of Primary Dealers. In this case, the relevance of NBFC guidelines for PDs which deal only with Government securities, need to be reviewed by the RBI. Similarly, corporate debt issues are regulated by Securities and Exchange Board of India (SEBI), Registrar of Companies, Ministry of Finance, Stock Exchanges, etc. Clear and consistent regulations are an important aspect that directly affect the functioning of the markets.

Securities Lending

When interest rates are rising, players in the Government securities market are restricted from taking a view on investments. This is because short selling is disallowed under SCRA. Presently, the participants can either square up at the end of the day, or carry long positions. Introduction of short selling would add depth to the market. Initial steps in this direction can be taken by permitting stock lending and by introducing the ‘when issued market’ through a Government Notification. Otherwise, market participants cannot undertake firm commitments to trade in Government paper prior to an auction. Introduction of the ‘when issued market’ by RBI will enable participants to trade in a security after the announcement, but well before the actual date of the issue.

Pricing

In case of public issues, with specific reference to corporate bonds, the time period between finalisation of the instrument and interest structure, and the opening of the issue, is long. In the absence of a well-defined yield curve, any change in the interest rate structure, in the mean time, may make a big difference – like in the case of the ICICI Bond offer in April 1997. There is, therefore, a need to make pricing more realistic and related to proximate market conditions. Book building is one option for which steps have been initiated but this concept is yet to become popular in India. Corporates and institutions could be allowed to tap the market through a shelf prospectus.

Institutional Asset Allocation Norms

The following restrictions on allocation of assets by institutional investors need to be relaxed :

- Provident / Gratuity Funds should be permitted to invest in corporate NCDs and purchase securitised paper.
- Insurance companies must be allowed to invest larger amounts of funds in non-Government paper.
- PSUs should be free to take investment decisions, especially in highly rated bonds – both public and private sector.

- Public Trusts should be given blanket permissions to invest in highly rated paper as against approvals on a case-to-case basis.

Tax

The 20% withholding tax on the interest income received by FIIs on investments in debt needs to be reviewed. In addition, the ambiguity regarding tax treatment for deep discount bonds, zero coupon bonds, etc. needs to be clarified.

Trustees

The role of trustees is to protect the interest of the bondholders. Among other things, the trustees must ensure that, for secured bonds, the charge must be created in favour of the trustee within a stipulated time of six months. This will enable the security to be enforced in the event of default. Recently, there have been cases wherein some trustees have been disqualified by SEBI as a result of defaults. Hence, trustees need to be more responsible and accountable to the bondholders. There is a need for specific detailed guidelines as also self-regulation in this regard.

Debenture Redemption Reserve

As per the current provisions of the Companies Act, a company has to create a Debenture Redemption Reserve (DRR) from its current profits, whenever bonds with a maturity of over 18 months are issued. In most cases, debt is raised in order to create fixed assets. Since companies provide depreciation on these assets, this depreciation reserve may be enough to provide for eventual redemption of debt. Creation of a DRR is an added strain on a company's dividend payment policies, specially in case of long gestation period projects. Abolition of such a stipulation should be considered.

Credit Rating

Price fixation largely depends upon the credit rating of the issuer and the instrument. However, the recent CRB scam has made credit rating agencies

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wary. It has also resulted in a loss of credibility of ratings. The current process of credit rating in India needs to be reviewed, and a system of multiple credit rating may be considered.

Investor Base

There is an urgent need to increase the investor base for debt instruments. Debt – other than zero coupon bonds and fixed coupon bonds of corporates – is not popular with retail investors. The following steps can be considered to change this:

- Investors needs to be educated regarding specific attributes of Government securities like liquidity, safety and rate of return.
- Dedicated gilt-funds could be set up by mutual funds.
- Marketing and retailing of Government securities by the Primary Dealers.

Settlement System

The settlement systems in India need to be made more efficient and effective – both in terms of procedures and time. One positive step taken is the setting up of the NSDL.

Conclusion

Significant policy initiatives have already been taken to improve the efficiency and add depth to the Indian debt market. These measures have had a positive impact, indicating that the market responds favourably to positive policy initiatives. The next phase of required reforms should be initiated now in order to place India's debt markets on a higher growth path, and on the road to self-regulation.