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Widening and Deepening of the Secondary Debt Market

Chitra Ramkrishna[1]

Any discussion on the fixed income market in India is very closely inter-linked to the policies relating to interest rates. The recent reforms and deregulation of interest rates have had a sedentary effect on the secondary market for debt.

Deregulation of Interest Rates

Some of the important policies in the deregulation of interest rates have been :

1. The lending and deposit rates that have, over time, been considerably freed. Lending rates are now largely linked to the PLR, and the spreads are freely determined by the banks depending on their risk perceptions. Deposit rates beyond one year have been freed, and deposit rates under one year linked or pegged to the Bank Rate. All re-finance, the Reserve Bank open market operations, and liquidity to the Primary Dealers (PDs), have again been linked to the Bank Rate. To that extent, we do find that Bank Rate is emerging as a kind of a reference rate in the interest rate scenario.

[1] Senior Vice President, WDM, National Stock Exchange of India Limited
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2. The second interesting aspect here is that borrowings by the government (since 1992) have been at market related yields.

3. Last, but not the least, the PSUs and FIs, who had been largely depending on budgetary support for their resources, have been forced to go to the market to raise their resource requirements. In fact, between 1994-95, they raised about Rs. 3,500 crore. The amount raised by them has doubled in 1996-97, to about Rs. 7,500 crore.

Integration of Markets

The other important aspect of the fixed income market, is the close inter-linkages between the money and the debt segments. While an integration of these two markets may have yet to take place, the participants in these two markets are common and, they therefore, in effect, act like bridges or linkages between these two segments. On the money market segment, since 1988, we have been seeing policies opening up participation in the call segment. From being restricted to banks and institutions earlier, even mutual funds were permitted to lend in the market. In fact, in 1997, facility of routing call transactions for corporate traders was extended through Primary Dealers and minimum size of such transactions was reduced to Rs.10 crore. We have therefore seen policies for widening the access to the money market segment. As many of these participants are common, we see linkages between the debt and the money market segment.

Money Market Mutual Funds

The policy for introduction of Money Market Mutual Funds (MMMFs), was originally introduced in 1992, and subsequently revised in 1995 as the current guidelines stand. The operational modalities of the MMMFs and private sector have been vastly freed. They have also been permitted to set up schemes since 1996. However, MMMFs are yet to become popular due to the following two factors that require consideration:

1. A cheque book facility that could be made available on the Money Market Mutual Fund account, and,

2. The 30 day lock-in period.

Primary Dealers

We have seen the emergence of primary dealers as important players on both these markets. Since their introduction in July 1996, their contribution to the total turnover in call and securities segments of the market has been very significant. They have contributed roughly Rs.90,000 crore in Government securities and Treasury Bills for 1996-97 and over Rs.1,40,000 crore in call segment. Therefore, these new market players have, in a sense, lent liquidity and depth to both of these segments.

Term Rate

We have already discussed the integration of the money, debt and other financial markets. We have also discussed that doing away with interbank CRR is probably the one major step ahead in permitting this kind of a linkage. The moderation of the interbank CRR, despite retaining the minimum at 3%, is a step in this direction.

Table 1. **Trends in Securities Trading at NSE**

	1994-95	**1995-96**	**1996-97**	**Apr 97-Sept 97**
Traded Value*	6781.15	11867.68	42277.59	58503.30
Average Daily Volume*	30.41	40.78	145.28	403.47
No. of Trades per day*	5	10	27	61
No. of Active Securities*	183	304	525	482

* *In crore Rupees*

Table 2. **Security-wise Volumes at NSE**

	1994-95	(%)	1995-96	(%)	1996-97	(%)
Govt. Securities	3026.42	44.63	7727.77	65.12	27352.25	64.70
T-Bills	2633.72	38.84	2259.84	19.04	10957.05	25.92
PSU Bonds	757.55	11.17	996.03	8.39	1968.45	4.66
Institution Bonds & Bank Bonds	66.17	0.98	153.44	1.29	816.06	1.93
Certificate of Deposits	104.50	1.54	136.75	1.15	487.02	1.15
Commercial Papers	187.50	2.77	539.00	4.54	128.12	0.30
Corporate Debts	5.29	0.08	54.85	0.46	568.64	1.35
TOTAL	**6781.15**		**11867.68**		**42277.59**	

Milestones in the Debt Market

- The introduction of the Wholesale Debt Market (WDM) segment on the National Stock Exchange of India (NSE) in June 1994, was a step towards providing an organized platform for trading in debt securities. Since 1994, we have witnessed a gradual growth in the volumes of the total debt market activity on the NSE segment, as well as on the direct deals between banks and institutions. From a daily average volume of about Rs.30-35 crore that we saw in 1994, we today witness an average daily volume of about Rs.400 crore. But we still have miles to go. Nevertheless, the 3 years of activity shows some amount of liquidity and deepening of the markets.

- In terms of price-volume dissemination, again since 1994, we have had at least a daily price-volume dissemination of trades on a particular date, through the NSE quotes and, subsequently, through the SGL publications. We have a very good sense of what the prices were like on a particular day. Interestingly, when we look at the prices of a particular security in 1994 (as published in the SGL) and as published on the NSE today, we find a narrowing down of the difference in the price spreads, as published in a transparent mechanism like the NSE or the SGL in terms of the other parameters which determine market transparency and efficiency.
- Another interesting statistic is in the number of trades. These have increased from around 5 trades per day during 1994, to as much as around 65 to 70 trades on an average. These have even gone up to around 200 trades on an active day on the debt segment. This increase in the number of trades – keeping the average trade size constant – is another indicator of the widening of the interest in the market.
- The other attribute which build this trade volume, is the security-wise competition. In 1994, and even today, there has been a consistent predominance of turnover from the Government securities and Treasury Bills. It was close to 90% in 1995-96 and continues to be about 93-94% even today. Interestingly, while Treasury Bills were quite active in 1994-95, today the predominance is more on the Government securities and not so much on Treasury Bills. Instruments like Public Sector Bonds, have in fact, shown a decline in their overall volumes.
- Earlier, there was a tendency to deal only on the fresh issues that were made during the year. Therefore, a large proportion of the turnover, particularly in a year, would predominantly be from the issues that were made during the year. During the current year, we find that this tendency is no longer valid with activity across old as well as new issues. As a result, 10 or 15 days prior to the primary auctions, we find activity in securities of related maturity adjusting themselves on the basis of the market's expectations of the yield. We will also notice that the yields are aligning themselves. Thus, we today see some amount of tendency of convergence of the secondary market yields towards the primary yields.

- How does all this add up in terms of market depth, if we were to look only at the number of securities which had any interest in 1994-95 or early 1996? During (say) 1996-97, there were around 500 securities that were traded as against around 100 during 1994-95. In the current year, i.e. just six months from April 1997, we find over 400 securities that have already registered activity or have been traded. On a monthly basis, when we consider the trading interest from July 1996 – when there were about 80 active securities – the figure has jumped up to about 180 to 200 securities in July 1997. As far as widening of the participant base is concerned, we find that over the last 12-14 months, the number of active intermediaries has gone up. A lot of new intermediaries have come into the market and are registering activity. We thus see an increase in the number of participants that registered a presence in the secondary market activity.

Market Practices

Over the last two years, at different points of time, we have felt the need to change many of the market practices, to make them more acceptable, and in line with developed markets. Some important decisions that have been taken in the last 36 months are:

- The entire concept of unbundling of the price and brokerage ever since the introduction of the screen based system. In short, the possibility of knowing a clean price for a security.
- The abolition of the voucher. For a long time, many of us have been discussing the voucher element dirtying the price of a Government security or an asset. The abolition of TDS has been a major step in helping the dissemination of a clean price.
- The increase in the marked to market ratios. With the increase in the marked to market ratio, the prices of securities have been much more in alignment with their market values. This is unlike earlier occasions or earlier circumstances, when prices had to be structured to reflect and be closer to the values at which they were held in the books of different participants.
- The introduction of the DVP system which has brought a lot of settlement efficiencies, at least for the large participants, who are linked to and have access to the DVP system.

Development of Instruments

Some of the interesting, instrument related developments, that have helped the debt market are:

- The Ministry of Finance Guidelines in 1994 which permitted the listing of privately placed debt paper. Till then, a lot of debt that was raised by corporates was really in an un-tradable form. This was because it was either in the form of loans, or privately placed debentures with institutions, and therefore did not really reach the secondary market. These Guidelines in 1994 made it possible for privately placed debt paper to make its way to the secondary market and also to be off-loaded to retail or other investors.
- The second recent Guideline which has also given a fillip to corporate paper is the varying of the requirement that equity has to be listed before debt can be listed. This was the earlier position. Now it is possible for the debt of a corporate to be listed even though the equity may not be listed on the exchange. This will again enable a lot of corporate debt paper, which would have otherwise remained out of the access of the secondary market, to reach the secondary market intermediaries.
- In a small way, securitised debt paper has met with success in the form of a single issue, that is already traded on the exchange. A lot of issues are now in the pipeline. Though securitised debt is a new instrument, it has generated a great deal of interest and come onto the secondary market for trading.
- Some earlier problems related to instruments like CPs and CDs, which inhibited secondary market activity in them, have also been done away with over time. The first significant reform here was in reducing the minimum maturity of a CP to thirty days. The second was in reducing the size of CDs from Rs. 25,00,000 to Rs. 10,00,000.
- The permission for FIIs to participate in Government securities is also seen as a very important measure which will enable widening of the participant base for Government securities. However, we are yet to see or register much statistics on FII participation in the Government securities activity.

Primary Debt Issues

Since 1995-96, there has been an increasing amount that has been raised through primary private placements and public issues. More importantly, the participation of the private placement sector, in terms of how much the private sector has been able to source out of the market, has increased from a tiny 10% in 1996-97 to close to 27% in the six months since April 1997.

Secondary Market Investors

We need to observe the investor profile in this market. What are the kind of investors which were earlier participating in this market? What are the trends or changes in this investor composition? A significant change has been in the contribution from Primary Dealers in the total market activity. The second significant change is the rise in the share of Indian banks in the total activity. This is predominantly due to the entry of private sector banks and their contribution to the total trading activity.

Market Intermediaries – Some Issues

There are significant reforms though some issues are still pending and certain changes are yet to be implemented :

- The Satellite dealers scheme has been introduced. However, it is yet to be operationalised.
- The borrowing limit against securities has been increased. Though this is definitely a step in the right direction, it is still a very low figure at Rs.10 lacs.
- The initiative to permit banks to retail Government paper. Given the kind of retail reach that banks have, and given the kind of stocks that they hold, they would therefore be in a position to create a two-way price and a two-way market for Government securities. Given the close contact that banks have with retail investors, if this scheme really takes off, it could open up a lot of retail interest in Government securities. In addition, it will help in the

widening of the retail investor base, initially in the Government securities market, and subsequently, in other kinds of debt instruments.

- The underwriting scheme for PDs, has also helped in a large way to improve the primary distribution mechanism for Government securities.
- In terms of widening the participant base, the recent changes to liberalize the PF investment norms; the October 1996 Circular to permit banks to directly purchase NCDs from the secondary market; and doing away with the 5% ceiling on investment by banks in bonds and debentures, are fairly important steps which could generate a lot of interest in the corporate debt segment and the bond segment. This could see a widening of the participant base in the secondary market for debt.

The participant base widening seems to be a very crucial factor in this whole exercise of widening and deepening of the market, and to that extent, many of these steps are all steps in the right direction.