

# *Suggestions for Reforms in the Secondary Debt Market*

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Though markets need to evolve continuously, I will focus on reforms which needs to be implemented immediately. This may serve as an agenda for the regulators. Specific recommendations have been divided in three critical areas:

1. Measures to diversify the investor base,
2. Settlement system reforms, and,
3. Market related reforms.

## **Measures to Diversify the Investor Base**

Active participation by a number of investor segments, with diverse views and profiles, would make the market more liquid. Some recommendations to facilitate this are :

- A separate limit should be carved out of the general limit under Section 80L of the Income Tax Act for investment in all debt instruments. This would encourage retail investors to hold debt securities as a part of their savings portfolio.

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- Though guidelines for Money Market Mutual Funds (MMMFs) have been announced, they are still not popular. To popularise MMMFs, checking facilities should be allowed. Unless the difference in yield is substantial, retail investors prefer ease in dealing.
- Investor awareness about risk and return, especially at a retail level, should be promoted.
- Provident funds, gratuity funds, etc. should be allowed to invest in highly rated debentures of private sector companies. Instead of a class of issuer, a minimum rating should be prescribed.
- Provident Funds and NBFC's should be allowed to invest in dedicated debt funds, in the ratio of their investment pattern. Such investment should be considered as part of their statutory investment. For instance, Pension Funds, which have to invest 25% in GOI securities, should be allowed to invest this in dedicated Government of India mutual funds. Likewise, they should be allowed investment of 15% in dedicated State loan funds and 40% in dedicated PSU bond funds. Trusts should be given a blanket permission to invest in highly rated paper. Currently, issuers need to take approval on an issue-by-issue basis, which is a tedious procedure and also creates anomalies in the market. For example, two issues by the same issuer, with the same maturity paper, may trade at different yields, because one is trust approved while the other is not.
- Restrictions on banks to purchase securities only from registered holders should be lifted. This discourages the trader and trading banks to take short term positions as the trader will have to register in his name thereby increasing his holding period. Alternatively, the trader will have to search for a non-bank buyer, thus reducing the marketability of the paper.
- Clarification by the RBI, on secondary market purchases of non-government paper by banks, should be provided immediately. For instance, banks which receive a clarification from RBI on purchase of the Letter of Allotment (LOA) in the secondary market, buy the LOA. However, other banks which have not yet sought clarification, may assume that they cannot buy LOA in the secondary market. General clarifications should therefore be made available and applicable to all banks.

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- Treasuries of Banks should be treated as separate profit centres with greater degree of delegation of investment decisions. Such investment performance should be measured by the overall returns rather than profit or loss on individual transactions. Though most nationalised banks understand holding period return, most of them will not enter into such a transaction.

### Settlement System Reforms

- Corporate Bonds should be dematerialised and allowed to settle through NSDL. Existing hurdles need to be ironed out at the earliest, including stamp duty on transfers. Issuers – particularly PSUs – need to recognise the importance of this, as also of an active secondary market for their paper.
- In the meantime, standardised settlement norms should be introduced for physical delivery. NSE is almost ready with standardised settlement terms which could be introduced shortly.
- Though DVP settlement is a much welcomed step, a few issues merit attention. For example, a standardised redressal system for non lodgement of SGL by the buyer required. While same day buying and selling is allowed, technical problems need to be sorted.
- While banks do not generally have much of a problem with cash because of a reserve balance, non-bank players do. To start with, PDs and SDs should have an overdraft facility from the RBI. Securities transfer in DVP settlement on the same day has a technical problem (if the seller fails). Therefore, securities lending should be introduced, with the initial objective of solving such technical problems of same day buy/sell. Eventually, netting of transactions should be introduced.
- Funds should be transferred electronically, thereby removing time constraints and geographical restrictions – both inter-city and intra-city.

### Market Related Reforms

- CRR and SLR need to be removed on all interbank liabilities to develop a term interbank market.
- Term money market should be made broad-based by allowing more category of players. To start with, since direct SGL account holders can do a reverse repo, banks liabilities, by way of borrowing from such entities like

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financial institutions, should also be exempted from CRR and SLR requirement.

- Transparency to be brought into interbank term and notice market by also allowing it to trade on the NSE. Since the number of players in the call market – banks, financial institutions, mutual funds and primary dealers – currently total more than 100, there is a definite need to introduce intermediaries in this market.
- A centralised information database regarding non-Government bonds should be set up on a priority basis, to be accessible to all players.
- The Government borrowing program should follow a regular, and well publicised timetable. Debt of different bench mark maturities should be issued periodically. This helps in reducing uncertainty of supply and also helps in creating a benchmark.
- Satellite Dealership should be activated as soon as possible, to cater to the retail and semi-wholesale segments.<sup>2</sup>
- Growth of market intermediaries should be encouraged. The limits on volume of business a bank can conduct through brokers should be removed. Market intermediaries like interdealer brokers should be allowed to access credit at cheaper rates until the repo market is in place.
- Greater access to repos should be allowed – notification for repo in all Government securities and reverse repo for direct SGL account holder should be provided immediately.<sup>3</sup> Allow repo and reverse repo for constituent SGL holders in all Government securities. Finally, repos for all dematerialised corporate bonds should be allowed.
- With the removal of TDS on Government Securities, it would be easy to introduce trading in strips of GOI securities which will help meet the demand of a different class of investors.
- “When issued” should be instituted. This will create a demand for new paper, aid in price discovery, and lead to closer alignment between primary and secondary yields.

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<sup>2</sup> Introduced

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- A definite time frame should be set up for the introduction of interest rate derivatives like options, futures, interest rate swaps, etc.
- Forward contracts can be implemented immediately and easily after legal clarifications under SCRA Laws. To start with, SGL account holders should be allowed to trade. This can be regulated by the RBI by affecting value date transfer on the date of transaction. For example, if one trades today for settlement (say) 20 October 1997, the SGL will be lodged with RBI today, specifying the settlement date as 20 October, 1997. The RBI can post the entries today, which will be triggered off on 20 October. The buyer and the seller have to see to it that they maintain adequate balance on 20 October.
- Eventually, forward and short-selling in all dematerialised securities should be allowed.

### **Conclusion**

Given the objective of sustaining, and in fact accelerating economic growth, there is a need for a vibrant debt market. Critical reforms in a number of areas should be implemented simultaneously.