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Indian Debt Market - A Current Paradigm

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Abstract: ***Development of long term debt market is critical for the mobilization of the huge magnitude of funding required to finance potential businesses. India has ill-defined long term corporate debt market. Traditionally, bank finances along with equity market and external borrowings have been preferred funding sources. Large fiscal deficit, high interest rates, inadequate market infrastructure, lack of transparency, excessive regulatory restrictions on the investment of financial institution may have hamper the development of well-functioning corporate debt market. This paper deals with over view of the literature, steps that should be taken to reform the debt market and how a debt market can be used as a tool in transforming the Indian economy.***

Keywords: debt – market, bonds, government securities

1. Objective of the Study

1. To highlight the role and importance of debt market in India.
2. To know the factors responsible for growth and development of debt market.
3. To know the process of reform in Indian debt market.

2. Research Methodology

This study is based on secondary sources of information from publication of various journals printed & on-line, newspapers, organization, websites, books. The information is collected from libraries & websites.

3. Introduction

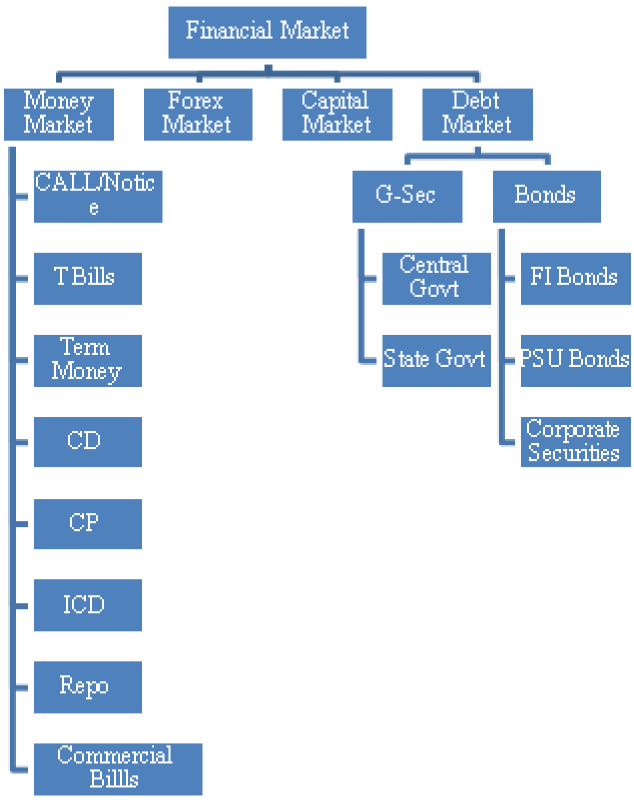
In developed markets, debt markets are larger than equity market the debt market are liquid with large volumes and are driven by interest rate movements. In India, debt market is illiquid as it is not preferred option for issuers because of high interest rates. In developed countries, debt market has significant influence on the life line of the entire commercial activity and is a major indicator of the level of development of an economy. A well-functioning debt market is one which has adequate breadth to accommodate a variety or instruments to meet the needs of different kinds of investors a sufficient depth to absorb large trading volumes without much price variations.

The debt market in India consists of following three segments.

1. The government sector which includes the central government and different states governments that has mainly been issuing Zero-coupon bonds, coupons bearing government securities and Treasury BILLS, Government securities can be considered as Zero risk instruments. Mostbanks invest in government securities to meet their statutory liquid ratio(SLR) requirements rather than for investment purpose.
2. The second segment is the public sector which includes PSU'S and DFI'S which issue government guaranteed Bonds, PSU Bonds & Commercial papers.
3. The third sector is the provide sector comprising of the corporate entities and private sector banks which issue debentures, Bonds, CP, Floating Rate Bonds etc. without any guarantee.

4. The Debt Market in India

4.1 Structure of Financial Market



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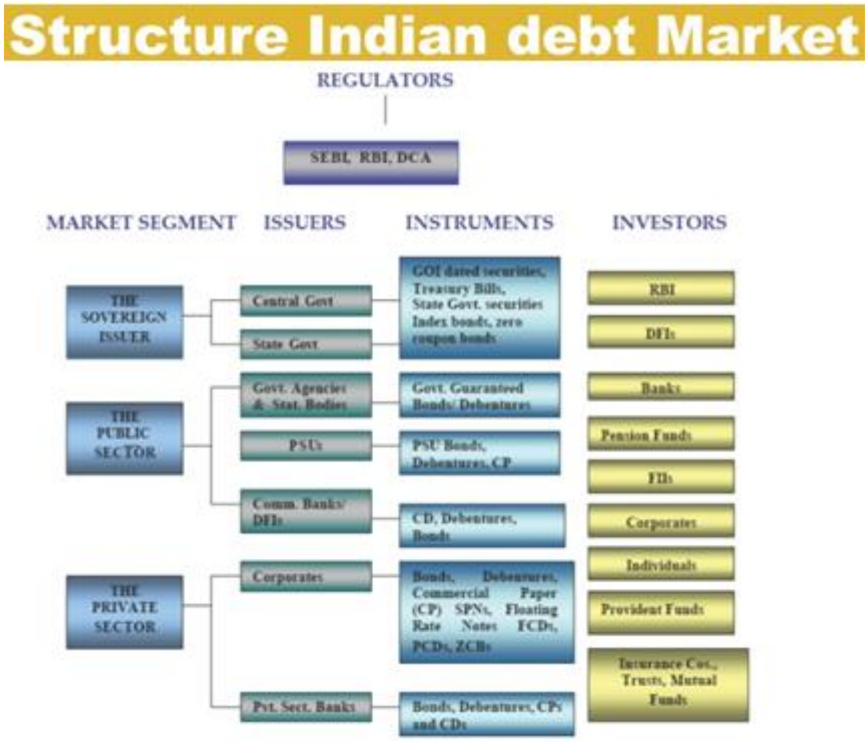


4.2 Debt Market Instruments

Alike equity market,there is a market of debt instruments, which implies instruments floated or issued by companies,institutions,or banks which are debt to the issuer and are payable to the contributor of debt along with considerations in the form of interest or premium on repayment/redemption security and consistency in returns.Such debt instruments may be- Government bonds-fixed rate or floating rate bonds , PSU Bond, certificate of deposits, debentures, pension bonds, tax free bonds, certificates(rural bonds,kisanvikaspatrasetc.), company deposits, bond options, structured obligations, securitized instruments, gilts.

4.3 New Instruments

With the on-going liberalization and deregulation of capital markets,a number of new instruments have been used by companies and financial institutions in record past as a tool of raising funds from capital market-Commercial paper, zero interest bonds and debentures, option bonds, deep discount bonds, cumulative convertible preference shares, debentures with equity and tradable warrants, secured premium notes(SPN) euro convertible bonds(ECB), multiple option convertible debentures(MOCD), optionally fully convertible debentures(OFCD), regular returns/retirement bonds.

There are other couple of risk investments available to investors which are not securities as defined in the law. Such investments instruments may be time share of holiday resorts, time sharp car ownership scheme, oil-palm scheme, milk, mineral water scheme or plantation schemes, such schemes are innovative and structured in a mannered to attract common man who is looking for non-conventional investment avenues. Such schemes are not subject to any regulation in India. Such schemes are highly risky and thus offer a much higher returns than ordinary investment.

4.4 Instruments Issued Outside India

Companies can issue financial instruments and securities in foreign markets and in foreign currency. Such securities are subscribed by non-residents and foreign citizens in foreign currency and are convertible into equity shares of the issuer company, the instruments issued are-

Foreign currency convertible bonds, depository receipts, euro convertible bonds, foreign currency options, American depository receipts.

Due to different requirement of the companies and the investor aforesaid instruments have been tried out in Indian capital market. These instrumentsare certainly going to create a sound footing in capital market.

4..5 Factors Affecting Debt Market

1. Interest rates
2. Inflation
3. Credit rating.

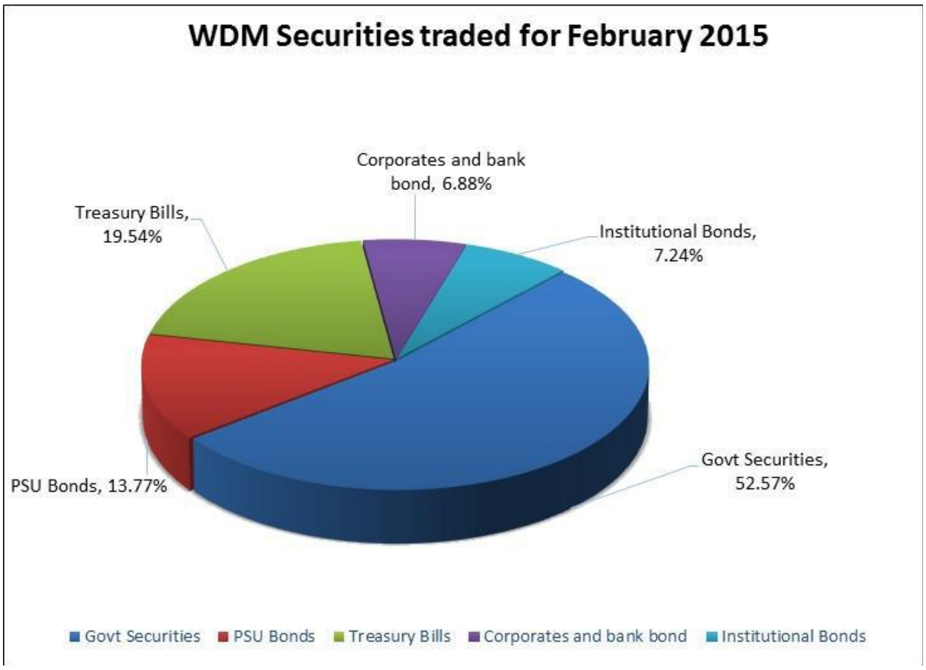
4.6 Role of Debt Market in Transforming Economy

The state of the Indian capital market and its emerging scenario has attracted considerable attention in recent years with economic reforms; capital market restructuring could provide an important impetus to the real sector growth.
While the markets for both debt and equity could be developed to meet the emerging needs of the economy, the debt market in particular, assumes great importance for the following reason:

1. Debt markets provide an assured rate of return to the investors, particularly when real and financial sector are all geared for change;

2. Debt markets can signal about the long run prospects of the economy, through a constellation of growth-inflation-interest rate expectation;
3. A shift of focus from an automatic accommodation of fiscal deficits would mean that both state and central governments would have to rely on debt market;
4. The restructuring of public sector enterprises would involve greater access to capital markets and with less equity dilution at the moment implies that they will have to depend on the bond market, the equity market in India can be said to have become sophisticated and vibrant during the last decade, although a number of regulatory pressures still cripple itsgrowth. However, the bond segment is still narrow and lacking dynamism. This is the sharp contrast with the bond markets in the world over where these are a prominent segment and serve as the base to all other markets.

Traditionally, government has shown preference for liberalizing the bond market segment to the international investors than diluting the ownership of domestic companies through equity. This situation has given enormous impetus to the growth of foreign and Eurobond market with the opening up of the Indian debt and equity markets, overseas investors seem to have been only attracted to the later.



Security Information

Market Composition

Type of Security	No. of Securities as on February 27, 2015	Issue Size* (Rs. in millions)				Increase / Decrease in Last one Year (%)
		As on 27 Feb, 2015	As on 30 Jan, 2015	As on 31 Dec, 2014	As on 28 Feb,2014	
Govt. Bonds	120	28573192	28637492	28637492	28307446	0.94
State Govt. Bonds	1746	12506254	12264351	11973836	10487075	19.25
Treasury Bills	52	3734853	3861322	4011011	3425756	9.02
State Enterprise Bonds	1098	4332778	4264277	4148765	3627491	19.44
Financial Institutions / Bank Bonds	917	3903804	3857552	3809139	3727673	4.72
Corporate Debt	2463	3498043	3453946	3374172	2911667	20.14
Supra Institutional Bonds	10	3300	3300	3300	0	100.00
Local Bodies	18	29840	29840	29840	30088	-0.82
Mutual Fund	6	7502	7502	7502	0	100.00
Total	**6430**	**56589565**	**56379582**	**55995057**	**52517196**	**7.75**

*rounded off to the nearest million.
**Debt oriented Mutual Funds not included in the above data.

DEBT POSITION OF THE GOVERNMENT OF INDIA

The outstanding internal and external debt and other liabilities of the Government of India at the end of 2013-2014 is estimated to amount to ₹ 56,51,484.22 crore, as against ₹ 50,39,131.01 crore at the end of 2012-2013 (RE). Broad details are as follows:-

(In crores of Rupees)

	As on 31st March 2013	As on 31st March 2014
Internal debt and other liabilities	48,66,829.00	54,68,622.11
of which under Market Stabilisation Scheme	...	20,000.00
External debt	1,72,302.01	1,82,862.11
Total	**50,39,131.01**	**56,51,484.22**

5. Conclusion

Government must relax restrictive investment mandates that tend to limit participation of financial institutions in primary and secondary debt markets.Further such norms may result in long term holding of government debt in skewed proportions, illiquidity as well as lack of pricing information. When financial institutions donot have a large pool of qualifying assets to choose from, it may result in excess demand for government debt, in turn resulting in mis-priced government debt market. Relevance of such investment may need to be addressed from time to time.

High fiscal deficit, high interest rates may keep corporate borrowers away from debt market,there should be effective & efficient management of public debt and monetary operations. The government securities act of 2006 serves as the essential framework for the management of public debt and cash management. It provides RBI the power to issue and manage the government debt securities.

6. Reforming Government Securities Market in India

Auctions, Benchmarks, and Vintages: Government must make a credible commitment to conduct regular and predictable auction cycles with defined benchmarks, across the maturity spectrum. The goal should be to develop (and sustain over time) at strategic point along the yield curve, deep and liquid benchmarks. Right now, Indian Government Securities Markets is too fragmented, with many illiquid issues, and very few actively traded issues in isolated points on the yield curve. This issue is not difficult to solve, but does require an enlightened thinking on the part of Ministry of Finance, RBI and institutions in the private sector. For example, it is important to consolidate old vintages through repackaging and buy-backs. Private sector can repackage if the markets are transparent and legal roadblocks to securitization are removed. Second, Government must make a commitment to be an active and predictable issuer in some strategic benchmark maturity sectors: two-years, five-years, ten-years, twenty-years, and thirty-years. This is central to the price discovery function.

Broadening Institutional Ownership: It is a stunning fact that 85% of the Government securities in India is in the hands of three classes of institutions – commercial banks, Life Insurance Company (LIC), and the Reserve Bank of India (RBI). This type of an arrangement is insidious and promotes opacity, and sets wrong incentives. In contrast, the Treasury debt issued by the United States is invested by many private sector institutions such as pension funds, mutual funds, insurance companies, banks, foreign institutions, etc. The ability of the Government to raise large amounts of debt capital (which is sorely needed in India for many infra-structure projects) critically depends on how liquid and transparent the underlying Government Securities Markets is. In addition to this very narrow ownership of Government Securities, which resemble a "private placement" market, the captive holders (such as banks in India) of Government Securities are given dispensations such as Hold to Maturity (HTM) accounting provisions, whereby the securities are held at par value, irrespective of their market prices (which in itself is difficult to get at as there is no liquid secondary market at all maturities). HTM provisions that banks enjoy serve to understate the true risk that banks present to the Indian economy. It makes the bond markets more opaque, and adversely affects the ability of the Indian Government make large scale bond issues. Banks which tend to hold Government Securities may also have less of an incentive to lend to private sector and this hinders the efficiency of the most critical credit channel in the economy. It is also in the self-interest of the Government to eventually have all Government Securities trade in secondary markets to establish a "market determined" cost of borrowing at different terms. A useful counterfactual is the following: if a significant fraction of Government Securities that is held by banks is to be eventually sold to private parties at market prices over time, what would be the yields at which they would trade? What would be the effect on capitalization of banks? Basel III and other guidelines will eventually force all countries to get their book in order, and it behooves India to think ahead and act to avoid a potentially major crisis.

2. Establishing a Retail Investor Base: It is ironic that in India where National ID can be used to deliver cash to poor households directly by the Government, we do not have the ability for saving households to electronically invest in Government securities in a "user friendly" manner. While such facilities may exist in principle, I gather that they are not a very important segment of the investor base. It is worthy of note that many households invest in bank debt instruments with a (possibly incorrect) view that such securities are default-free. The introduction of a significant retail investor base such as saving households for the Government Securities through web-based investing in small denominations will enable the Government to directly access the savings in the economy, and simultaneously put banks on notice to look for alternative sources of funding and/or be more competitive in attracting retail term deposits. Stock Exchanges can play a role in promoting Government Securities to the retail investor base. They already have a significant amount of expertise in delivering stocks to retail investors through electronic networks. They are therefore ideally situated to deliver Government Securities to retail investors as well. Significant issues, such as taxation of income from Government Securities, custody, clearing and other issues have to be addressed to make this happen.

Ability to finance long and short positions: institutions should be able to express their bullish or bearish views on interest rates at different points across the yield curve, in order to promote price discovery. In developed markets such as the United States and Europe, this is accomplished through markets for repurchase (repo) and reverse repurchase (reverse repo) agreements, backed by clearing arrangements, schedule of haircuts or margins for different eligible collateral. While much progress has been made recently in this area, it is nevertheless the case that liquidity is lacking for reasons cited earlier. The development of an active market for repo and reverse repo transactions with appropriate safeguards is an essential step to invigorate the cash market for Government Securities in India.

3. Spill-Over Effects of an Active Government Securities Market: Indian Corporate Bond markets will be a significant beneficiary, if an active and transparent Government Securities Markets were to develop in India. For Indian firms, this will provide an opportunity to tap debt capital directly from investors at a much bigger scale. Additional reforms in the following areas would be important to secure a thriving corporate bond market:

Post-trade transparency, whereby investors are in a position to see recently completed trades in the market, the size, the initiator of the trade, and the trade time. In the United States, TRACE has provided such a transparency enabling a more active participation of retail investors in corporate bond markets.

Bankruptcy reforms, to ensure that the process of financial distress resolution in efficient. Hart (1999) has suggested three metrics for an “efficient bankruptcy code”: first, the code must be ex-post efficient, ensuring that the residual value available to all claimants is maximized. Second, the code must set the right incentives so that the creditor’s rights are protected ex-ante. This calls for severe punishments to borrowers who do not comply with their contractual obligations to the creditors. Third, some residual value must be set aside for the borrowers so that they do not take excessive risks when the firm approaches the bankruptcy state. The extent of delays and dead-weight losses associated with the distress resolution process will clearly be a key determinant, ex ante, of the attractiveness of corporate bond to the investor.

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