Primary Dealers, Debt Markets and State Finances : Challenges and Responses

Mr. Joshi and friends,

I am happy to be amidst you in the third of the annual Seminars organised by the Primary Dealers’ Association of India (PDAI). I wish to place on record the valuable contribution of the PDAI not only in regard to Government Securities market, but also in the consultative process in policy making in important areas in financial markets. My presence here today is a reinforcement of our collaborative efforts to enhance efficiency and assure soundness in the financial sector of India and thus contribute to price stability and growth.

In this address, I will first narrate how some challenges in the market borrowing programme of the Central and State Governments have been met and highlight the role of Primary Dealers (PDs) in the process. A few issues relevant to the role of PDs will be flagged. In the second part, progress of reform in debt markets, particularly in Government Securities and private placements will be reviewed with a view to raising some issues for further debate and action. The concluding part focusses on several aspects of State Governments’ borrowings, finances, and linkages with the banking system and PDs.

The State finances are significant for social development component of reform, fiscal adjustment in general government sector, development of debt markets and emerging role of PDs. In this regard, it will be necessary to recognise some non-transparent trends in the aggregate borrowings of State Governments, which apart from having an adverse impact on their open market borrowings, and distorting the process of development of debt markets in general, render the operations of the RBI as their fiscal agent and banker complex, and also complicate the conduct of monetary policy.

Challenges in Government Borrowings

We had to face a serious challenge in managing the growing borrowing needs of Government of India, which rose in ten years, by about thirteen times in gross terms and over eleven times in net terms.

It is noteworthy that inspite of growing size of Government borrowings, undue pressure on interest rates was avoided.

The RBI has been able to pursue a strategy of elongating the maturity pattern of the outstanding Government debt since 1995-96 to reduce the refinancing risk though uncertainties in the financial markets during the first half of 2000-01 necessitated issuance of shorter-term securities.

In the more recent times, there is focus on increasing the range of maturities. Thus, the range of maturities of loans issued was 2.89 – 20 years during 2000-01 as against 5.26 – 19.67 years during 1999-2000. The weighted average maturity of the loans issued during the current year i.e. 2001-02 so far has been pushed up to 13.37 years, with the Government resorting to a 25 year issue for the first time after reform.

The market borrowings of State Governments also increased significantly, especially in the very recent years. In 1997-98, net market borrowings amounted Rs. 7,193 crore, which rose sharply to reach Rs.12,405 crore in 1999-2000 and to Rs.12,880 crore in 2000-01. The weighted average interest rate on State Government dated securities, which was 11.82 per cent in 1991-92 increased to reach 14 per cent in 1995-96. It has thereafter been steadily declining to reach 10.99

per cent in 2000-01. During 2001-02 so far, (upto September 21, 2001) the weighted average interest rate was 9.97 per cent.

The impressive performance reflected in these indicators, during a period of considerable domestic and international uncertainties, indicates respectable exercise of skills and judgement by RBI coupled with excellent cooperation from market participants, especially the institution of PDs.

Role and Performance of Primary Dealers

What have been the role and performance of PDs in meeting these challenges?

The share of PDs in primary issuances of dated securities of Central Government rose by about four-fold in 2000-01 from Rs. 11,916 crore in 1997-98. In the Treasury Bills market, the share of PDs was 85 per cent of total issues of Treasury Bills in 2000-2001.

Of very recent origin is the close involvement of PDs in State governments' borrowings – a subject to which a large part of this address is devoted. Between August 1999 and August 2001, State Governments have raised Rs. 4,680 crore from 18 auctions. The share of PDs in the State Government auction issues held so far including purchases due to underwriting commitments amounted to 36 per cent of total issues.

In the secondary market too, the PDs achieved a noticeable expansion in their transactions covering a major part of transactions on outright basis and almost three-fourth of outright plus repos. In 2001, the PDs achieved a turnover of outright plus repos of Rs.5,09,133 crore, representing 72.8 per cent of market transactions, out of which transactions on outright basis amounted to Rs.3,37,039 crore or 58.9 per cent.

To fund their stocks of Government securities, all the fifteen PDs with Net Owned Funds of a little over Rs. 3,000 crore have tended to rely on two major sources of funds, the call money market and the liquidity support from the RBI. PDs share of the total call money market turnover stood at about 30 per cent in 2000-2001.

The RBI has for its part taken a number of steps for developing and strengthening the PD system and making it more effective. For instance, it now takes into account both the bidding commitment and the performance of PDs in the primary and secondary markets for determining the quantum of liquidity support. Further, since PDs are only required to make bidding commitments in auctions of T-Bills, the system of underwriting by PDs in respect of such auctions has been withdrawn.

Capital adequacy guidelines for PDs were revised in December 2000. PDs now have to work out market risk, based on Value at Risk (VaR) model and standardised method and maintain capital charges based on the higher of the two. As a transitional measure, until PDs stabilise their VaR model and get these vetted by RBI, they have been allowed to work out the market risk requirement at 7 per cent of the portfolio.

Issues for Primary Dealers

At this stage, it is appropriate to mention a few issues for PDs to ponder over.

First, given the size of market and the uncertainties involved, PDs may consider increasing the size of their net owned funds, besides enlarging the scope of stable short- to medium-term borrowed funds. The holding capacity, market presence and intrinsic strength that a strong capital base provides cannot be substituted by other sources of funding. Strengthening of the capital base and stable borrowed funding will automatically reduce excess dependence on call money borrowings and RBI liquidity and the resultant risk on account of market volatility during uncertain circumstances. No doubt, PDs now have the flexibility of hedging their interest rate risks through the swap market.

Second, the RBI has already announced its intention to move over to a full-fledged Liquidity Adjustment Facility (LAF), which does not envisage assured liquidity support. PDs should incorporate this as part of their future business plans and strategies. PDs should strengthen their market risk management and quickly move over to risk based capital measures like VaR.

Third, as you are aware, RBI is not averse to an exit route for PDs where necessary.

Fourth, it is open to all eligible entities to apply for a PD's licence at any time, since the policy of RBI is to keep it as an on-going process. Thus, both entry and exit routes are kept reasonably open to promote efficiency through competition.

Fifth, as you are well aware, the RBI has embarked on changes in the technological infrastructure, rationalisation of current account and Subsidiary Ledger Account, introduction of new products like STRIPS, T-Bills futures etc. The RBI is in consultation with the PDs and the rest of the market on all these issues. Nevertheless, market players including PDs would be well advised to position themselves for these changes appropriately.

Reforms in Government Securities Markets : Review and Issues

In the last meet, I had flagged a number of issues for further consideration. It would be useful to review the progress in each of those issues, to separate those where we have gained further ground from those, which still need to be addressed.

First, on the status of the Clearing Corporation of India Ltd. (CCIL), it has since been set up with State Bank of India as the main sponsor. It will act as central counter-party in the settlement of all trades in Government Securities, Treasury Bills, money market instruments (like commercial paper and certificates of deposits), repos and foreign exchange. To begin with, CCIL will be settling all transactions in repos and Government Securities reported on the Negotiated Dealing System (NDS) of the RBI and also the rupee-dollar forex spot and forward deals.

On its part, the RBI has already opened current account and SGL account for CCIL and given approval for its membership to INFINET. As regards forex clearing, RBI is in correspondence with the Federal Reserve Bank of New York for regulatory approval. CCIL on its part is reportedly setting up the hardware and software in place and has held many meetings with banks for finalising procedures of settlement, changes to systems of member banks, etc. The first phase of the project is expected to go live in November 2001, alongwith the expected commencement of parallel run of NDS.

RBI attaches great deal of importance to CCIL in its reform process of the financial system, and in particular, from a monetary policy point of view, the second stage of moving towards pure inter-bank market is linked to the date of its operationalisation. RBI is also keen that CCIL should help to broaden and deepen the debt and the forex markets.

RBI welcomes any suggestions that this Conference can offer to us in making CCIL a mechanism that provides efficiency and safeguards on par with best international standards.

Second, the RBI has commenced an integrated project on Negotiated Dealing System (NDS) for complete automation of the operations of its Public Debt Office. NDS will be an interface between the members (SGL account holders) and the PDO. The entire system will be working in a networked environment and INFINET will provide the backbone for communication. The NDS fully integrated with the computerised PDO and CCIL will lead to higher efficiency in trading, guaranteed settlement and other improvements in services to investors in government securities. In this regard, a decision has been taken to closely coordinate the work relating to NDS with the CCIL, and in fact, place the whole system within the overall technological and institutional infrastructure for transactions in the financial sector with which RBI is intimately concerned.

The NDS software application has been installed and over 80 institutions have tested software and given suggestions for improvements, which are being looked into by the vendor. The NDS is envisaged on lease lines and about 60 work orders have been released by MTNL.

Some concerns have been expressed about the dependence on the MTNL lease line instead of VSAT network in view of the advantages of the latter. The RBI is discussing this issue with participants. Another issue that has been raised relates to the auction design on the NDS. There is a suggestion that screen based interactive auction system whereby participants would be able to revise their bids would be more efficient. Similarly, there is an opinion that anonymous order matching system in NDS should be considered by the RBI. In this context, there seems to be a view in favour of wider participation in the NDS so that members can participate even from small centres.

RBI urges the PDs to discuss these issues and come out with concrete suggestions.

Third, with the amendments to the Securities Contract Regulation Act, 1956, there is greater clarity in the jurisdiction of the RBI over transactions in Government Securities, money market securities, gold related securities, derivatives based on these securities as also ready forward contracts in debt securities. This enables the RBI to introduce new instruments and innovative practices in the money and Government Securities markets appropriately without legal hurdles.

Fourth, a few issues were flagged for further action in the T-Bills market. As you are aware, a number of reforms were undertaken with a view to rationalising the T-Bills market. The 14-Day and 182-Day T-Bills have been discontinued. The notified amount in the 91-day T-Bills has been increased to Rs. 250 crore and in 364-Day T-Bill auction to Rs. 750 crore. The 91-Day and 364-Day T-Bills now mature on the same dates and together they now form a larger fungible stock of T-Bills of varying maturities in the secondary market.

An issue which has been raised by PDs relates to their exclusive access in primary auctions of T-Bills and in open market operations with regard to Government dated securities. International experience with the Primary Dealers System shows that very few developed countries have introduced exclusive access to PDs in OMO (USA and UK). On the other hand, many countries, both developed and emerging, have given exclusive access to PDs in the primary auction process. PDs have exclusive access to the RBI's OMO in Treasury Bills since February 2000. In addition, RBI conducted "switch operations" for the first time in August 2000 that was restricted only to PDs.

There are also views that exclusive access might create private monopolies, which go against the creation of a deep and liquid market. There is another view that exclusive access to PDs may raise the cost of financial intermediation, which may not be desirable from the viewpoint of efficiency of financial markets. Moreover, there are certain operational constraints that PDs face in the present environment that increases their funding costs and exposes them to market risks. Under the circumstances, it is felt that the existing arrangement should continue and the issue of allowing PDs exclusive access to either primary issues or OMO should be revisited later.

Fifth, on the issue whether RBI should withdraw itself from primary auctions of T-Bills and restrict its operations only to the secondary market, the RBI in its Monetary and Credit

Policy of April 2001 acknowledged that although it is desirable in principle, separation of debt and monetary management functions is a long-term process that is dependent on the fulfillment of three conditions, viz., development of financial markets, reasonable control over the fiscal deficit and necessary legislative changes. There has been progress of some of these aspects including, as I mentioned, the amendment to the SCRA, the setting up of the Clearing Corporation and the technological infrastructure being put in place.

Once legislative actions with regard to Fiscal Responsibility and Budget Management Bill and amendments to the RBI Act already proposed to Government are accomplished, the separation of debt functions from RBI could be operationalised.

When the debt management function is moved out of RBI, the question of institutional set up that could satisfactorily meet the needs of both Centre and States needs to be worked out since the latter may justifiably seek a stake in ownership or control of a public debt office. The related issue is the nature of relationship between the separated debt office and institution of PDs. Finally, the nature of relations, if any, between RBI and PDs under the changed scenario needs to be examined.

Sixth, in the money market, the medium-term objective at present is to make the call/term money market purely inter-bank market for banks, while non-bank participants, who are not subject to reserve requirements, can have free access to other money market instruments and operate through repos in a variety of instruments. The completion of documentation and certain other operational details with regard to repos is critical to keep up with announced time schedule.

In the context of LAF, there is a suggestion that we introduce a fourteen-day repo and reverse repo alongside the current daily operations. Whether such 14-day operations should be undertaken at all, and if so, what is the opportune time? Further, should such operations be as a temporary measure when needed or on a regular basis. The RBI would appreciate your views in this regard.

Introduction of the LAF has been one of the most important changes in the money market in recent times. It has rendered the necessary flexibility to the RBI to operate on liquidity as well as signal interest rates in the short-term money market. The LAF operations combined with strategic open market operations consistent with market liquidity conditions have evolved as the principal operating procedure of monetary policy of the Reserve Bank. A market for interest rate swaps and Forward Rate Agreements already exists, although they are not very deep. The absence of a benchmark in terms of inter-bank term money market has been a shortcoming in the Indian market. A number of measures have been taken over the years, including greater interest rate flexibility to banks, exemption of inter-bank deposits from CRR requirements, reduction in minimum maturity of deposits, phasing out of non-bank participants from the call money market, etc.

With the stabilisation of the full-fledged LAF and the termination of segmented refinance at pre-determined interest rates, the RBI would have greater control over liquidity to move as appropriate interest rates in the short-term within a narrow band, thereby contributing to stable conditions. The Bank Rate would continue as a signalling and reference rate. This could pave the way for banks to take slightly longer positions than overnight and create a robust inter-bank term money market. It is necessary for the market participants and analysts to recognise the changing role of Bank Rate since it has been reactivated about five years ago.

Private Placement in Debt Markets

The issue of private placement of debt has recently been engaging the attention of Government of India and Reserve Bank. In fact, Company Law amendments seek to partially remedy the observed shortcomings by restricting the number of subscribers. The issue, however, has to be approached with greater care not only in view of growing size and possible non-tradeability of some components but also the inadequate attention to end-use of funds, including funds raised by public enterprises, often guaranteed by Government. As a consequence, there are implications for the health of financial sector as a whole and banking sector, in particular.

The RBI Annual Report of 1998-99, had recommended regulation of the private placement market in view of the potential systemic risks involved. It suggested disclosure of all relevant information in privately placed issues and the need to restrict an issue to a limited number of subscribers.

While reviewing the private placement market, the RBI's Technical Paper on the Regulation of Debt Markets (2000) recognised the regulatory gaps in the market, and recommended that for any privately placed issue of debt, where the intention is that it will eventually be listed, the norm for public issues or a simpler version thereof may be followed. For any other issues through private placement, the security will have to be treated as loan and prudential regulations for loans should be applicable for financial institutions.

In June 2001, the RBI after extensive in-house analysis and widespread consultations, issued guidelines to banks on non-SLR investments covering prudential limits on investments including cap on private placement, credit risk analysis of investment proposals, internal rating of unrated issues. The banks were also asked to diversify unrated privately placed bonds as risk management measure, stemming from the concern of deficiencies in the appraisal of privately placed debt due to absence of mandated disclosures. With encouragement from RBI, FIMMDA has commenced announcing bond valuation effective March 31, 2001, which has an inbuilt disincentive for unrated bonds.

Inspite of these measures, a number of concerns relating to the private placement market still exist, and a regulatory review of bank's participation in private placement has become necessary in view of the systemic implications of the private placements. Out of the non-SLR investment, it is estimated that close to half is invested in the private placement market. A major concern relates to the liquidity of such instruments as most of the instruments are not listed or even quoted in the OTC market and banks do not have exit route. A core issue relates to non-performing assets arising out of the privately placed issues. More information, therefore, needs to be obtained by banks/FIs regarding the exposure of companies raising funds through the private placement market as also the utilisation of funds and the NPAs on such investments. There is a view that compulsory listing may not be a feasible option, in view of operational constraints and also due to the fact that the issuer has very little incentive to list them, particularly for the bonds of shorter maturity. It was also felt that such compulsory listing would adversely affect the small and medium sectors' access to funds through the private placement market.

The RBI is currently devoting special attention to this issue and comprehensive guidelines are being considered to enable greater monitoring of this market and infusing transparency in transactions. PDs/banks/FIs/issuers and investors are urged to forward their suggestions to the RBI as soon as possible.

State Governments Market Borrowings : Status and Issues

There have been significant developments in the management of borrowings of State Governments, consistent with the objective of healthy development of debt markets in general. It is necessary to trace the background and recent initiatives to flag the emerging issues.

The market borrowing programme of the State Governments is finalised by Government of India and Planning Commission, keeping in view Article 293(3) of the Constitution of India, whereby a State may not without the consent of the Government of India raise any loan if there is still any loan outstanding to the Government of India. Before the beginning of the fiscal year, the feasible levels of the market borrowing for Centre and States (including those under guaranteed bonds) together is advised to the Government by RBI. The feasible market borrowing programme as projected by RBI is taken into account by Government of India before finalising the borrowing programme for the next fiscal. As regards States, the programme is finalised by Government of India, Ministry of Finance in consultation with Planning Commission. The State-wise allocation of borrowings in respect of a particular fiscal year is conveyed to RBI for the conduct of borrowing programme. RBI does not invest in State Government loans either in primary issues or in the secondary market.

The normal procedure that was being followed until the first half of the ‘nineties was that the RBI would complete the combined borrowing of all States in one or two tranches at a predetermined coupon. After announcement of the loan, the RBI would write to banks indicating their expected contribution, mainly based on the share of deposits, with a request to invest in the State Government bonds. Thus, high statutory preemptions in the form of SLR and the tie-up of the loans by the RBI ensured a captive market in banks for these bonds and the successful completion of the borrowing programme.

With the substantial increase in the market borrowing programme of the Central Government, progressive reduction in SLR, increasing sophistication of debt markets offering diversified portfolio choices to banks, marked to market valuation norms, changes in risk weighted capital and the deteriorating financial position of States, it was becoming increasingly difficult to complete the market borrowings through the tranche system of preannounced coupon.

In order to reflect these new realities including the market perception of the status of State Governments, in 1997 the coupon rate for all the borrowing programme for all States was fixed broadly on the basis of a 25 basis points mark-up over the yield rate of ten-year stock of Central government.

Apart from the fact that banks showed increasing reluctance to voluntarily invest in State Government paper, the market had started discriminating among States in terms of their perceived strengths and weaknesses. In order to enable well managed States to take advantage of market conditions and raise loans at finer rates and at the same time protect the interest of the smaller States, it was decided to introduce some flexibility in their market borrowings on an optional basis replacing the totally pre-announced coupon approach.

Based on the consensus in the meeting of the Finance Secretaries held in RBI on November 8, 1997, an option is available to the State Governments to enter the market through a flexible approach on their own to the extent of 5 to 35 per cent of their gross borrowings. The timing and volume of issues for auction are decided by RBI, taking into account the market and liquidity conditions and in consultation with State Governments.

The auction system was experimental from the year 1998-99 with one State entering the market through auction system in January 1999, two State Governments entering the market during 1999-00 and six State Governments entering the market in 2000-01. The experience has been that States that have taken the auction route have generally been able to attract borrowings at a rate lower than the tranche rate which implies a spread lower than the usual spread of 25 basis points above ten-year Central Government yield.

The recent experience of the subscription to the State loans, after the introduction of auction, reveals that despite a 25 basis points differential over Central Government 10-year yields and the State Governments' canvassing with the banks to ensure full subscription to the amounts notified, there are cases of some under subscription for a few States. Of late, the under subscription for some States has become repetitive, particularly in respect of States that are not prompt in honouring guarantees issued by them in respect of their enterprises. The initial undersubscription may not be noticed since the RBI has generally been successful in persuading the banks and other financial institutions to do the filling of gaps in subscription, but the process is found to be difficult to operate as the gaps tend to increase. In fact, the RBI in its Monetary Policy Statement of April 2001 had explicitly indicated that the borrowing programme in respect of some States has come under stress.

The emergence of under subscription could lead to a serious reputational risk of the under subscribed State Governments, and thus put severe pressure on the successful completion of market borrowing programme through conventional floatation. There are risks inherent in all forms of raising funds, which emanate not merely from the fundamental financial situation of States but also the method of raising funds. First, under the pre-announced fixed coupon with notified amount, the subscription received in respect of fixed coupon method depends on the extent to which banks and financial institutions are prepared to invest in concerned State Government bonds at the yield offered. There is a downside risk of subscription not being received to the extent of the amount notified. Second, under the auction method with notified amount, the rate at which the State is able to raise full subscription would depend on the rates of interest at which banks and financial institutions are prepared to invest in the concerned State Governments bonds. There is a downside risk of higher interest rates for filling the notified amount and possible risk of sufficient bids (even to the extent of notified amount) not being received. Third, under the tap issue without notified amount, the amount received depends on the coupon offered, market conditions and the interest shown by banks and financial institutions. There is a downside risk that the amount subscribed may fall short of expectations.

The issue was discussed again in the Eighth Conference of State Finance Secretaries on May 21, 2001. In this meeting, considering the risks in various methods of raising funds, it was decided to extensively adopt borrowings by tap issuances without announcing the notified amount, so as to avoid the embarrassment of any under subscription. In fact, in the same meeting, PDs were also invited to discuss with State Finance Secretaries and explore the possibility of raising borrowings through a process of book building.

It may be noted that the market borrowing is only one component accounting for 12.4 per cent of the capital receipts of State in 2000-01. The amount mobilised in the form of small savings from the public in competing instruments and at high effective interest rates outside the market borrowing programme constituted about 32 per cent. It is, therefore, conceivable that in future, a higher proportion of the debt of State Governments will be raised through the mechanism of market borrowings as compared to small savings instruments. Thus, it is possible to visualise a larger market-borrowing programme of State Governments, which will have implications for the development of debt markets as also the role of PDs. I would urge upon the PDs to take a more proactive role and guide State Governments in investment opportunities and treasury management.

In any case, over a period of time, it may be necessary for all State Governments to move over to a totally flexible approach to market borrowing in terms of method, timing and maturities, particularly in the context of reduction in SLR of banks and the overall reforms taking place in the financial sector and in particular financial markets.

Non-transparency in State Borrowings and Bank Financing

During the last few years, the debt securities issuance sponsored by State Governments outside the market-borrowing programme has been on the rise. It may be recalled that market borrowing allocations to Government enterprises excepting State Finance Corporations have been discontinued since 1994-95. Public Sector Enterprises, particularly State Level Undertakings backed by Government guarantee outside the market borrowing programme are major issuers of debt, mostly by way of private placement.

Many public sector enterprises both Central as also State, like Power Finance Corporation, Rural Electrification Corporation, Mahanagar Telephone Nigam Ltd., State Electricity Boards, etc., issue bonds with guarantee of Central/State Governments that are outside the Market Borrowing Programme (MBP) for which approval from RBI is not applicable. In view of the security of the Government guarantee, the limitations/prescriptions applicable to unsecured bond issues, which are treated as public deposits under the Public Deposit Directions are not applicable to such issues, and, therefore, issuance is fast and easy. They also carry higher rates than the coupon rates under market borrowings, resulting in substantial distortion in the market yields.

The RBI has been receiving complaints from the banks and financial institutions of delay/defaults by the States/State bodies regarding their obligations for payment of interest/maturity proceeds. The adverse effect of non-honouring of guarantees on borrowing by State Enterprises was recently discussed in the Eighth Conference of State Finance Secretaries in May 2001. It was revealed that often, guarantee was given only because financial institutions investing in these bonds insisted upon it. In the cases of some financial institutions, guarantees were mandatory for investment.

It needs to be understood that guarantees should not substitute credit appraisal. The Technical Committee of Finance Secretaries on State Government Guarantees, while exhorting the States for prudent financial management and preserving the credibility of the guarantees issued, suggested certain measures such as – the States should adopt selectivity in giving guarantees, institute limits/ceilings on guarantees and set up Guarantees Redemption Fund. While some States have taken the initiative and put in place some of the recommendations in this regard, not all the States have done so.

It is essential that the practice of routinely seeking guarantees particularly by Central Government owned institutions be given up and where seeking such guarantee is mandatory, laws be amended urgently.

There is another disturbing tendency of diverting the funds raised by public enterprises ostensibly for commercially oriented purposes to support budget operations of the Government concerned. Such diversions lead to erosion of fiscal transparency, but more important, constitute diversion of bank funds raised through private placement for Governments' budgetary expenditures. In this process, the only backing for such assets of the financial system is the guarantee of Central or State Governments. These operations, as they grow in size, distort both the fiscal and financial systems of the economy and give rise to potential for vulnerability.

Planning Commission and the Ministry of Finance may be approving proposals for the States facilitating them to raise funds from the market through Special Purpose Vehicles (SPVs). These SPVs consequently seem to issue bonds with guarantee by the concerned State Government. It has also been reported that there have been instances where the State Governments have been allowed to resort to such method for specific Plan projects also, presumably with the approval of Planning Commission. The bonds issued by these entities with the guarantee of the State Governments are mostly unrated and are privately placed. A State Government had also sought direct debit permission from RBI on one such instance. Such practices tend to not only dilute the monetary management by RBI, but when carried too far, could undermine the macro-economic stability, introduce non-transparent fiscal burden on State Governments well beyond the sustainable level, and impart ill-defined quality to assets of the banking system.

Lending institutions are sanctioning such accommodation with minimum credit appraisal as regards the commercial viability and bankability of the project, substituting it by the guarantee of the Government. In respect of State-level SPVs, it is reported that in a few cases, the bonds are neither serviced by the issuing entity nor honoured by the concerned State Government when the guarantee was invoked. If it is to be repaid out of budgetary funds, then the appraisal goes beyond the project and into the realm of assessing the viability of the State finances. There is a danger that these bonds and loans could turn non-performing if the fiscal burden of the guarantees increase to such an extent that there will be large scale default. States, in such cases, face serious reputational risk and the risk of their market-borrowing programme not going through, despite the efforts of RBI. It can be argued that the moral risk extends on to the RBI as their debt manager.

The RBI has issued explicit guidelines that in respect of projects by Public Sector Undertakings (PSUs), term loans may be sanctioned only for corporate entities. Further, the term loans should not be in lieu of or to substitute budgetary resources envisaged in the project. The term loan could supplement budgetary resources to the PSU if such supplementing was contemplated in the project design. The intention clearly is to enable bank financing of commercially viable projects undertaken by public enterprises as a supplement to Government financing of such commercially viable projects. Certainly, the intention is not to enable bank financing of Governments budgets through public enterprises.

RBI is sensitising the banks that for guaranteed loans, the prime factor should be the credit assessment of the commercial viability of the project and that they should not merely ask for rating by the rating agencies but also ensure that the funds have been utilised for the purpose for which they have been raised.

The issue of Automatic Debit Mechanism has been discussed at length in the Report of the Technical Committee on State Government Guarantees in February 1999. It was specifically mentioned that automatic debit mechanism runs the risk of insufficiency of funds relative to such pre-emption and minimum obligatory payments such as salaries, pensions, amortisation and interest payments. Reservations have also been expressed about such arrangements on other grounds as well. Debit amounting to incurring of expenditure has to be authorised by State legislature in its budget and automatic debits being open-ended or uncertain may be outside the specifically authorised expenditure. Recourse to automatic debit mechanisms should, therefore, be subjected to great circumspection.

The issue of automatic debit mechanism in respect of loans guaranteed by State Governments was also discussed in the Conference of State Finance Secretaries held on

November 15, 1999. It was then, felt that such mechanism eroded the credibility of the Government concerned and should not be encouraged either by Ministry of Finance, Government of India, or by the RBI.

There is another and more serious problem with issue of automatic debit mechanism, apart from the legal validity and moral basis of authorising open ended expenditures by the executive in the absence of specific legislative sanction. That issue relates to the automatic debit mechanism becoming a substitute for State Governments guarantees, thus undermining the ceilings on guarantees imposed by the legislature.

In case where such debit mechanism is offered in addition to formal guarantees, it erodes the confidence in all formal guarantees of such a Government.

In brief, State finances are under stress and hence recourse is being taken to extraordinary means of funding budget operations of non-commercial nature with bank finance. Such funding is not only outside approved market borrowing programme, but is often outside formal guarantees. When automatic debit mechanism is superimposed on such a situation, there could be significant, open-ended, mutually reinforcing vulnerability of both fiscal and financial sector. Mechanisms to tackle the fiscal stress of both Centre and States should be devised urgently, and whenever the non-transparent practices are noticed , they should be given up forthwith, for healthy development of debt markets, and overall macro-economic stability.

Under the circumstances, it may be necessary for the RBI to consider issuing guidelines to banks to closely monitor end-use of funds available to Central and State level enterprises to ensure that these are not diverted from commercial operations to provide direct or indirect support to State and Central Governments budgets. It would also be necessary to reiterate the need for ensuring commercial viability of bank funding of operations irrespective of guarantees and automatic debit mechanism. It may be desirable to advice banks and financial institutions to dispense with the practice of seeking automatic debit mechanism. It is also essential for them to eschew any indirect support to budgetary operations of Governments through public enterprises. To the extent such streamlining of procedures results in more market borrowings in a transparent manner, it would be appropriate to take recourse to such necessary borrowings in lieu of non-transparent and open-ended support to budgetary operations from the financial system.

[?] Inaugural Address by Dr.Y.V.Reddy, Deputy Governor, Reserve Bank of India, at Seminar on The Future of Government Securities Market in India organized by Primary Dealers Association of India, at Bangalore on September 22, 2001. Dr.Reddy is thankful to Dr.A.Prasad for his valuable assistance.