Address by C.Rangarajan Governor, Reserve Bank of India at the SBICAP Debt Market Seminar 1997 (Activating Debt Markets in India) Mumbai

Activating Debt Markets in India

1. I have great pleasure in being with you this morning. I would like to congratulate the SBICAP for organising the seminar on `Activating Debt Markets in India'. This subject has assumed greater significance in the context of the ongoing financial sector reforms and the efforts to widen and deepen the financial system.

Role and Significance

2. Debt market, otherwise called the Fixed Income Securities Market, apart from being a source of funds for the corporate sector plays the role of generating the level and term structure of interest rates or the yield curve. In a liberalised financial system, the changes in the shape of the yield curve and also the relative shifts in the yield curve have come to signify the market expectations about real sector activity and inflation rates. In the absence of a vibrant and liquid debt market, emergence of a market determined yield curve becomes well nay impossible, impairing the efficiency of financial markets, including the foreign exchange market. Therefore, development of an active debt market is vital for financial market efficiency.

3. More often, growth in size and activity of debt market is viewed as a reflection of poor performance of equity market and therefore the equity and debt markets are treated as competing with each other. On the contrary, the growth in size of debt market is rather complementary to equity market development, inasmuch as the augmentation of risk or equity capital propels the debt market; debt capital cannot grow beyond a limit without the support of equity capital, due to constraints on leverage. Furthermore, since equity alone cannot meet the demands of investor preferences, debt market also plays a significant role in mobilising savings and thus, enhancing capital formation.

4. Economists classify the financial development of markets broadly into three stages (1) Bank oriented stage, (2) early capital market oriented stage, and (3) highly capital market oriented stage. In the first stage, the banks and development financial institutions contribute to a significant part of financing capital formation and development. In the second stage, the capital market development in the form of issues of equity and debentures starts playing a role meeting a part of the financing needs and in the third stage capital market becomes a major source of financing long-term funds requirements. The nature of banking business also undergoes a change from commercial banking to universal banking with investment banking assuming a role.

5. Recent years have seen significant transformation in the debt market in India with far reaching policy implications. At present, India's debt market is one of the largest in Asia next to Japan and Korea. The debt market in India is conventionally classified into three segments, viz., (i) Government Securities Market, (ii) Public Sector Units (PSU) Bonds Market and (iii) Corporate Debt Market.

6. Within the bond market, the significance of Government securities market would depend upon the fiscal policy stance towards deficits. Among the Asian economies, in Korea and Indonesia for example, the predominant segment is the corporate bond market. This is because the Korean Government does not normally run a fiscal deficit and in the case of Indonesia, Government is

precluded by its Constitution from issuing bonds in domestic markets. In Korea, bonds guaranteed by banks have gained prominence. However, in both Korea and Indonesia, the Central Banks issue securities for monetary stabilisation purposes. In our country, the Government securities segment has remained predominant due to large Government deficits. The relative share of non-Government bonds is likely to pick up in the coming years with the Government's policy to bring down the fiscal deficit and opening of the financial sector.

7. Even so, given the magnitudes, Central to the development of debt market in India would be the development of the Government securities market. In fact, the Government securities market not only provides resources to Government, but also enables pricing of other debt instruments of varying risk perceptions.

Market Dimensions

8. The outstanding securities of the Government Sector (Central and State Governments) as on March 31, 1997 amounted to about Rs.3,50,000 crore. Similarly, outstanding corporate debt, inclusive of private placement, could be around Rs.1,10,000 crore. Of the outstanding corporate debt, public sector accounts for about 15 per cent.

9. In 1996-97, the Government sector (Centre and States mobilised Rs.42,688 crore as compared to Rs.46,783 crore in 1995-96. The PSU bonds, through public issue and private placement, mobilised Rs.3,394 crore in 1996-97 and Rs.2,291 crore in 1995-96. Private sector bonds and debentures amounted to Rs.6,731 crore in 1996-97 and Rs.8,041 crore in 1995-96.

10. The Wholesale Debt Market (WDM) segment of NSE witnessed phenomenal growth during 1996-97 with the inclusion of several new categories of securities viz., subordinated debt bonds issued by banks, Units 64, Promissory Notes issued by corporates and cumulative bonds issued by public sector undertakings (PSUs). The number of instruments available for trading on WDM increased to 657 as at end-March 1997 from 456 a year ago. The market capitalisation of these instruments aggregated Rs. 3,29,172 crore by end-March 1997 indicating a rise of 42.7 per cent over the level at end-March 1996. The average daily volume during 1996-97 was Rs.145 crore as compared with Rs.41 crore in the previous year. The Government dated securities and Treasury Bills accounted for nearly 90 per cent of the total turnover of WDM during 1996-97.

11. The monthly average turnover in outright transactions in Government securities, as reflected through Subsidiary General Ledger (SGL) Accounts in Mumbai, accounting for bulk of transactions, showed a substantial improvement during 1996-97 recording a little over three fold increase to Rs.7,827 crore. The monthly average volume of outright transactions showed a significant jump to Rs.12,403 crore in the first three months of 1997-98 due to aggressive trading driven by the expectations of falling interest and inflation rates. The institution of Primary Dealers have partly contributed to this trend, besides easing of money market conditions and lower interest rates which encouraged banks to trade in large volumes.

Recent Developments in Government Securities Market

12. With these preliminary remarks on the role, importance and the dimensions of debt market in India, I would now turn to trace some of the recent developments. Till about the middle of 1991-92, the Government securities market remained almost dormant characterised by a passive internal debt management policy with borrowing at pre announced interest rates, targeting a captive group of investors. This coupled with automatic monetisation of budget deficit prevented a deep and vibrant Government securities market. As an active Government securities market is a precursor for an integrated financial market, Reserve Bank and Government of India have undertaken series of policy initiatives towards (a) Instrument development, (b) institutional

development and (c) strengthening market transparency and efficiency with particular reference to secondary market development.

Instrument Development

13. Since 1992, Central Government borrowings have been undertaken at market related rates, primarily through auctions of Government securities of different maturities. The new instrument of 364 day Treasury Bills through auctions was introduced in April 1992. The auction system for the sale of Government of India dated securities was introduced in June 1992 and for 91 day Treasury bills in January 1993. Consequent upon the primary market acquiring depth with market related rates, some innovative instruments were introduced viz., conversion of auction Treasury Bills into term security, Zero Coupon Bonds, Tap Stocks and partly paid stocks. During the current fiscal year with the discontinuance of ad hoc and 91 day tap Treasury Bills, a scheme of 14 day Intermediate Treasury Bills was introduced to enable State Governments, foreign central banks and other specified bodies with whom the Reserve Bank has an arrangement to invest their temporary surplus funds. Coupled with this, it was decided in August 1997 to issue Treasury Bills of varying maturities to facilitate better cash management for the Government as also the investors. Accordingly a new instrument called 14 day auction Treasury Bill has been introduced since June 6, 1997. Introduction of Capital Indexed Bond as a hedge against inflation has been announced.

Institutional Development

14. With a view to developing an efficient institutional infrastructure for an active secondary market in Government securities and public sector unit bonds, the Securities Trading Corporation of India (STCI) was set up in May 1994 which commenced its operations in June 1994. Furthermore, in order to strengthen the securities market infrastructure, improve secondary market trading, liquidity and turnover and encourage voluntary holding of Government securities amongst a wider investor base, a system of primary dealers (PDs) has been operating since March 1996 with six PDs offering two way quotes with bidding commitments in the auction of dated securities and 91/364 day Treasury Bills. A scheme for payment of underwriting fees to primary dealers was introduced in June 2, 1997 replacing the earlier system of payment of commission on primary purchases of PDs. All auctions conducted since June 2, 1997 fall under the new scheme. In addition, with a view to broadening the market with a second tier of dealer system and imparting greater momentum in terms of increased liquidity and turnover, guidelines for Satellite Dealers (SDs) were issued in December 1996. The scheme for approval for both Primary and Satellite Dealers has been made as an on going process.

15. The guidelines for the scheme of liquidity support to mutual funds dedicated exclusively to investments in Government securities, either by way of outright purchases or reverse repos in Central Government securities outstanding as at the end of the previous calendar month were issued on April 20, 1996.

16. Recently, it has been decided to allow the Foreign Institutional Investors (FIIs) in the category of 100 per cent debt funds to invest in dated Government securities. This is expected to encourage further flow of foreign capital in to Indian capital market and help bridge the gap between domestic savings and investment in a more cost effective manner and also to provide more depth and liquidity to the Government securities market.

Strengthening Market Transparency and Efficiency

17. Several policy measures have been undertaken to strengthen the market transparency and efficiency. They are (i) larger percentage of marked to market valuation of investment portfolio of the banks (ii) Delivery versus Payment (DVP) System, (iii) publication of SGL data (iv) changes in

strategies of open market operations and repo auctions (v) liberalisation of policy on banks' investments (vi) rationalisation of underwriting Commission/fees for Primary Dealers (vii) abolition of Tax Deduction at Source (TDS) on interest income from Government securities.

18. Investments in Government and other approved securities by banks are classified into `Permanent' and `Current'; while permanent category securities are permitted to be valued at cost, the current category securities are to be `marked to market'. As a step towards moving to a fully marked to market basis of valuation of investments, the current category securities are required to be increased to 60 per cent for the year ending March 1998.

19. In order to ensure settlement by synchronising the transfer of securities with the cash payment, Delivery versus Payment(DVP) system has been introduced in Mumbai with effect from July 1995 in dated securities and February 1996 in Treasury Bills and the system has been extended to all Public Debt Offices by May 1996. Greater transparency has been introduced since September 1994 with publication of transactions in Government securities recorded by Reserve Bank under SGL Accounts.

Monetary and Credit Policy: Implications for Debt Market

20. Open Market Operations (OMO) including repo operations have been emerging as a principal indirect instrument. With a view to broad basing the repo market, as part of the Monetary and Credit Policy for the first half of 1997-98, it was announced that repo facility will be extended to all dated Government of India securities and that non-bank entities who are holders of SGL Accounts with Reserve Bank of India will be allowed to enter into reverse repo transactions with banks and primary dealers. With the addition of securities, the total volume of eligible securities would increase by Rs.1,09,400 crore to Rs.2,14,300 crore. This is expected to provide further depth to the repo market.

21. In a move to augment the stock of marketable securities for active Open Market Operations (OMO), special securities at 4.6 per cent of value aggregating Rs.20,000 crore were converted into marketable securities of 10-year, 7-year, 8-year and 5-year maturities at 13.05 per cent, 12.59 per cent, 11.19 per cent and 11.15 per cent on June 3, June 18, August 12, and September 1, 1997, respectively.

22. Repo auctions were resumed by the Reserve Bank effective November, 1996 and were effectively used for money market interventions with repo periods of 3 and 4 days. The daily average repo amount outstanding worked out to Rs.2,942 crore upto August 25, 1997 at repo rates ranging between 2.4 per cent and 5 per cent.

23. In the recent past, policy on banks' investments in PSU bonds/private corporate debt has been considerably liberalised, taking into account the increased market preference for these instruments vis-a-vis bank credit. Banks had been allowed to invest in debentures/ bonds/shares of private corporate bodies and PSU shares upto 5 per cent of their incremental deposits in the previous year. Within this ceiling, banks were later allowed to purchase such debentures/bonds/shares in the secondary market. As part of the Monetary and Credit Policy for the first half of 1997-98, it was further decided to exclude from the limit, investments in preference shares/debentures/ bonds of private corporate bodies. In other words, the limit is now applicable for investments only in respect of ordinary shares of corporates including PSUs.

24. During 1996-97 banks' investments in bonds/shares/ debentures of public sector undertakings (PSUs) and private corporate sector and commercial paper increased by Rs.6,577 crore compared with a decline of Rs.164 crore in the previous year. This trend continued during the year 1997-98 with banks' investments in these instruments increasing substantially by

Rs.5,774 crore upto August 15, 1997 as compared with Rs.1,598 crore during the corresponding period last year.

Abolition of Tax Deduction at Source (TDS)

25. It may be recalled that Tax Deduction at Source (TDS) at the time of payment of interest on Government Securities combined with the market practice of notionally deducting `voucher' or tax accrued for broken periods in secondary market transactions led to the unhealthy practice of `voucher trading' around interest payment dates merely to gain tax advantage. The differential rates of tax applicable to different investors, as also tax exemptions granted to certain institutions, have provided an opportunity for such trading. This practice remained unhealthy because the buyer gets a benefit not legitimately due to him. Furthermore, prices for Government Securities quoted in the secondary market were not clean, since voucher element got loaded into the price; calculation of yields on Government Securities got distorted with voucher-loaded prices. As a part of the budget announcement for 1997-98 Government has exempt interest income on Government Securities from the provision of Tax Deduction at Source (TDS) under Section 193 of Income Tax Act, 1961 with effect from June 1997. Abolition of TDS has facilitated quotations at `clean prices' and genuine trading in secondary market.

Impact of reforms

26. The series of policy measures had several beneficial impacts on the system in terms of (a) greater market absorption of Government securities with lower devolvements on RBI, (b) helping competitive pricing of securities (c) market responsive yield curve and (d) increased attention by investors to treasury management and interest rate risk management.

27. The market acceptance of Government securities at market related rates has considerably helped to reduce the extent of devolvement on Reserve Bank of Government securities in primary issues. The Reserve Bank's absorption of primary issues was 13.3 per cent and 16.6 per cent in 1996-97 and 1997-98 till August, respectively, as against 32.6 per cent in 1995-96 and 45.9 per cent in 1992-93.

28. An elastic band of interest responsiveness from the investors as part of active investment management, to a range of maturities is an important step in the process of competitive pricing of securities in primary and secondary markets. Auctions have contributed to the development of bidding skills among banks and institutions. Banks are paying special attention to investment desks as centres of profit.

29. It is pertinent to note that a consequential impact of competitive pricing of securities has been the shifts in yield curve reflecting changing liquidity conditions and market expectations about interest and inflation rates and also exchange rates. In a highly liquid market, the yields in secondary market should anticipate the yields in primary issues emerging from time to time. However, depending upon the demand-supply balance in different maturities and the liquidity conditions in the system, there could be small divergences between the two yields. The recent trends show that because of high liquidity in the secondary market for Government securities of varied maturities, there had been a convergence between the secondary market yields and market expectations about the primary yield. This had also enabled a more efficient price discovery process.

30. For the Government securities yield curve, to have impact upon the pricing of other debt instruments in the market, the various segments in the money and capital market should remain well integrated, with level playing field for all the market participants. The behaviour in Government securities market shows that the yields of short-term maturities upto around three years showed significant sensitivity to call money market rates. 31. The open market operations

including repo auctions have come into sharp focus during 1993-94 and 1996-97, given the imperative of neutralising the excess liquidity generated from the build up of the foreign exchange reserves as well as the need for rates of interest and exchange rate to rule at reasonable levels. Reflecting this, net sales of Government securities during 1993-94 and 1996-97 amounted respectively to Rs.9,047 crore and Rs.10,435 crore as against Rs.583 crore in 1995-96. During 1997-98 upto August 8, 1997, the net sales amounted to Rs.2,061 crore as against Rs.1,186 crore during the corresponding period of the previous year.

32. Easy liquidity conditions coupled with aggressive trading in secondary market, resulted in the significant softening of interest rates on securities across the maturity spectrum especially at the shorter end of the market, beginning 1997. For example, the weighted average coupon rate on Government of India dated securities has declined to 12.19 per cent in 1997-98 (upto August 29, 1997) from 13.69 per cent in 1996-97. Similarly, the weighted average cut-off yield rate on 364 day Treasury Bills has come down from 12.16 per cent at end March 1997 to 9.25 per cent at present. The decline is more perceptible in 91 day Treasury Bill weighted average cut-off yield which came down from 9.27 per cent at end March 1997 to its present 6.75 per cent.

33. The above trend was slightly reversed on September 1, 1997 when a cut-off yield was 11.15 per cent on five year Government paper as against a cut-off yield of 11.19 per cent for a 8 year Government paper issued on August 12, 1997. Nevertheless, it may be noted that the rate on five year was distinctly lower than last year when the rate was 13.55 per cent on five year bond.

34. The system of Primary Dealers (PDs) which has been operating since March 1996 with six PDs offering two-way quotes and with bidding commitments in the auctions of 91 day/364 day Treasury Bills as also in the floatations of new loans has provided the necessary fillip to activate the Government securities market. For the year 1997-98, all PDs have given a bidding commitment of Rs.12,600 crore in Treasury Bills and Rs.14,700 crore in dated securities. The limits for liquidity support to Primary Dealers aggregating Rs.3,710 crore have been granted for 1997-98. During 1997-98 (upto September 4, 1997), the devolvements on Primary Dealers aggregated Rs.1,903 crore in Government of India dated securities and Rs.981 crore, in Treasury Bills.

35. The new scheme of paying underwriting fee should promote an element of healthy competition and the Primary Dealers should take this as an incentive available to them to market making and also meeting inter-temporal mismatches in supply and demand in the market for securities. They should ensure that the efficiency of price discovery process is not distorted through the element of underwriting fee being built into their direct deals with final investors.

Agenda for further reform

36. Now, I would like to flag some specific issues which would be of interest for discussion in the Seminar and help in formulating an agenda for further reforms.

Auction system

37. The auction system for the sale of dated Government Securities is relatively new in India dating from June 3, 1992. This has enabled the emergence of a diversified investor base, an awareness among investors of market risks inherent in bond markets and thereby bringing about a qualitative change in investment management function of market agents, in particular banks, insurance companies and provident funds.

38. The multiple price auction which at present is practiced in India is the most popular method since every bidder gets allocations according to their bids quoted and apparently the issuer collects a premium from all bidders quoting lower than the cut-off yield. Although, the uniform

price system eliminates the problem of "winners' curse", it is not very common for sale of Government Securities. One point that has not, however, been resolved is the question of cost. According to one view, the multiple price system is more cost effective for the Government as the Government can sell bonds at a low yield and collect premium for the bidders with quotes lower than the cut -off yield. According to another view, however, multiple price auction actually leads to low revenues as bidders tend to shade their bid price to avoid the `winners curse'. Currently, most major countries follow multiple price system. These countries are the U.S.A., the U.K., Germany, France, Japan, New Zealand and Australia. Switzerland and Denmark, however, follow uniform price system. Italy follows multiple price system for Treasury Bills (upto 1 year maturity) but, uniform price auction for medium and long term bonds (i.e., of 2 years or more maturity). For sometime, the United States, the U.K. and Germany experimented with uniform price system but, later have given up this method. Germany switched from a uniform price auction to a multiple price auction system because uniform price system had resulted in small banks placing very high bids as this gave them sure access to liquidity without the risk of having a significant impact on the price to be paid. If the current Seminar can throw some further light on this aspect, it would be useful.

Non-competitive bids

39. Another important issue is the practice of entertaining non-competitive bids and allocating amounts to non-competitive bidders on the basis of the weighted average price. It is pertinent to note that the practice of accepting non-competitive bids is prevalent in countries like USA, the UK and Italy. Competitive bidders are usually financial intermediaries who buy in large volumes and possess expertise in financial investment. Non-competitive bidders are usually small and/or inexperienced bidders. The country practices, thus, show that the non-competitive bidders are made allocation within the notified amount. The procedures relating to non-competitive bidding could be another point for discussion.

Diversification of investor base

40. A critical step in the direction of improving liquidity in government securities would be the diversification of investor base to the non-traditional investor groups like individuals, firms, trusts and corporate entities. The level of diversification achieved in equity and private debt market has not yet penetrated into the Government securities market. As per the present ownership pattern, the Government securities are predominantly held by banks, financial institutions and provident funds. For example, investments by scheduled commercial banks in Government securities currently showed a quantum jump with an increase of Rs.26,860 crore during 1996-97 as compared with an increase of Rs.14,542 crore during 1995-96. The diversification of investor base is also important for the reason that only under such circumstances can there be an active market with investors' need to buy and sell not being in the same direction at various points in time. This condition is not well met, when the investor base is narrow and where seasonal demand for funds is more or less identical. Some of the possible measures to diversify the investor base are: Primary Dealers could make special efforts in marketing these securities. The investors should be made aware of the special attributes of Government Securities in terms of safety, liquidity, return and availability of loans from banks against them. Dedicated gilt-funds could be set up by mutual funds. While there are several public and private sector mutual funds, their concentration has been on income and growth oriented schemes focusing essentially upon the equity market. There are investors who attach greater importance to safety and liquidity factors. There is thus enormous scope to attract such investors through pure gilt-funds. As a step in the above direction, Reserve Bank announced as part of its credit policy for the first half of 1996-97, liquidity support to dedicated gilt funds and retailing of Government securities by banks. The Reserve Bank has decided to permit banks with effect from June 8, 1996 to undertake retailing of Government securities with non-bank clients. Government could consider extending fiscal incentives, particularly to investment in Gilt funds by retail investors.

41. Major commercial banks with wide branch network have a crucial role in marketing Government Securities to retail customers. Reserve Bank of India has already made available the facility of a second SGL account to commercial banks to enable them to hold Government Securities, on behalf of their customers, in safe custody in dematerialised book entry form. This has been done so that retail and institutional investors have access to a user-friendly system for holding Government Securities in scripless form. The feed-back that the RBI has received is that many of the larger banks with country-wide net-work have yet to make this facility available to their branch customers. Banks should take appropriate step in this direction as it will then encourage retail investors to invest in Government Securities.

Settlement System and Repo Market

42. The secondary market can acquire depth only with an efficient transfer, payments and settlement system and as such the procedures should ensure that transactions costs are low. In the Government securities market, (Delivery Versus Payment) DVP system through the SGL Accounts has been put in place. In the PSU bonds market as well as the private corporate bonds market, the depositories and settlement systems are yet to be made completely operational. Furthermore, since the stamp duty on transfer of bonds/debentures falls under the domain of State Governments it is subject to different regimes in different States. It is important to examine the scope for rationalisation of stamp duties in the interest of activating secondary market in such instruments.

43. With operationalisation of the National Securities Depository Limited(NSDL), it was expected that a sizeable stock of private debt instruments and Public Sector Units bonds would be dematerialised and covered by a secured payments and settlements system. At present, NSDL, is able to dematerialise only those scrips which are exempt from stamp duty and those which are transferable by endorsement and delivery. As most bonds and other corporate debt instruments are not exempt from stamp duty on transfer of bonds, NSDL has expressed difficulties in dematerialising them since in the automated environment of the depository, it is not possible for them to keep, a track of such transfers and duty payable on them. NSDL has, therefore viewed that unless the issue of waiver of stamp duty on transfer of debt instruments is settled with the State Governments, NSDL will not be in a position to extend its services to bonds and other private debt instruments. However, since NSDL is located in Mumbai and a large part of transactions take place in Mumbai, suitable amendments to stamp duty regime by Government of Maharashtra in the form of one time levy or a consolidated fee payable by NSDL could resolve the issue to a significant degree.

44. While DVP system in Government Securities transaction has eliminated settlement risk through SGL accounts, putting in place such risk-free transfer payments and settlements in respect of other debt instruments like PSU bonds and corporate debentures can pave way for the resumption of repos in these instrument s.

When issued market

45. Currently, market participants cannot undertake to enter into firm commitments to trade in a Government paper to market participants prior to an auction. In fact, `short selling' of securities is prohibited under the Securities Contracts (Regulation) Act, 1956. There is a view in the market in favour of introducing `when issued' market which requires a Government notification to this effect. This is expected to enable market participants to trade in a security in the market well before its actual date of issue, after the announcement about the issue. It may be useful to deliberate on the usefulness of such a notification at this juncture.

Private Placements

46. As regards the PSU and corporate bonds market another crucial issue relates to the large volumes of private placement. In recent years private placement has emerged as an important vehicle of raising resources by banks, financial institutions and public and private sector companies. For example, during 1996-97 private placements increased by 12.8 per cent to Rs.15,066 crore accounting for as much as 49.1 per cent of total resources mobilised by the government and non-government companies. Interestingly, the public sector has become a major user of private placements. In private placements bonds have emerged as the most preferred instrument. Further, the private placement market has been witnessing the introduction of several innovative debt instruments such as step-down/step-up debentures, liquid income debentures, sub-ordinated bonds etc. The popularity of private placement method could be attributed perhaps to lower issuance costs and saving on issue management time lag, apart from the fact that private placement has not been coming under the strict regulatory provisions applicable to public issues. The issues such as inclusion of disclosure requirements in the memorandum of information, protection of investors' interests, transparency in the event of retailing private placement issues etc. may require a closer look in the interest of improving information efficiency and avoiding problems arising out of information asymmetry in the bonds market.

47. I trust that the issues which I have raised will also serve as useful reference points for further debate on the subject and help formulate an agenda for further reform.