# Development of Debt Markets in India·

Mr. Chairman, Honourable Finance Minister Yashwant Sinhaji, Mr.Lim and friends,

At the outset, I would like to thank The World Bank for organising this high-level well attended, interactive, business-like seminar on a subject of high priority for India. My presentation would start with features and magnitudes of debt market in India and briefly touch on policy developments since 1991-92. Significant reforms in debt markets undertaken since last year will then be recalled, I will conclude by placing before you, what we consider to be the agenda for further action. I trust that this would facilitate your appreciating both the current status of debt markets and our intentions for the immediate future, and thus assist in making your business plans. We also hope to benefit from your comments and advice on these matters.

· Address by Dr.Y.V.Reddy, Deputy Governor, Reserve Bank of India, at Conference on Private Investment in Infrastructure in India, at Paris, on November 2, 1998.

* I am grateful to Dr.A.Prasad for his valuable assistance.

## Features and Magnitudes

The debt markets in India comprise basically three segments, viz., Government Securities Market, which is oldest and most dominant; PSU Bonds Market, which is basically a development since late `eighties; and Corporate Securities Market, which is growing fast after liberalisation, especially in the last two years. The major focus in the development of debt markets has been the Government Securities Market for three reasons. First, it constitutes the principal segment of our debt market. Second, as a market for sovereign paper, it has a role in setting benchmarks in the financial markets as a whole. Third, it is critical in bringing about an effective and reliable transmission channel for the use of indirect instruments of monetary control.

The outstanding securities of the Central and State Governments as on March 31, 1998 amounted to over Rs. 4,000 billion and a significant part of it is held by commercial banks who have statutory obligations in holding such securities in their portfolio. Reflecting the increasing depth in the Government Securities market, the aggregate volume of transactions in Central and State Government securities and Treasury Bills (outright and repos) was significantly higher at Rs.1,857 billion in 1997-98 as compared with Rs.1,229 billion in 1996-97. The average monthly volume of outright transactions in Government dated securities during 1997-98 was higher at Rs.100 billion than that of Rs.50 billion during 1996-97.

Outstanding corporate debt as at end March 1998 (inclusive of private placement) is estimated to be around Rs.1,100 billion. The Wholesale Debt Market (WDM) at National Stock Exchange (NSE) continued to witness sharp expansion during 1997-98 as the number of securities listed on the WDM segment rose to 418 from 307 during 1996-97. The number of active securities rose from 525 to 719 while the number of active participants also increased to 79 from 73 during 1996-97. The average daily turnover during 1997-98 was Rs.4 billion as compared with Rs.1.5 billion during 1996-97.

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Several new instruments such as deep discount bond, securitised debt, PSU infrastructure bond, Government index bond, corporate floating rate bond and institutional tax free bonds were added to the debt segment in the recent past.

**Early Policy Developments in Debt Market**

Since the 'sixties and until the 'nineties, the Government Securities market remained dormant since the Government was borrowing at preannounced coupon rates from basically a captive group of investors, such as banks. So, we had a passive internal debt management policy. This, coupled with automatic monetisation of budget deficit prevented a deep and vibrant Government Securities market. Internal debt management became an active instrument of policy since economic reform of the 'nineties, with the main objectives of smoothening the maturity structure of debt, enabling debt to be raised at close-to market rates, and improving liquidity by development of an active secondary market. Reforms instituted by the RBI, in close coordination with Government of India included the selling of Government Securities through auctions, introduction of new instruments such as zero coupon bonds, floating rate bonds and capital index bonds, introduction of Treasury Bills of varying maturities, conversion of Treasury Bills into dated securities, establishment of specialised institutions such as DFHI and STCI, institution of system of Primary Dealers in Government Securities, operationalising the Delivery Versus Payment System for settlement, transparency in dissemination of information relating to volumes and yields, prescribing standard valuation norms, etc.

Significant reforms in the non-Government debt market should also be recognised. National and local stock exchanges have been established where trading in corporate and Government debt is done on the exchanges through screen based systems. Securities and Exchange Board of India (SEBI) was established, which regulates the primary issuances in capital and debt markets other than Government securities and ensures sound trading practices in the secondary market through stock exchanges. Depositories have been set up for equity and debt to facilitate dematerialisation and easier and safer transfer and settlement. Also, there is complete transparency in trades in Government Securities settled through the book entry system of Subsidiary General Ledger (SGL) accounts by the Reserve Bank of India and other debt transacted through the National Stock Exchange. Information on trades settled through the central depository with RBI is disseminated to market participants to enable them to have access to data on volumes and prices in the secondary markets.

**Reform in Debt Markets since 1997-98**

Since April 1997, a number of structural and institutional changes in the different segments of financial markets have been brought about, and these include debt markets, especially the Government Securities and money markets.

### Introduction of Scheme of Ways and Means Advances to Central Government

As long as automatic monetisation existed, it was difficult to assure a framework for Government securities market in terms of matching demand and supply through price mechanism. Hence, the most significant development during 1997-98 has been the elimination of the practice of automatic monetisation of the Central Government budget deficit through *ad hoc* Treasury Bills with effect from April 1, 1997 and the introduction of a new scheme of Ways and Means Advances (WMA). The Government can avail of WMA within prescribed limits (currently Rs. 11,000 crore for the first half of the year i.e., April-September and Rs.7,000 crore for the second half of the year, i.e., October-March). The rate of interest on WMA is linked to the Bank Rate. Consequent upon this, the outstanding *ad hoc* and tap Treasury Bills (T-Bills) were converted and added to the stock of special securities with RBI, without any specified maturity, at an interest rate of 4.6 per cent. During 1997-98, special securities to the tune of Rs.20,000 crore were converted into marketable securities of varying maturities, in order to augment the stock of marketable securities for active open market operations. It may be pointed out that during the early part of 1997-98, the RBI had to resort to sterilised intervention in the management of capital inflows. Also, a scheme of 14-Day Intermediate Treasury Bills was introduced in the place of 91-Day tap Treasury Bills to enable State Governments, foreign central banks and special bodies to invest their temporary cash surpluses.

### Introduction of 14-Day Auction of Treasury Bills

14-Day Treasury Bills were introduced in June 1997 on a weekly auction basis with a view to developing the Treasury Bills market further and providing investors with financial instruments of varying short-term maturities and to facilitate the cash management requirement of various financial market participants. Thus, investors now have the option to invest in 14-Day, 91-Day and 364-Day Treasury Bills.

A few announcements such as the introduction of 28-Day Treasury Bills, reintroduction of 182-Day Treasury Bills and changes in the frequency of Treasury Bills auctions were put on hold since there was reduced investor interest in Treasury Bills due to unprecedented market developments. Uniform price auction in respect of 91-Day Treasury Bills is proposed to be introduced soon as an experimental measure. Uniform price auction method is expected to eliminate the problem of winner's curse and encourage more aggressive bidding in the primary market.

### Pre-announcing Notified Amounts in Auctions

For enhancing the credibility of the auction process and the development of secondary markets, a transparent auction system and market clearing yields through the primary auctions are significant preconditions. To foster market clearing rates in the primary market and bringing about more transparency in auctions, the RBI is now pre-announcing notified amounts in auctions of Treasury Bills (14-Day, 91-Day and 364-Day) and dated securities.

Currently, fifty per cent of the notified amounts in auctions are being offered to Primary Dealers for underwriting, thus reducing the scope for devolvement on RBI, though there is some cost in terms of underwriting fee. In order to minimise the possibility of devolvement on the RBI, the notified amounts are also varied from time to time to reflect the market demand.

**Non-Competitive Bids**

As another measure towards more efficient market clearing pricing in auctions, non-competitive bids are now kept outside the notified amounts. Until the current financial year, non-competitive bids in 14-Day and 91-Day Treasury Bills auctions were being allocated bid amounts within the notified amount and this practice was found to distort the auction process. Country practices do show that non-competitive bids are made allocation within the notified amount, but in those countries, the bidders comprise essentially small and retail investors. In India, however, State Governments are major non-competitive bidders who have large and volatile surplus funds positions and these render the pricing pattern and allotment of bids uncertain for competitive bidders.

**Retailing of Government Securities**

As I mentioned earlier, since the 'sixties, a retail market for Government securities ceased to exist. However, since the beginning of reform, it has been recognised that a strong retail segment for Government securities needs to be developed. The Reserve Bank of India has been actively trying to promote this objective. First, one of the major objectives of setting up the primary dealers and satellite dealers systems was to enhance the distribution channels and encourage voluntary holding of Government securities among a wider investor base. Further, in order to facilitate the Satellite Dealers (SDs) in their objectives of trading and distribution of Government Securities, a scheme for availing liquidity support from the RBI has been made available to them. Secondly, the RBI announced special liquidity support for dedicated gilt funds. However, not much interest has been evinced in this channel so far. Thirdly, banks are now allowed to freely buy and sell Government Securities on an outright basis and retail Government securities to non-bank clients, without any restriction on the period between sale and purchase. This is meant to promote the retail market segment and to provide greater liquidity to retail investors. Fourthly, with a view to enabling dematerialisation of securities of retail holders, institutions such as National Securities Depository Ltd. (NSDL), Stock Holding Corporation of India Limited (SHCIL) and National Securities Clearing Corporation Ltd. (NSCCL) have been allowed to open SGL Accounts with the RBI. Furthermore, SDs have also been extended the facility of repo transactions (as lenders) since March 1998.

**Strengthening Dealers System**

In order to make the Government securities market vibrant, liquid and broadbased and to ensure development of underwriting and market making capabilities outside the RBI, a system of Primary Dealers was established. The Primary Dealers' presence in the Government Securities market has brought about an element of dynamism, both in the primary and secondary segments. The RBI has been facilitating the operation of Primary Dealers through a variety of measures.

**Liquidity support is being provided to PDs by the RBI.**

Since some operational problems were observed in the form of liquidity support through repos, the RBI dispensed with the practice of reverse repos with Primary Dealers in specified securities and instead agreed to provide liquidity support against the security of holdings in SGL accounts. The PDs are in the process of switching over to the new system.

A system of payment of underwriting fees on the amounts underwritten by them through competitive bids is in place. In order to facilitate their continued presence in auctions, the RBI invites bids for underwriting in respect of all auctions. Routing operations in the call money market are allowed through PDs. In order to facilitate ease of operations, PDs have been allowed to open a current account and two SGL accounts (one for their own investments and the other for clients) with the RBI. Further, they are allowed the facility of transfer of funds from one centre to another under the RBI's Remittance Facility Scheme. Recently, the Primary Dealers Association of India was formed as a self-regulatory organisation. The PDs are in active coordination with the RBI on various aspects of financial markets.

The RBI has recently enlarged the number of PDs from 6 to 13 by announcing in-principle agreement to register 7 PDs. The addition of 7 more PDs (DSP Merrill Lynch Ltd., Kotak Mahindra Capital Company Ltd., Ceat Financial Services Ltd., Tata Finance Securities Ltd., JP Morgan Securities India Pvt. Ltd., ABN Amro Bank Subsidiary and Deutsche Bank Subsidiary), is expected to increase activities in terms of liquidity and depth both in the primary and secondary markets.

**Investment in Central Government Securities by FIIs**

To widen the participants in the debt market, including Government securities, it was felt that foreign institutional investors should also be permitted to operate, though such participation had to be consistent with overall ceilings on external commercial borrowings.

FIIs were, however, allowed to operate only in dated Government Securities in the primary and secondary markets, including those with remaining maturities of less than one year until April 1998. Their entry in Treasury Bills market was deferred pending rationalisation of auction procedures. With the commencement of pre-announcement of notified amounts in respect of Treasury Bills auctions and exclusion of non-competitive bids from the notified amounts, FIIs are now permitted to purchase/sell Treasury Bills within the overall approved debt ceilings. FIIs' investments in debt instruments are permitted to be fully covered in the forward foreign exchange market.

**Ready Forward Transactions**

In our market, two types of repos are currently in operation – inter bank repo including PDs and the RBI repo which is used for absorption/injection of liquidity. After the irregularities in securities transactions in 1992, interbank repos are permitted under regulated conditions with eligible participants and instruments being generally restricted and expanded gradually.

In order to further expand the base in the interbank repos market, the participation was extended to non-bank entities that had already access to call money market as lenders. Repos have also been permitted in PSU bonds and private corporate debt securities provided they are held in dematerialised form in a depository and the transactions are done in recognised stock exchanges. This will be operationalised after Government issues a clarification regarding applicability of stamp duties on dematerialised instruments.

In the most recent monetary and credit policy, the RBI removed the restriction of a minimum period of 3 days for inter bank repo transactions. This would further enable banks and other participants in the repo market to adjust their liquidity in a more flexible manner.

In recent months, open market operations of the RBI, both through outright sales of Government Securities and repo operations have gained considerable momentum. At present, the RBI conducts three-day and four-day repos in the market. The primary objective of these operations is to absorb or provide liquidity from/to the market, though under certain circumstances, repos have also been used to signal changes in interest rates. The monetary and credit policy for the first half of 1998-99 proposed to use both fixed interest and auction based repos, as appropriate. It also stated that in addition to the current three-day and four-day repos, RBI will, in due course, use one-day repos (including reverse repos) to absorb (or infuse) liquidity into the system. With the continuous availability of fixed rate repos for absorption of liquidity, the proposal to use one-day repos/reverse repos for liquidity adjustment has been deferred. In view of the current market conditions, the fixed rate repos will be continued for some more time. Use of auction repos will have to be considered at an appropriate stage.

**Agenda for Further Action**

Since the introduction of the reform measures, the various segments of the financial market have responded favourably and become increasingly integrated. Although significant progress has been made in the debt markets also, a number of rigidities persist and major issues still need to be tackled keeping in view a consistent framework. The framework that should continue to govern our agenda for further action may be summarised as under :

- Establish a transparent and credible price discovery process in the primary market
- Develop a vibrant, liquid and broadbased secondary market
- Evolve standard procedures, documentation and code of conduct for transactions in securities
- Improve the institutional infrastructure by further strengthening the primary and satellite dealers systems
- Support and encourage self regulatory bodies
- Develop wide retail network
- Ensure a smooth, well functioning and efficient settlement system
- Upgrade technology and set up an electronic dealing system
- Create an enabling legal structure
- Establish a strong regulatory framework
- Ensure transparency in operations, proper disclosure and quick information dissemination.

The actions required for this purpose may be classified into areas relating to legal, technology, regulatory and market microstructure, retailing, standardisation and risk management.

## Legal Issues

### Repeal and Replacement of Public Debt Act

The Government Securities and their management by the Reserve Bank of India is governed by the Public Debt Act, 1944. The procedures prescribed are archaic and some of the provisions have ceased to be of relevance in the present context. A new legislation titled the Government Securities Act proposes to repeal and replace the Public Debt Act. The Government Securities Bill has already been approved by the Cabinet and is awaiting Parliament clearance. However, since the Public Debt Act, 1944, is applicable for marketable loans raised by the RBI on behalf of both the Central and State Governments, the proposal requires consent of all State Governments. The State Governments have to pass a Resolution for the purpose either prior to enactment by the Centre or subsequently adopt the same by passing a Resolution. Once the new Act is enacted, the RBI will have substantive powers to design and introduce an instrument of transfer suited to computer environment. The new Act will also give flexibility to allow Government Securities to be held in Depositories while at the same time specifically excluding Government Securities from the purview of Depositories Act, 1996.

### Amendments to Securities Contracts (Regulation) Act, 1956

In order to curb certain unhealthy trends that had developed in the securities market and to prevent undesirable speculation, the Government had prohibited forward trading in securities in June 1969 through a Notification. It is held that rescinding this Notification is now necessary for the development of the securities market. Simultaneously, there is a proposal to amend the SCRA to add an enabling provision to provide jurisdiction to the RBI also in the regulation of the debt markets. With this, the respective regulatory roles of SEBI and RBI in the debt market will be formalised. The proposed changes in the SCRA will pave way for a more active repos market and introduction of new market features like when-issued trading.

### Stamp Duty Reform

Development of financial markets is being inhibited by multiple prescriptions of stamp duty which is creating friction in active secondary market trading by increasing the transaction cost and administrative hassles. Although the State Governments claim right to levy stamp duty, exemption of financial instruments from stamp duty is advocated in the interest of development of efficient financial markets. Repos in private corporate securities in dematerialised form through a depository have stalled on this count. In regard to instruments which fall within the jurisdiction of Central Government, such as promissory note and transfer of shares, they have already been granted remission by Central Government. State Governments may be finding it difficult to grant remission to financial transactions since for the purpose of stamp duty almost all items fall within the description of financial transactions excepting a couple of items.

A Group is actively monitoring the progress on Stamp Duty Reform. This is a matter of crucial importance and exemption of debt instruments from stamp duty or alternatively rationalisation of the procedures by imposing a flat fee would go a long way in increasing secondary market activity and liquidity in debt instruments. The suggestion that the Indian Stamp Act be amended to enact a specific provision exempting transactions of all securities in Depository in dematerialised form from stamp duty also needs to be seriously considered.

## Technology

### Technological upgradation in Debt Market

Development of technology is an integral part of reforming the debt market, especially in the context of providing a technologically superior dealing and settlement system. Hence, the RBI has embarked upon the technological upgradation of debt market. This includes screen-based trade reporting system with the use of VSAT communication network complemented by a centralised Subsidiary General Ledger (SGL) accounting system. It will be integrated with the regional current account system. The existing system provides paper based DVP system at the offices of RBI. The operationalisation of trade reporting will facilitate logging bids in the auctions of dated securities and treasury bills to other parts of the country which is presently available at Mumbai. This will broaden the participation in the auction system, help enlarging the investor's base and increase the competitiveness in the auction system. The centralised SGL accounting system will improve the speed of settlement of secondary market transactions.

The operationalisation of VSAT by end of December 1998 will provide on- line linkages between offices of RBI, Central Government (Ministry of Finance), monitoring of Government finance (receipts and expenditures) and also among other participants (banks/primary dealers/satellite dealers/financial institutions). This will open new areas in technological development of payment systems.

Y2K Compliance by Primary Dealers and Satellite Dealers (System Software and Hardware) with the target date December 1998 are also being monitored.

### Electronic Dealing System

Electronic dealing systems lend transparency and efficiency to market operations. Ideally, the screen could cover OTC deals in money market instruments like call and notice money, term money, repos, as also Government Securities including Treasury Bills. Besides banks, PDs, financial institutions and other market participants, the RBI could use the screen in the conduct of its open market operations as also for monitoring money/securities market activity.

The RBI is actively coordinating with the Primary Dealers Association in developing an Electronic Dealing System to facilitate dealing in call, notice and term money, Treasury Bills, Government Securities and repos. This is expected to be operationalised by March 1999.

**Regulation of Private Placement**

In the PSU and corporate bonds market, a crucial issue relates to large resources raised through private placement. For instance, private placements increased by as much as 80 per cent during 1997-98 to Rs.27,069 crore, accounting for 85 per cent of the resources mobilised from the primary market. The share of public sector in total private placements remained high at 68 per cent of total private placements but much lower than its share of 83 per cent in 1996-97. This popularity of private placement may be attributed to the low issuance cost, ease of structuring instruments, saving on time lag in issuance. Notwithstanding these benefits, healthy development of the private placement market calls for more transparency, better disclosure and protection of investors' interest.

An Informal Group on Primary Market under the Chairmanship of Dr. Shankar Acharya also looked at the issue of private placement. The Group has recommended that the facility of private placement should be restricted to not more than 99 qualified institutional investors and should be tradable on OTCEI. The Group also recommended that financial institutions/banks/mutual funds which participate in private placement should mandatorily give information on a regular basis to SEBI and the RBI.

**Market Microstructure**

As pointed out earlier, a number of measures have been implemented to develop the primary and secondary markets. A number of suggestions have been recently received towards further development of the markets and these are listed here though they are yet to be examined.

a) At present, PDs underwrite a sizeable proportion of the market loans and quote an underwriting commission. In case of a devolvement, PDs are allotted at the cut-off rate. There is a suggestion that PDs should be required to ensure that in each auction they put in a minimum percentage of the notified amount and with the increase in the number of PDs, the minimum bids of all PDs taken together should be 100 per cent of the notified amount. The point that is stressed is that PDs should be given allocations only at the price or yield at which they have bid and should not be given a forced allocation at an artificial cut off.

b) RBI should not participate in the primary auctions, but in the transition it could take up to 20 per cent of the notified amount, subject to a pre-announced policy. If, after the 20 per cent devolvement, the issue is not fully subscribed, the RBI should have the option of cancelling the entire auction.

c) Initially, the RBI should move out of 14-Day and 91-Day primary auctions and then the 364-Day auctions. Thereafter, it could gradually phase out its presence from the dated securities auctions.

d) With the withdrawal from the primary market, the RBI would need to establish a strong presence in the secondary market with two-way quotes.

e) The RBI could consider price-based bidding at auctions.

f) Preparatory work towards introduction of Futures/STRIPS and other value-added features should commence.

**Retailing of Government Securities**

As I alluded earlier, there is an imperative need to generate a strong retail segment of the gilt market. The RBI has already established the institutional infrastructure for retailing by setting up the system of Primary Dealers and Satellite Dealers in Government securities market. PDs and SDs should take up this task earnestly and move ahead in building awareness among retail investors about Government securities. There is a view that the capital of PDs need to be enhanced not only to accommodate the increasing size of Government securities market but also to further increase the commitment of PDs to fresh issuances, market making and distribution capabilities.

Another eminent way of retailing Government securities is through the gilt fund route. Currently, the tax concession for gilt funds is clubbed with other 80L instruments and a case has been made out for giving exclusive tax exemptions for income earned from gilts and gilt funds. Also, there have been suggestions that investment in the units of dedicated gilt funds should be treated as SLR securities. These suggestions need further examination.

The opening of SGL account with NSDL was also expected to increase the retail segment of the Government Securities Market. This will become operational once SEBI issues necessary clarifications exempting Government Securities from their jurisdiction.

**Standardisation of Practices**

Standard practices in the market need to be evolved with regard to the manner of quotes, conclusion of deals, etc. Code of best practices has to be evolved for repo transactions. It is proposed to ensure that the Primary Dealers Association and FIMMDAI quickly set up a time frame for standardising the documentation and market practices and if need be the RBI will come forward and indicate a time frame. Most importantly, the code of conduct will have to be compatible with the contemplated dealing screen and the technological upgradation.

**Risk Management**

Investors in debt instruments face three major types of risk, viz., credit risk, interest rate risk and foreign currency risk. In case of Government bonds, credit risk is zero. Non-resident investors like FIIs who are prone to currency risk have already been permitted to take forward cover to enable them to hedge their currency risk. Investment in all debt instruments is exposed to interest rate risk. Introduction of rupee derivatives will go a long way in providing instruments for investors to hedge their exposures. The Reserve Bank has decided in principle to create an environment that would facilitate introduction of interest rate swaps. The RBI proposes to examine in consultation with market participants, relevant aspects such as standard documentation, benchmark rate, prudential prescriptions, etc. before allowing the product in the market.

**Conclusion**

In conclusion, significant progress has been made with regard to the development of debt markets in India. The RBI is taking active interest in creating legal and institutional framework, evolve standardised procedures and code of conduct, upgrade technology and establish a strong regulatory framework. As you would have noted, the agenda that was just set out is complex. Successful completion of the agenda would require close coordination between the RBI and Government and cooperation from the market participants.

I solicit your suggestions and advice.

Thank you.