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Debt Markets in India – Issues and Prospects*

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I am very happy to be amongst you today to deliver the keynote address at the 3rd Annual Citibank - Fitch Debt Markets Conference. I understand that the response to the previous Citibank-Fitch debt markets conferences has been very encouraging, which has motivated the organisers to convert this into an annual event. This kind of interaction among investors and issuers provides an opportunity for mutual discussions in the interest of fostering further market development.

Development, sustenance and expansion of the debt markets is a very complex activity. Our experience so far suggests that a well functioning debt market needs to be carefully nurtured over time and requires a great deal of discussion between issuers, investors, intermediaries, and regulators, alike. Today's deliberations, I am sure will provide newer visions towards such a collaborative developmental process.

I. Prologue

A well developed capital market consists of both the equity market and the bond market. While the exact composition of the market varies from country to country, it is generally found that the debt market segment of the capital market develops more slowly than the equity market. Purely from an issuer angle, the debt market could be segregated into G-Sec and corporate bond market. Due to their genre, I shall discuss them separately.

The existence of an efficient government securities debt market is usually seen as an essential precursor for the corporate debt market. Following a developmental model rather than a regulatory and supervisory model, the Reserve Bank of India took up the task of developing the government securities market, so as to facilitate overall improvement in the strength of financial and economic system of the country. Along with the initiation of overall economic reforms in the early 1990s, the development of the government securities market was initiated in 1992. Today after a decade of the reforms process, it is an opportune time to take a look at the current issues that are of interest to the market.

The limitations of public finances as well as the systemic risk awareness of the banking systems in developing countries have led to growing interest in developing bond markets. It is believed that well run and liquid corporate bond markets can play a critical role in supporting economic development in developing countries, both at the macroeconomic and microeconomic levels. Corporate debt in developing countries has traditionally been raised from banks through plain vanilla bank lending. The need for a developed bond market with a sizeable corporate debt segment is particularly important as it offers an effective alternative to banks for raising capital by corporates, leading to improvement in efficiency of the capital market. Corporate debt markets also function as a stable source of finance when the equity market is volatile. Generally, there have been two models for developing debt markets internationally. Whereas, in developed countries like the U.S., regulators stepped in to bring about an orderly way of doing business after the markets had by themselves developed reasonably, in several developing countries such as India, the regulators have had to assume the role of market developers.

What have the developments in these segments of the financial market? What needs to be done? What issues remain the paramount concern of the regulators? Let me today trace some of the developments and share with you some of my thoughts on these issues.

II. Overview of Developments in the G-Sec Market

Let me take you to little bit back in time. As we all know, the Government securities market before the 1990s was characterised by administered (and often artificially low) rates of interest, captive investors (essentially banks)

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due to high Statutory Liquidity Ratio (SLR) requirements, absence of a liquid and transparent secondary market for G-Secs and lack of smooth and robust yield curve for pricing of the instruments. Low coupon rates were offered on government securities to keep government borrowing costs down, which made real rates of return negative for several years till the mid-1980s. During the 1980s, the volume of debt expanded considerably, particularly short-term debt, due to automatic accommodation to Central government by the Reserve Bank, through the mechanism of ad hoc Treasury Bills. With a captive investor base and interest rate below the market rate, the secondary market for government bonds remained dormant. Artificial yields on government securities affected the yield structure of financial assets in the system, and led to higher lending rates. Driven by these compulsions, Reserve Bank's monetary management was dominated by a regime of administered interest rates, and rising Cash Reserve Ratio (CRR) and SLR prescriptions. High CRR and SLR left little room for monetary maneuvering.

What were the compelling factors for initiating reforms? The following factors were extremely important in particular:

- Increasing borrowing requirements of the government due to a rising fiscal deficit;
- The need to keep the cost of borrowing reasonable;
- The need for developing a benchmark for other fixed income instruments for the purposes of pricing and valuation;
- Operation of monetary policy through indirect instruments like Open Market Operations and repos, which required an active secondary market for G-Secs and
- Improving the overall efficiency of the financial markets. Some of the most salient reforms initiated in the G-Sec market after 1991-92 are presented below.

In this perspective the primary objective of the reform process in the G-Sec market was to raise government debt at market related interest rates. In order to do so, development of appropriate market infrastructure, elongation of maturity profile, increasing the width and depth of the markets, became extremely critical. Improving risk management practices and transparency were the other important considerations.

What did we do? The sequence of Reserve Bank's market development activities in the 1990s is now well known. I will only recount some of the key reform measures:

- **1992**: Introduction of auction system for price discovery
- **1993**: Introduction of 91 day T- bills for managing liquidity and benchmarking
- **1994**: Zero Coupon Bonds were issued
- **1995**: Primary Dealer (PD) system was set up; DvP settlement system introduced; Floating Rate Bonds issued
- **1997**: Technical Advisory Committee set up, permitting repos in G-Secs, allowed FIIs to invest in G-Secs; system of Ways and Means advances introduced for Government of India; introduced Capital Indexed Bonds
- **1999**: OTC interest rate derivatives like IRS/FRAs introduced.
- **2000**: Introduction of Liquidity Adjustment Facility (LAF) to manage short term liquidity mismatches
- **2002**: Operationalisation of Negotiated Dealing System (NDS) and CCIL. Trade data on NDS made available on RBI web site for transparency
- **2003**: Introduction of trading of G-Secs on stock exchanges, permitting non-banks to participate in repo market, introduction of exchange traded interest rate futures

III. Recent Developments

Subsequently, significant measures have also been taken during the current year, 2004. An important development has been the introduction of the Real Time Gross Settlement System which will facilitate better liquidity management. The DvP III mode of settlement has been enabled which permits net settlement of both funds and securities legs. The DvP III mode of settlement has also permitted the rollover of repos. Another significant development was the introduction of the Market Stabilisation Scheme which has expanded the instruments available to the Reserve Bank for managing the surplus liquidity in the system.

These reforms can be briefly viewed as a systematic exercise for the development of the debt market as well as integration of the entire financial markets by making it deep, wide and transparent. In looking back at the

sequence and pace of these reforms that have been put in place over a decade, one begins to appreciate the complexity and difficulty that is intrinsic to the development of an efficient debt market. And we still have a long way to go.

These reforms were linked to operational autonomy of the RBI. Measures such as the abolition of automatic monetisation through ad-hoc Treasury Bills (in 1997) and its replacement by Ways and Means Advances facility, with limits, to meet temporary cash flow mismatches for the Central Government, were considered critical for the stabilisation of monetary policy. You are also aware that these measures have been taken in close collaboration with the market players. This underscores the need for collaboration and consultation between regulatory authorities and market players in the process of development of any market. It is heartening to note that this has been achieved very successfully in the Indian debt market because of the existence of industry associations like FIMMDA and PDAI, and an active PD system wherein the Primary Dealers have acted as a linking mechanism between the market and the Regulator. The heterogeneity of market participants, some of whom have brought in to the Indian market the best international technology, risk management practices, know how of the instruments, especially derivatives has also helped greatly.

Let me discuss some of the recent developments in greater detail :

a) Interest Rate Futures (IRFs)

Consequent upon the decision to introduce IRFs on NSE, guidelines in respect of RBI regulated entities were formulated to enable their participation. NSE introduced three futures instruments on June 3, 2003, *viz.*, futures contracts on notional 91 day Treasury Bill, futures contracts on notional 10 year coupon bearing bond and futures contracts on notional 10 year zero coupon bonds. While banks were allowed to use futures only to hedge their G-sec investments in Held for Trading (HFT) and Available for Sale (AFS) categories, PDs were allowed to deal in interest rate derivatives (IRDs) for both hedging and trading. However, due to the lack of liquidity of the exchange traded futures market, Securities and Exchange Board of India (SEBI) in consultation with FIMMDA simplified futures contracts on a 10-year notional bond, which is priced on the basis of the 'Yield To Maturity' (YTM) of a basket comprising three bonds with maturity ranging from 9 to 11 years. The exchanges are in the process of launching such a new product.

b) Legality of OTC Derivatives – Amendments to SCRA

OTC interest rate derivatives were introduced in 1999. Banks could undertake plain vanilla FRA and IRS contracts for their own balance sheet management and also for market making purposes, provided they ensure adequate infrastructure, risk management systems and internal control systems. The volume in the market has grown noticeably with the outstanding notional amount at around Rs. 6,40,000 crore[1]. However, there has been some apprehension regarding legality of OTC derivatives with section 18A of the Securities Contracts (Regulation) Act, 1956 (SCRA), making only derivatives contracts that are executed on exchanges legal and valid. Accordingly, certain modifications by way of supplementary provisions to the proposed amendments are under discussion with the Government of India so as to ensure that the proposed amendments do not jeopardize the legal status of OTC derivatives. Specifically, it has been suggested that section 18A be amended so as to make contracts of the class and nature as notified by RBI legally valid, even if they are not traded on any recognised stock exchange. Exchange traded derivatives have their own role to play in the debt market - but by their very nature they have to be standardised products. OTC derivatives, on the other hand can be customised to the requirements of the trading entities. Thus both OTC and exchange traded derivatives are essential for market development.

c) Rollover of Repos

With the decision to move gradually towards a pure inter-bank call/term money market, there is a need to remove the operational/regulatory constraints in the repo market. One of the perceived hurdles in the development of the repo market is the inability to rollover contracts. To enable continuous access to funds from the repo market, it was decided to permit rollover of repos which will be enabled along with D*v*P III.

d) DvP III Mode of Settlement

In order to reduce the price risk assumed by market participants, sale of securities previously purchased is proposed to be permitted with certain safeguards built in to prevent short sales. To enable this as well as to enable

[1] As on September 17, 2004, this amount increased substantially to Rs.8,53,000 crore.

rollover of repos, net settlement in securities is required. Therefore, it has been decided to shift the settlement mode to D*v*P III.

e) Market Stabilisation Scheme

As a response to the large-scale capital inflows in recent years and the consequent problems faced in managing liquidity, the Reserve Bank introduced the Market Stabilisation Scheme (MSS) after consulting the Government of India for mopping up liquidity of a more enduring nature in March 2004. Under this scheme, the Government would issue existing instruments, such as, Treasury Bills and/or dated securities by way of auctions under the MSS, in addition to the normal borrowing requirements, for absorbing liquidity from the system. The intention of MSS is essentially to differentiate the liquidity absorption of a more enduring nature by way of sterilisation from the day-to-day normal liquidity management operations. In order to provide transparency and stability to the financial markets, an indicative schedule for issuance of Treasury Bills/dated securities on a quarterly basis is being announced.

f) Capital Charge for Market Risk

With a view to ensuring smooth transition to the norms under Basel II, banks were advised to maintain capital charge for market risk over a two-year period as under:

- Banks would be required to maintain capital charge for market risk in respect of their trading book exposures (including derivatives) by March 31, 2005.
- Banks would be required to maintain capital charge for market risk in respect of the securities included under available for sale (AFS) category by March 31, 2006.

g) Primary Dealers and their Role

As we know, PDs are expected to promote retailing in the G-Sec, active market making in G-Secs and price discovery. While the institution of PDs has led to improved liquidity in the secondary market, retailing of G-Secs and promoting a retail market has not been undertaken by the PDs on the scale and intensity that was expected. With the proposed order driven trading in G-Secs on the NDS, PDs are expected to play a significant role in developing the retail markets on exchanges. PDs should also improve their market making in interest rate derivatives, particularly with a larger category of institutions like insurance companies coming into the market. Thus, in order to fulfil their obligations, Primary Dealers will have to assume a greater role and responsibilities for market making and retailing of G-secs. On the benefits side, the long pending demand of the PDs for exclusivity in the auctions of G-Secs in a limited way has been under the active consideration of RBI. In addition, the Standing Technical Advisory Committee on Money, Government Securities and Forex Markets has formed a Sub Group to look into the issue of broad basing the PDs portfolios by permitting them to invest in the sovereign securities abroad, setting up of overseas joint ventures, wholly owned subsidiaries, and the like.

As a result of all these measures, the Indian G-Sec market has been transformed substantially over the last ten years. A major outcome of this development is that the market is becoming increasingly broad based: with the market now looking well diversified with the participation of banks, financial institutions, provident funds, insurance and pension funds, primary dealers, 100 per cent gilt mutual funds, corporate bodies, provident funds, trusts, individuals, foreign institutional investors (FIIs) and non-resident Indians (NRIs). The consolidation of securities achieved over the years, has resulted in the development of active benchmark securities. Hence we now observe that the auctions for Government securities have developed a high degree of sophistication. There is an ever narrowing gap between the cut-off price and the weighted average cut-off price; the bids at the primary auction are nearly perfectly correlated with the secondary market yield curve indicating excellent price discovery. A reasonably smooth and elongated yield curve of up to 30 years maturity has emerged, which is probably comparable with those in developed economies. Volumes of trading in the secondary market are increasing and bid-ask spreads are narrow. The annual turnover in the secondary market for G-Secs now is more than twice the GDP of the country and that, after Japan, India's G-Sec market is probably the largest in Asia.

I would like particularly to emphasise the high quality of infrastructure that has been put in place in India. Through a process of novation, a Central Counter Party like the Clearing Corporation of India Limited (CCIL), has provided excellent infrastructure and risk management means. The efficacy of the settlement system of government securities and forex transactions through CCIL was clearly brought out recently when the settlement in respect of transactions of the Global Trust Bank following the moratorium, was put through

smoothly. There is still no room for complacency and the need for sustained efforts to further improve market practices and to benchmark them against the international standards is of paramount importance.

In fact in the process of reaching where we are today in developing the G-Sec market, several issues had to be addressed and problems were faced in the areas of broadening the primary market with appropriate auction methodology, promoting depth and liquidity in the secondary market, fostering market intermediaries and market making, setting up of reliable trading and settlements systems, ensuring adequate institutional, legal and risk management systems and facilitating data dissemination and transparency. It is gratifying to note that despite these challenges, we could develop a deep and liquid market for government securities in India.

III. Review of the Corporate Debt Market

Having delineated the developments of the G-Sec market, let me now come to the other segment, *viz.*, corporate debt market, although it is the Securities and Exchange Board of India (SEBI) that has the primary responsibility. But I do have some *locus standi* to speak on this issue as Chairman of SEBI's Market Advisory Committee! Whereas the Government Securities market has developed a great deal, the corporate debt market has a long way to go. Though the corporate debt market in India has been in existence since independence in 1947, it was only after 1985-86, following some debt market reforms that state owned public enterprises (PSUs) began issuing PSU bonds. However, in the absence of a well functioning secondary market, such debt instruments remained highly illiquid and unpopular among the investing population at large.

However, corporates continued to prefer private placements to public issues. Such a dominance of private placement has been attributed to several factors, *viz.,* ease of procedures and operation of private placement, involved procedure and considerably higher costs of public issues, and higher subscriptions for private placements. Essentially for these reasons, the financial institutions have tended to dominate public issues in the primary corporate debt market. The secondary market for corporate debt has also certain shortcomings. Lack of market making resulting in poor liquidity, tendency on the part of institutional investors to hold these securities to maturity and consequent reduction in market supply of these securities are some of them.

Several measures have been taken in the recent past to transform the corporate debt market in India predominantly under the aegis of SEBI. Some of these measures include de-materialisation and electronic transfer of securities, rolling settlement, introduction of sophisticated risk management, trading and settlement systems. Towards the end of 2003, SEBI has also taken steps to reform the private placement market. In conjunction with these measures, Reserve Bank of India, issued guidelines to banks on investment of their non-SLR securities. All these measures are expected to improve the functioning of corporate debt market in India.

Since this conference is a confluence of people across different sides of the debt markets in India, let me share a recent development. To help in the further development of the corporate debt market, a Group has recently been set-up with the participation of RBI, SEBI and other market participants. Among others, the group intends to look into the following issues:

- Examination of the issues relating to primary issuances as well as growth of secondary market of corporate debt securities in the light of international experience.
- Examination of the regulatory aspects for the development of the market for Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS).
- Analysing the issues relating to trading, settlement and accounting of corporate debt securities including the issue of DvP settlement for corporate debt market.
- Suggesting measures to enhance transparency in pricing and valuation of corporate debt securities.

I understand that the deliberations of the Group are underway. Taking advantage of this conference, let me invite your suggestions and comments for furthering the development of the corporate debt market, so that we can take a comprehensive review and propose measures which are pragmatic and relevant.

IV. Shape of Things to Come in the G-Sec Market

In order to have a feel of the shape of things to come in the G-Sec market, let me have a quick review of the various proposed measures in the G-Sec market.

a) Diversification of Instruments:

Different investors have a variety of investment horizons, risk appetite and needs. It is therefore important to diversify the instruments available.

Floating Rate Bonds: There is a perceptible improvement in the issuance of Floating Rate Bonds (FRBs), which is an effective instrument for hedging interest rate risk by investors in the context of elongation of the maturity profile of Government debt. A total of Rs. 16,000 crore was raised through Floating Rate Bonds during 2003-04, which accounted for 16 per cent of the total issuances of dated securities, excluding those issued by way of private placements with the RBI. The calendar for H1/2004-05 also provides for issuance of FRBs for about 10 to 20 per cent of the total issuances. We have already issued Rs.18,000 crore in this fiscal year. These instruments are particularly popular during times of perceived market uncertainty.

STRIPS: Introduction of STRIPS is one of our top priorities. An informal interdepartmental Group in RBI on operationalisation of Separate Trading for Registered Interest and Principal of Securities (STRIPS) has recommended certain system requirement specifications which are being evaluated internally. Meanwhile, steps have been taken to realign the coupon payments dates on four identified dates so as to create a critical mass for issue of coupon STRIPS. Necessary enabling legal provisions are expected to come into effect as and when the Government Securities Bill is introduced and passed by Parliament soon. With introduction of STRIPS, the long felt needs of the market in the areas of ALM mismatches and better cash flow management would be addressed, besides, improving the opportunities for the retail segment for investing in long term discount instruments.

Capital Indexed Bonds: The RBI proposes to re-introduce Capital Indexed Bonds (CIBs) with modified features. The proposed CIB, in line with structures prevalent internationally, would offer inflation linked returns both on the coupons and the principal repayments. The proposed CIB would be offered with market determined real coupon rate, which would remain fixed during the currency of the bonds. The semi-annual coupon payments on the bonds would be made by applying the fixed real coupon rate to the inflation-adjusted principal. The principal repayment at maturity would be the inflation-adjusted principal amount or its original par value, whichever is greater, thus providing an in-built insurance that at the time of redemption the principal value would not fall below par. The proposal for the reintroduction of such CIB is under discussion with the Government. Our proposals on the characteristics of capital indexed bonds have also been put on our website to elicit expert and market views. We will welcome any views you might have on the appropriate design of these instruments. It may be indicated that CIB was introduced in December 1997 which matured in December 2002. No subsequent issue has been made till date.

b) Screen-based Trading of Government Securities

A countrywide, anonymous, screen based, order driven system for trading in government securities introduced in the stock exchanges (NSE, BSE and OTCEI) in January 2003 has continued to suffer from very poor trading volumes during 2003-04. In order to examine the various issues related to the successful operationalisation of the screen-based trading, a Working Group on Screen Based Trading in Government Securities was constituted. The Group has made several recommendation relating to improving the NDS in terms of software and hardware and linkages with INFINET, administration of NDS functioning, setting up of an NDS user Group etc. The Group has also recommended that it would be desirable to make available an anonymous, screen-based order driven trading system for the NDS members in a Straight Through Processing (STP) mode. The Group has also suggested in the Report several measures to develop the retail gilt market on the exchanges. These include, obligation on market intermediaries to provide two-way quotes, spreading awareness through concerted campaigns by exchanges *etc.* The Group also highlighted the need for market making on exchanges by the Primary Dealers.

As you are aware, the Reserve Bank of India has decided to implement the recommendation relating to introduction of screen-based order matching trading system on the NDS. The trading platform, called '**RBI-NDS-GILTS-Order Matching Segment**, (or, **NDS-OM**, in short) is a part of RBI's NDS application. It will be available to the NDS members in addition to the existing trading mechanism. It will be temporarily hosted at CCIL pending installation of required infrastructure at RBI. The new trading system will be audited by external experts during the trial run phase to ensure robustness of security features and connectivity, and efficiency of the system. The proposed system which was demonstrated by CCIL to the market participants recently on August 11, 2004 is expected to go live as soon as system integrity is ensured

and appropriate training has been imparted to traders in the NDS members. I am sure that this new option to the market traders would go a long way in addressing some of the issues relating to transparency, price discovery, credit risk *etc.*

c) Clearing of OTC Interest Rate Derivatives by CCIL

A central counter party based clearing arrangement for OTC derivatives would reduce counterparty risk and extend the benefits of netting. Accordingly, in order to strengthen the OTC derivatives market and to mitigate the risks involved, a clearing arrangement through CCIL for the OTC interest rate derivatives is under examination. This measure is expected to strengthen the OTC interest rate derivatives market.

d) Trade in non-SLR Securities - Settlement and Information

Prudential guidelines on banks' investment in non-SLR securities require banks to report all 'spot' transaction in listed and unlisted non-SLR securities on the NDS and settle through CCIL, from a date to be notified. CCIL is working out an arrangement for settlement on non-guaranteed basis and dissemination of information relating to trades in listed as well as unlisted non-SLR debt instruments by NDS members. This measure would improve transparency of trades in corporate debt market.

V. Potential of Corporate Debt Market

In order to improve transparency and improving the market for private placement of debt, SEBI issued guidelines on September 30, 2003 stipulating the conditions to be complied in respect of private placement of debt. These conditions governed issuance, listing and trading of privately placed debt securities. Subsequent to the issue of the circular, market participants made representations and suggestions and sought clarifications on various provisions of the circular from SEBI. There was a general feeling in the market that the guidelines were too stringent. It may be mentioned here that from time to time, RBI had been interacting with SEBI on the issue of Private Placement of Corporate Debt. Based on the feedback received from market participants and banks, RBI has modified (on December 10, 2003) the prudential guidelines for banks' non-SLR investments. Besides, SEBI was advised to take steps to address the issues of (i) a simplified listing procedure for listed companies and (ii) to spell out an appropriate listing procedure for unlisted companies. SEBI issued a circular on December 22, 2003 to all the stock exchanges incorporating the above suggestions. It was observed that the clarifications issued by SEBI effectively addressed almost all the issues raised by the market participants. The feedback received from the market confirmed it.

a) Infrastructure Financing

With the development of an elongated and smooth yield curve and aided by abundant liquidity in the system, I think the stage is set for growth in infrastructure financing. It is needless to highlight the importance of infrastructure financing if the stated objective of attaining the developed country status for India is to be achieved. Therefore, the developments in the debt markets should percolate down to this sector as well. On its part, RBI has been actively encouraging the government and the market participants to work more on the issue and ensure credit enhancement to the sector. In the recently held 13th State Finance Secretaries Conference, a decision was taken to set up a Working Group to study the issue of credit enhancement to the infrastructure financing in states. I feel that the private sector infrastructure agencies could also be active in the long term financing, but for this to work, the credit enhancement has to pick up. While in 1995-96, there were large number of issuers, today we have a substantial pool of potential investors, who need to be tapped for this credit enhancement to materialise for the infrastructure area. At the same time, I hope that a bond insurance mechanism can potentially be developed for ensuring credit enhancement and investor safety.

There have been enough indications that infrastructure needs would go up, which would contribute to an efficient functioning of corporate debt market. The crucial issues involved in developing the corporate debt market are the ways and means of elongation of maturity of corporate debt paper, improving the liquidity in secondary market, improving institutional mechanics *etc.* While the G-Sec markets were now fairly well-developed, the corporate debt markets needed to go a long way so that India can have a well-integrated financial market. An integrated financial market is necessary for efficient transmission of monetary policy, keeping in view the fact that it is now operated on indirect instruments. Fortunately, the foundations for developing an efficient corporate debt market have already been laid as the necessary infrastructure and institutions that have been created for the G-Sec market are already available. The regulators have also taken the first initiative in this regard with SEBI

announcing its guidelines on trading and listing requirements for corporate debt and the RBI asking banks to invest only in listed and rated corporate paper on a private placement basis.

The economy being on a high growth path would create higher demand for funds, especially in infrastructure development. Corporates looking to raising funds from the capital markets would also require them to raise the balancing debt. With term lending from financial institutions on the decline, corporate funding needs, especially of the infrastructure segment, would necessarily have to be met by the bond market. With these motivating factors for development of corporate debt market and a large pool of well-informed urban population with 35 cities having 10 million population, there is a huge potential in this market for new issuers and investors. However, we need innovations in credit enhancement with the active participation of brokerage houses, retail investors *etc.*

However, while the development of corporate debt market was an opportunity, the experience of developing the G-Sec market has shown that it is a long drawn out and arduous effort which requires cooperative and collaborative efforts from not only the regulators but also from the market participants and self regulatory organisations. The players – both issuers and investors - in the corporate debt market would be varied. It was therefore important for the regulators to focus attention on protecting investors' interest by developing processes of clearing and settlement that would ensure a risk free environment. This calls for effective regulation and innovative approaches as well. One of these innovations could be conversion of loan market in to bond market of banks. Since the cash flows being similar, and loans outstanding are significant, these loans could be securitised and bonds could be issued against them. This would lead to high credit quality and reduction in overall risks.

b) Repo in Corporate Debt Papers

To facilitate the growth of corporate debt market, the Reserve Bank is actively considering introduction of repos in corporate bonds, to be settled through CCIL. Participation of corporates in repo market is also being considered positively.

c) Securitisation Market

The securitisation market has been growing at a rapid pace, particularly after the SEBI/RBI introduced regulations on the private placement in debt market. To encourage the growth of this market, the Reserve Bank excluded investments in Asset Backed Securities (ABS)/ Mortgage Backed Securities (MBS) from the 10 percent ceiling on the investment of banks in unlisted non-SLR securities. However, several issues relating to regulation, listing and improvement of liquidity need to be addressed. Most MBS/ABS are issued by Special Purpose Vehicles (SPVs) in the form of trusts which are not regulated. ABS/MBS issued by trusts cannot be listed, although these are rated. Only the securities issued by the companies can be listed. On the other hand, there is legal ambiguity on the status of the listing of ABS/MBS. Exchanges reportedly sought SEBIs clarification on the issue and it is learnt that SEBI preferred an unambiguous enabling provision in the SCRA that these mortgage backed securities can be listed. Even in the case of U.S.A., where the ABS/MBS market is very large, the regulatory process is still evolving. In fact, the SEC is proposing comprehensive new and amended rules and forms covering registration, disclosure and reporting requirements for ABS and MBS under the Securities Act of 1933 and the Securities Exchanges Act of 1934.

The Group on corporate debt market is examining the issues relating to development of securitised market in India in a comprehensive manner, including the issues relating to pricing, valuation and credit enhancements.

VI. The Road Ahead

How do we see the future? Taking a cue from Woody Allen, the American film maker who said "forecasting is difficult, particularly for the future", let me refrain from giving any futuristic scenario. Instead let me flag four issues *viz.,* (a) securitisation of state government paper; (b) FRB and its impact on the debt markets; (c) the derivatives market and (d) corporate governance and risk management.

a) Securitising State Government Paper

Promoting liquidity in state government papers is a crucial issue, especially in the context of large borrowing by the state governments under debt swap of high coupon state government loans with the government of India. The recent issue of power bonds has also added to the stock of state government paper. Against this background and in the scenario of the continued large borrowings by state governments, there is an urgent need to promote liquidity

and trading in state government papers. One way of solving this issue could be to securitise the various state government paper. Such securitising of state government paper and issuing units based on these underlying state government papers, addresses the issues of fungibility, transferability *etc.*, besides improving liquidity in state government papers, I therefore, urge the market participants to think on this issue and get back to us with comments and suggestions.

b) Fiscal Reponsibility and Budget Management (FRBM) Act and the Debt Markets

Over the last two decades, sustained budget deficits produced large issuance of government securities in India. Taking advantage of this, we were able to develop a deep and liquid government securities market. Improvements in the fiscal position in the last two years have resulted in a lower than budgeted fiscal deficit. The government has embarked on a process of fiscal consolidation through the Fiscal Responsibility and Budget Management Act through which the improvement in the fiscal position (zero revenue deficit) is projected to be achieved in the next five years. The fiscal deficit is sought to be brought down to 3.0 per cent. The achievement of these targets can be expected to lead to a significant decline in the share of government securities in the total assets of the financial system. However, after accounting for inflation and expected real GDP growth, there may not be much fall in the absolute level of net issuance of government securities in the coming years. The Indian market has been used to rising fiscal deficits and large borrowing programmes of government over the years. So we will continue to have active issuance of government paper in the foreseeable future. Banks especially have been investing in government securities much more than the statutory requirements. The Reserve Bank of India, through its monetary and credit policy statements and other fora, has been cautioning against such a substantial exposure to market risk if the yields reverse. In fact, the annual policy statement issued on May 18 reads “The movement in interest rates during 2003-04 corroborates the view that banks should, in their interest, take steps to build up investment fluctuation reserves (IFR) in a smooth and phased manner for better risk management”.

The challenge facing the Indian economy is the acceleration of the growth process. The availability of adequate infrastructure facilities is vital for the acceleration of the economic development of a country. However, the financing of infrastructure projects is a highly challenging task. Banks are hesitant to finance infrastructure projects partly because they lack the requisite skills in project appraisal and partly on consideration of asset-liability mismatches. The gap between increasing demand for financing infrastructure activity and lower budgetary support has led to a wave of deregulation and privatisation of infrastructure in a number of countries. The huge gap between investment demand and the supply of finances provides complex challenges to the different constituents of the financial system, which compel a search for alternative ways of financing these investments. With the development of an active and liquid market for securitised corporate debt, mutual funds, pension and insurance funds could also emerge as potentially large investors. Thus, in the context of infrastructure financing, the prevelance of a long-term debt market becomes critical. A vibrant debt market assumes importance in the context of providing mechanisms for greater liquidity as also for risk minimisation. In India, while equity markets have developed faster in terms of liquidity, infrastructure and regulatory framework, the debt market has lagged behind. As the fiscal consolidation process proceeds resources with financial institutions of different kinds will increasingly become available for investment in corporate debt for financing productive activities.

Third, with the decline of development finance institutions, one of the sources of finance for corporates, *viz.*, project loans has been falling. Corporates will therefore have to increasingly source their debt financing directly from the market. This underscores the importance of a transparent, deep and liquid corporate debt market. In order to promote infrastructure lending, the Governor proposed, in his Annual Policy Statement on May 18, 2004 to allow banks to raise long-term bonds with a minimum maturity of 5 years to the extent of their exposure of residual maturity of more than 5 years to the infrastructure sector. It was also proposed to expand the scope of the definition of infrastructure lending to include projects/sectors for construction in the areas of (i) agro-processing and supply of inputs to agriculture (ii) preservation and storage of processed agro-products, perishable goods such as fruits, vegetable and flowers including testing facilities for quality and (iii) educational institutions and hospitals.

All these point to the need and scope for the diversification of asset holding of the banking system in favour of corporate bonds. Several other instruments such

as ABS/MBS would also offer the scope for substantial business potential.

c) Derivatives Market

The need for a well developed interest rate derivatives market cannot be overemphasized in providing effective hedging tools for interest rate risks present in the balance sheet and in facilitating trading based on two-way view on interest rates, which is not possible in the underlying cash market in the absence of short selling. Deregulation of interest rates, which helped in making financial market operations efficient and cost effective, has brought to the fore a wide array of risks faced by market participants. To manage and control these risks, several instruments such as Forward Rate Agreements (FRA) and Interest Rate Swaps (IRS) were introduced in July 1999, which could provide effective hedges against interest rate risks. Further, in June 2003, the Reserve Bank of India had issued guidelines to banks/primary dealers/FIs for transacting in exchange traded interest rate futures, which were introduced on the exchanges. There has also been a sharp increase in the volume of transactions in the OTC products. Though there has been a significant increase in the number and amount of contracts, participation in the markets continues to remain limited mainly to select foreign and private sector banks and PDs. I would like to emphasise that the PDs are expected to be market makers in this segment. This coupled with recent modifications in the IRD features by SEBI and the expected clarification on the legality of OTC derivative is expected to give thrust to the interest rate derivatives market in India. In this connection, I would like to stress the need and importance of sound and adequate risk management practices by market participants in the derivatives market. International experience teaches us the need for greater care in handling these instruments. I would expect that the market players not only put in place an appropriate risk management policy and procedures for these products, but would also give equal importance to the skills development of their human resources to handle these instruments and to appreciate the underlying risks.

d) Risk Management and Corporate Governance

Presently, PDs measure market risk of their portfolios based on the internal VaR model and/or standardised model, while the banks are required to use a flat charge. In order to implement the BIS guidelines on measuring and managing market risk, banks have also been advised to measure their market risk in a phased manner. It is of paramount importance that market participants ensure sound and reliable risk management system to handle credit, market and operational risks. How well we guard the system against the various risks would decide the future direction of the market. I would also like to emphasise that the need for good corporate governance in all the institutions is some thing which we need to ensure in letter and spirit. I would like to quote *George Bernard Shaw* who said, *"The only man who behaved sensibly was my tailor; he took my measurement anew every time he saw me, while all the rest went on with their old measurements and expected them to fit me."* Corporate governance is conducting business in a transparent manner that meets the ever changing needs of the customers, society, regulators, investors and other stake holders.

VI. Epilogue

Development of debt market is not a one-off affair. This has to happen in a continuous way. I have tried to give you a flavour of what has been done, what could have been done and, in that light, how does future look like.

Let me conclude by submitting that while we have been able to foster the development of a deep and liquid G-Sec market in India, there are issues that need continued coordination and cooperation between the market participants and the regulators, and opportunities that offer excellent opportunities for making this a truly global debt market. We are aware of the complexities and the difficult road ahead, but are keen to approach the task with flexibility through the active involvement of market participants. Let me also wish the deliberations all success and look forward to learning from the expertise and experience of the distinguished participants.