1. INTRODUCTION

1.1. Traditionally, the capital markets in India are more synonymous with the equity markets – both on account of the common investors' preferences and the oft huge capital gains it offered – no matter what the risks involved are. The investor's preference for debt market, on the other hand, has been relatively a recent phenomenon – an outcome of the shift in the economic policy, whereby the market forces have been accorded a greater leeway in influencing the resource allocation.

1.2. In a developing economy such as India, the role of the public sector and its financial requirements need no emphasis. Growing fiscal deficits and the policy stance of "directed investment" through statutory pre emption (the statutory liquidity ratio – SLR - for banks), ensured a captive but passive market for the Government securities. Besides, participation of the Reserve Bank of India (RBI) as an investor in the Government borrowing programme (monetisation of deficits) led to a regime of financial repression. In an eventual administered interest rate regime, the asset liability mismatches pose no threat to the balance sheets of financial institutions. As a result, the banking system, which is the major holder of the Government securities portfolio, remained a dominant passive investor segment and the market remained dormant.

1.3. The *Indian Bond Market* has been traditionally dominated by the *Government securities market*. The reasons for this are (1) the high and persistent government deficit and the need to promote an efficient government securities market to finance this deficit at an optimal cost, (2) a captive market for the government securities in the form of public sector banks which are required to invest in government securities a certain per cent of deposit liabilities as per statutory requirement[1], (3) the predominance of bank lending in corporate financing and (4) regulated interest rate environment that protected the banks' balance sheets on account of their exposure to the government securities.

[1] Statutory liquidity ratio (SLR)

1.4. While these factors ensured the existence of a big Government securities market, the market was passive with the captive investors buying and holding on to the government securities till they mature. The trading activity was conspicuous by its absence.

1.5. The scenario changed with the reforms process initiated in the early nineties. The gradual deregulation of interest rates and the Government's decision to borrow through auction mechanism and at market related rates.

1.6. The move towards a market-based economy has a different dimension for resource allocation; here resources are allocated based on the risk return profiles of alternative investments instead of being guided by direct or indirect intervention of the Government. An efficient resource allocation mechanism in turn critically depends upon enabling environment that facilitates efficient asset price discovery.

1.7. The need for an efficient price discovery mechanism could be viewed from a different perspective. The fact that the monetary as well as government debt management functions are centralized in the RBI, calls for coordination between monetary and debt management policies. While the objective of the debt management policy is to reduce the cost of debt servicing in the long term, the efficacy of the monetary policy depends upon how efficiently the transmission mechanism works, the basis of which is an efficiently determined interest rates structure. On the other hand, since the sovereign paper acts as a benchmark for pricing corporate bonds, unless the prices of the former reflects its intrinsic worth, markets will not be able to price the latter. All these once again hint at the need to have an efficient price discovery mechanism.
Going by this crucial parameter viz., the system's ability to facilitate asset price discovery and thereby an efficient resource allocation, although the transformation of the debt market could be traced back to the reforms initiated in the government securities market in the late eighties and early part of the nineties, the year 1994 could be considered as a watershed for the landmark decision the Government of India has taken to put an end to the monetization of its deficits through issuance to ad hoc treasury bills to the RBI. Through this land mark decision Government chose to borrow from the market at market

related rates – thereby making the beginning of an era which allowed the markets to decide the price of money and thus the development of fixed income securities market.

1.8. Efficient price discovery cannot be contemplated independent of an appropriate market micro structure; it needs presence of liquid markets, whereby the transaction costs are minimized and the bid-ask spreads are narrowed. The development of appropriate market infrastructure also requires a supportive regulatory environment. On the other hand, any attempt at reforms also calls for a logical sequencing of the measures and a planned timeframe so that the markets move ahead with such reforms without any friction. The success story of reforms in the debt market is a testimony to the sequencing structure that the concerned authorities meticulously followed.

1.9. While that is the motivation and reasons behind the nature of the Government securities market as they exist today, the corporate debt market is still in its infancy, both in terms of market micro structure and market outcome. Traditionally, long term funding was provided by the developmental financial institutions, such as the Industrial Development Bank of India (IDBI). Ever since these development financial institutions changed themselves into banks, there has been a vacuum which logically should have facilitated the development of a debt market. However, the growth in internal resources and the equity financing averted this. Whatever resources had to be mobilized through the debt market, corporate preferred the private placement route. The absence of well developed derivatives market also hindered the development of the corporate market since there was no way both the issuers and investors could hedge their risks. Meanwhile banks, whose resource base (liabilities) are short term in nature, cannot undertake long term financing making themselves vulnerable to interest rate risk. On the other hand, the need for long term financing, given the investment needs of the infrastructure sector needs no emphasis.

1.10. The need to replace bank financing by bond financing was highlighted by the East Asian crisis, since the prevalence of bank financing was quoted as one of the reasons for the crisis. Bond financing is considered a relatively more stable source of debt

financing, as bank loans are primarily illiquid, fixed-price assets. In other words, unlike a bond, the price of the loan (the interest rate) does not change with changing interest rates. Thus, whenever there is a sharp movement in interest rates, all the adjustment has to take place by banks adjusting the quantity of lending. This leads to sharp booms and busts in bank flows.

1.11. There is thus a need to take a serious look at the issues that come in the way of developing a deep and vibrant corporate debt markets and the authorities, especially the Securities Exchange Board of India (SEBI) and the Government are trying to address the issues.