3. REFORMS IN DEBT MARKET

3.1. Government securities market

3.1.1. Abolition of tax deduction at source

Tax deduction at source (TDS) used to be major impediment to the development of the government securities market. This not only distorted the pricing mechanism, but also rendered trading in Government securities cumbersome. Recognizing this, the RBI convinced the Government to abolish it. The removal of TDS on Government securities was apparently a small but a major reform in removing pricing distortions for Government securities.

3.1.2. Introduction of auctions

The auction system introduced in a minor way in the second half of the eighties, and in a major way in the beginning of the nineties was a significant move to allow the markets to determine the prices for government securities. For such a major policy shift from administered interest rate regime to a market based regime, the choice of auction system needed to be carefully drawn, in order to give a comfort level to the government as a borrower as also to moderate the risks that might be faced by the uninitiated market participants. Accordingly, it was decided to begin with for "the sealed bid auction system with a post bid reserve price" (since the Reserve Bank of India as an agent to government participates in the auctions as a non-competitive bidder). Over a period of time, RBI withdrew from the primary market and with the enactment of Fiscal Responsibility and Budget Management Act, the government debt is being raised at market related rates through auctions.

3.1.3. Ending monetization of deficits

In 1994 and 1997, the Government of India and the RBI signed agreements whereby the regime of RBI financing the Government against the creation of ad-hoc treasury bills by the latter, was ended. The Government's bold and path-breaking decision to change its policy stance in favor of borrowing at market related rates also strategically required the continuance of the auction method described above. While even today there's an enabling provision in the auction notifications for the RBI's participation as a non-competitive bidder, the RBI's presence in the primary issuance has become few and far between and that too only to moderate those short-term interest rate volatilities which are based not on fundamental factors - and not with a motive of financing the government budgets.

3.1.4. Banks investments in Government securities valuation/accounting norms

Concomitantly, regulatory initiatives in introducing international best practices in valuation/accounting norms for the banks' investment portfolios (comprising mainly government securities) also necessitated the banks to *mark to market* their investment portfolios and forced them to actively trade. This gave an added impetus to the incipient trading activity.

3.1.5. Introduction of Primary Dealers system

Introduction of Primary Dealers (PDs) into the Government securities market brought a sea change in both the primary market (in terms of finer bidding) and secondary market (in terms of added liquidity and enhanced trading activity). In order to reduce Bank's role in the Primary Issuances the PDs were encouraged to underwrite primary issuances through incentives such as underwriting commissions. Further, to partially insulate them from volatility of the overnight interest rates (as they typically run substantially large portfolios compared to their capital base requiring them to leverage heavily) they were provided refinance facilities at favorable terms as against certain obligations on them such as price making[2] to facilitate liquidity in the market and minimum bidding commitments/success ratios to improve the quality of bidding in the primary market.

[2] A price maker is one who quotes – accordingly he keeps his the buying rates low and selling rates high; the resultant bid-ask spread is his profit. On the other side is the price taker who is worse off since he buys high and sells low

Considering the maturity PDs have attained, they are directed to depend on the markets more for their needs and less on the Reserve Bank.

3.1.6. Consolidation of stocks

In the primary market, consolidation of stocks through reopening (reissuance of stocks) served two purposes. While it enhanced the liquidity[3] in those stocks by creating critical volumes, in the absence of a when issued (foot note) market, such reopenings served as a proxy for a when issued market (since there is already a trading activity in those stocks to be reissued and hence a price). Primary issuance strategy was further finetuned towards issuance of benchmark securities to improve liquidity. Alignment of coupon payment dates for the new issuances also has been consciously attempted to promote stripping of government securities (STRIPS), which once materializes, can facilitate the establishment of zero coupon yield curve and also can take care of the segmental needs in terms of asset liability matching.

3.1.7. Zero coupon curve for pricing

To bring further improvements in the pricing mechanism, a need was felt to promote a zero coupon yield curve (ZCYC). As indicated earlier, STRIPS (Separate Trading of Registered Interest and Principal of Securities) can facilitate a ZCYC. In the meanwhile, National Stock Exchange (NSE) was the first to come out with a systematic and robust algorithm for ZCYC and it publishes a daily ZCYC based on the trade data obtained from its WDM segment. This curve is being used for pricing NSE’s interest rates futures transactions. FIMMDA/PDAI, publishes a monthly ZCYC for the market participants to value their government securities portfolios. However, the ZCYC based pricing has not been popular with the Indian market participants. The major reasons for that are as follows:

- A substantial premium for closer to par securities implies that there is significant coupon impact which nominal ZCYC algorithms can’t recognize

[3] Markets are said to be liquid if transactions can take place rapidly with little impact on prices

- A significant liquidity premier for on the run government securities means that there are parallel curves for liquid/semi liquid/illiquid government securities
- Absence of outstanding sovereign zero coupon bonds and short sales in cash markets imply that participants can't lock in the forward rates implied by the ZCYC rates rendering the creation of ZCYC curve more of a theoretical exercise.

3.1.8. Retail interest in Government securities

The retail interest in Government securities has been lukewarm mainly on account of competing small savings instruments and also due to the difficulties faced by a small investor in accessing/exiting the Government securities market. With the rationalization of interest rates on small savings instruments, some amount of parity could be brought between the returns on Government securities and small savings instruments. Further in developing and under developed economies, individuals show preference for more liquid bank deposits. Amongst the efforts to promote retail interest in government securities and thereby to widen the investor base, promotion of Gilt funds and trading of Government securities on stock exchanges are worth mentioning. However, poor liquidity in the order driven trading systems for government securities in the stock exchanges implies that much needs to be done to get the gilts to the retail investor.

3.1.9. Trading, clearing and settlement

Trading : The Bond markets world over are dominated by the OTC contracting over the telephones, although electronic trading is picking up. India is no different. Trades are predominantly bilateral involving counterparty risk or through dealer markets. Even though the Wholesale Debt Market (WDM) segment has been functioning on the National Stock Exchange for quite sometime, the platform has been used as a reporting mechanism for the negotiated deals rather than for order processing.

Informational efficiency is critical for price discovery process. From this angle, the dealer markets are non-transparent and do not provide pre and post trade transparency. Dealer markets are popularly known as quote driven. Here the dealers act as price makers, thus providing continuous liquidity. As against this, in an order driven or order matching market (known as "auction-agency markets") trades are processed through a centralized auction and agency process on a price-time priority while ensuring anonymity of counterparties. In dealer markets because the dealers have to give two way quotes, the spreads are wider considering the risk, whereas in order driven markets there are opportunities for price improvements and hence the reduced transaction costs[4]. But in the latter the there is an execution risk as the orders grow in size and the markets are not commensurately deep. On the other hand in quote driven market, there is an embedded insurance for trades, since the dealers make two way quotes in advance.

The Negotiated Dealing System (NDS) developed by the Reserve Bank was aimed at deriving the best of negotiated (NDS) and order matching (NDS-OM) systems. Quotes on NDS can be either indicative or firm. For indicative quotes negotiation takes place through the system (on the screen). Quotes can be public (where the quotes can be viewed by preferred counterparties as well as others – meant for price discovery only) or private (only for preferred counterparties). On the other hand NDS-OM follows the price/time priority and matches the trades. In effect, the NDS has done away with the brokers and brought in more transparency to the Government securities market.

NDS provides a screen based trading replacing the telephonic trades. The data availability helps price discovery and transparency. The identity of the concluding parties to the deal will not be disclosed to the market, thus mimicking an anonymous trading mechanism of an electronic trading platform. Since one of the basic objectives of NDS is dissemination of on-line price information of transactions in Government securities and money market instruments, transactions not concluded over the NDS will have to be necessarily reported through the NDS. NDS also provides an electronic bidding facility for the primary auctions of government securities.

[4] Transaction costs comprise order processing costs (all costs explicitly incurred to conclude a trade) and market impact costs (which occur because the transaction itself may change the market price of the asset)

Thus, the NDS is an extension of the exiting system with such improvements as dissemination of on-line price information and electronic trading (for which the present legal basis is the NDS bye-laws signed by the members of NDS – a firm legal backing will be in place once the new GS Act will be legislated). NDS in essence facilitates "paperless" transactions. NDS has an interface with the CCIL for settlement of transactions undertaken by members in Government securities.

Clearing : While the stock exchanges have their own clearing and settlement arrangements for the corporate/non-government securities, in the case of Government securities, RBI acting as the registrar, has been the final settlement authority. However, the RBI's SGL (Subsidiary General Ledger) account facility has been meant for an exclusive club, participant outside this club, in the Government securities market had a difficulty in transacting government securities. Extension of SGL facility to depositories such as NSDL and CDSL, along with the provision of Constituent SGL facility widened the investor base for Government securities, by allowing more participants.

The establishment of Clearing Corporation of India Ltd., (CCIL), with clearing and settlement of Government securities as one of its major functions, is expected bring about a reduction in both the processing costs and the settlement risk. CCIL derives these benefits for the members through a process of novation whereby, it stands as a central counterparty and guarantees settlement of all trades accepted for settlement and settles transactions through a multilateral netting mechanism. The multilateral netting vis-à-vis a bilateral netting system has other advantages to the counterparties in terms of reduced capital charge against the exposures and the reduced back office processing work.

Settlement : RBI has been a pioneer in the area of dematerialization of Government securities and more than 90 per cent of the holdings in Government securities are in dematerialised form. The DVP system was introduced in 1995 to address the counter party risk and is based on Model 1 of the BIS prescription – i.e., both the funds and securities are cleared on gross basis. The settlement is on T plus 0 as also T plus 1 basis.

On the stock exchanges the compression of the settlement cycle and the introduction of rolling settlement further reduced the unhealthy speculative activity and risk. Government securities are traded in the retail segment of stock exchanges on a T+3 rolling settlement basis while the settlement is up to T+2 for the WDM segment.

3.1.10. Regulatory issues.

The regulatory gaps and overlaps are gradually being sorted out through coordinated efforts from all the regulators. The High Level Committee (HLC) on Capital Markets, with representatives from the Union Finance Ministry, RBI, SEBI and IRDA was formed to delineate the powers, authorities and responsibilities of various regulators. For instance while the RBI is the regulator for the money and Government securities market amongst other things, these products when dealt with in stock exchanges are under the regulatory purview of SEBI and both the regulators have to work in tandem to promote these products.

Self Regulatory Organizations (SROs) are not in existence but the Fixed Income Money Markets and Derivatives Association (FIMMDA) and the Primary Dealers Association of India (PDAI) have taken initiatives to bring standardization to market practices and to educate the investors about the debt markets.

3.2. Corporate debt market

This segment includes Commercial Papers (CP), Certificate of Deposits (CD), corporate debentures and bonds, and the fixed income securities issued by financial institutions and local authorities. The evolution of Government securities market has an important bearing on the development of the corporate debt market, though the latter is not yet developed, for reasons stated above. The Government securities market had the benefit of unrelenting support from the Government and the RBI for obvious reasons. On the other hand, the corporate debt market did not enjoy a similar patronage. Some of the reforms in this area are as follows:

As part of the financial sector reforms, the Government in 1992 abolished the ceiling on interest rates that the erstwhile Controller of Capital Issues used to stipulate for issuance of corporate debentures.

The National Stock Exchange (NSE) started trading in debt instruments through its WDM segment in the year 1994. However, the WDM has been mostly used as a reporting platform for the deals done on the OTC (over the counter) market. The WDM segment of Bombay Stock Exchange (BSE) commenced operations in June, 2001.

The corporate debt markets in India are dominated by the non-transparent private placements. Furthermore, the private placement market is dominated by Financial Institutions, Banks and Public Sector Undertakings. In order to bring transparency to this market, SEBI mandated that the corporate bonds should be traded on the order matching screens of the stock exchanges. Alongside RBI issued instructions to the entities under its regulatory jurisdiction restricting their investment in unlisted corporate bonds.

As is evident, there is a lot more that needs to be done to attract both investors and issuers to the bond market which will be discussed in the later chapters.