Issues and challenges in the development of the debt market in India

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1. Introduction

This paper discusses the issues and dilemmas faced in the development of the debt market in India. After narrating the country context, the profile of the debt market in terms of outstanding issues, instruments and participants is highlighted along with the institutional arrangements. This is followed by an articulation of the broad objectives of development of financial markets by the Reserve Bank of India (RBI). The subsequent sections consider the important issues faced by the RBI in the simultaneous development of the debt and money markets in India, the dilemmas encountered in its role as monetary authority and debt manager, its function as regulator vis-à-vis supervisor of the banking system and its role as regulator of debt markets. The penultimate section discusses the processes adopted in the implementation of reforms in the financial markets. The last section gives the medium-term outlook for debt market reforms.

2. Country context

Until the late 1980s and early 1990s, the pattern of economic development adopted by India was essentially based on a fairly centralised approach to planning with a predominant role for the public sector. The public sector banks and financial institutions, which account for 75-80% of financial intermediation, contributed significantly to the development process, especially by way of captive investments in government securities and substantial lending to the public sector entities. Large statutory pre-emptions and borrowing from the RBI enabled the government to meet its borrowing requirements to finance large fiscal deficits. Interest rates on government debt were administered and kept below the market level. The interest rate on central bank financing, particularly through investments in Treasury bills, was concessional and debt monetisation was automatic and unrestricted. In maintaining macroeconomic stability, monetary policy had to counteract the monetary impact of such fiscal operations through successive, large increases in cash reserve and statutory liquidity requirements. Savings, mobilised through government-owned post offices, have been another major source of financing for both the federal (central) and provincial (state) governments. Interest rates were administered for all financial products, including deposits and lending operations in almost all formal and organised sectors. Exposure to external capital flows was confined to multilateral grants and loans to the government sector and, to a small extent, external commercial borrowings mainly by public or state-owned enterprises.

In such a milieu, there was little scope for development of an active government securities market. Most private industry was subject to licensing and, once licensed, it approached development financial institutions (DFIs) for debt finance. The DFIs, at both the central and state levels, had privileged access to financial resources from a captive group of investors. Working capital finance was provided by commercial banks, through an administered mechanism. Financing of agriculture and the non-corporate private sector was mainly through commercial banks and to some extent cooperative banks guided through public policy, though the informal financial sector also played an important role.

In brief, the formal financial sector was to a significant extent characterised by a large demand for funds by government or government-owned or licensed entities and supply of funds from government-owned banks, financial institutions or government-mandated institutions, while pricing of financial

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products and instruments, whether in the public or private sector, was administered. In the early 1980s, however, state-owned non-financial enterprises were permitted to access financial markets for their financing needs, mainly through bonds by way of special borrowing allocations. These bonds were essentially guaranteed by governments and generally funded by government-owned financial institutions and provident funds. Special borrowing allocations were discontinued in the mid-1990s.

The development of the debt market in India was led by the need for the government to raise increased amounts from the market, the encouragement given to financial institutions and corporations to raise funds from a competitive market without any specific borrowing allocations, the need for long-term infrastructure financing and the importance of a liquid debt market in promoting these objectives. Above all, the healthy development of the financial sector in a liberalised and competitive environment is considered an essential prerequisite for capital account liberalisation as it promotes global intermediation and risk-sharing in a more efficient manner.

In order to develop debt markets in an orderly fashion, as an initial condition for efficient price discovery, it was necessary to move away from administered interest rates. This, along with the reduced reliance by government on high statutory pre-emption of banks' resources and automatic monetisation of the deficit by the RBI, were two major areas of focus of reforms in the early 1990s. An important development was the move to an auction system for issuing government securities, which paved the way for market-related interest rates in the government securities market. This enabled the emergence of a risk-free yield curve providing a basis for pricing of other debt securities. The Statutory Liquidity Ratio was reduced to its statutorily prescribed minimum level of 25% in October 1997. The cash reserve ratio, which had reached an effective high of about 16.5%, has been reduced to the current level of 5.5%, close to the statutorily prescribed minimum of 3%. Another significant development has been the elimination of the practice of automatic monetisation of the central government's budget deficit through ad hoc T-bills with effect from April 1997 and the introduction of a new scheme of Ways and Means Advances (a limited financing facility available to central and state governments from the RBI to bridge the temporary mismatches in cash flows). In the 1990s, several other measures were taken by the RBI to create an enabling environment for market development. Prudential norms have been introduced in line with international best practices, banking supervision has been strengthened, transparency and disclosure standards enhanced to meet international standards and risk management practices have been prescribed. In the external sector, capital flows, especially direct and portfolio equity flows, were encouraged, and the exchange rate regime became market-driven with capital controls retained only on external debt and resident outflows. In the real sector, the reforms involved removing/lowering trade and tariff barriers, dismantling industrial licensing and administered prices and opening up the economy to international competition.

In brief, the policy for the development of debt markets has been devised and is being implemented over a period with enabling policies in several related sectors, mainly, though not exclusively, in the financial sector. Given the need to increase the depth in money and government securities markets (so as to improve the transmission channel of monetary policy through indirect instruments), a major focus of the RBI has been on the development of these markets, along with attention to orderly development of the foreign exchange market.

3. The debt market and its institutional arrangements

There are three main segments of the debt market in India: government securities, public sector unit (PSU) bonds and private corporate securities. The market for government securities comprises the central government securities such as T-bills and state government securities. The PSU bonds are generally treated as surrogates for sovereign paper, sometimes due to explicit guarantees and often due to the comfort of public ownership. Some of the PSU bonds are tax-free, unlike most other bonds, including government securities. Private corporate securities include corporate bonds and debentures, which are mostly medium-term papers with maturities up to seven years, and commercial paper, which is a short-term corporate debt instrument with maturities from 15 days to one year. The money market overlaps with the debt market inasmuch as T-bills and other short-term debt papers with maturities up to one year form an integral part of the money market.

The government securities market is the overwhelming part of the overall debt market in terms of both outstanding securities and trading volumes. Nearly 80% of the INR 7,500 billion of outstanding debt securities as at end-March 2001 was accounted for by government securities. Their yields serve as a

benchmark for the financial markets and the RBI increasingly uses them for open market operations. The maturity period of government bonds goes up to 25 years, the average maturity being around eight years. The major investors in government securities are banks, non-bank financial intermediaries, insurance companies, mutual funds and provident funds.

About INR 2,000 billion of corporate bonds are outstanding, with the major issuers being public financial institutions, public sector undertakings and corporations. The maturity period of corporate bonds varies from one to 10 years. To improve the quality of debt issues, all publicly issued debt instruments are required to be rated. The role of trustees in bond and debenture issues has also been strengthened. At present, almost 80% of issues in the non-government debt market are privately placed. Stringent entry and disclosure norms for public issues coupled with lower cost of issuance, ease of structuring instruments and faster procedures have led to the growth of the private placement market in recent years. A significant number of corporate debentures in India are hybrids combining features of both debt and equity. They are liquid and often have floating rates of interest. Government securities are almost entirely held in dematerialised form. While the secondary market activities are subdued, efforts towards dematerialisation since 2000 are seeing increases in turnover.

In the initial years of reform, with the objective of building up institutional and market microstructure, the RBI promoted institutions, inter alia, for developing the money and government securities markets. The philosophy of the RBI has been to promote institutions and then divest its holdings as the markets matured, the strategy being to avoid the problem of moral hazard of the lender of last resort and the conflict between ownership and regulation and supervision. In the process, it promoted the Discount and Finance House of India, to develop the money and T-bills markets, and the Securities Trading Corporation of India, mainly to develop the secondary market for government securities. Over the years, as markets reached progressively higher stages of development, the RBI divested most of its holdings in these institutions. A small portion of equity holdings in these institutions, along with holdings in similar institutions in the financial sector, are still in the process of being divested.

The system of primary dealers (PDs) in government securities was instituted in the mid-1990s, adapting to India's situation similar structures in advanced financial markets to widen and deepen the markets. Primary dealers have been playing an important role in the absorption of government securities in primary issues and providing two-way quotes in secondary markets. PDs underwrite primary issuances of government securities, for which they are paid an underwriting commission. They have bidding commitments and success ratio specifications in the dated securities and T-bills market. To enable them to fulfil these obligations, they have almost assured access to the RBI's Liquidity Adjustment Facility (LAF) and may participate in the inter-bank call money market. Given the requirements of a huge borrowing programme and the need to ensure liquidity and two-way prices in the secondary markets (no short sales are permitted) the PDs continue to enjoy a privileged role. Support to entities such as PDs in the early stage of market development had to be juxtaposed with the need to prevent undue risks being taken by such entities due to the assurance of continued support from the central bank. Capital adequacy for credit and market risks is prescribed for the PDs and monitored closely. As the markets develop, the special standing facilities of assured liquidity at predetermined interest rates for PDs will need to be replaced by market-related supports. PDs, however, would retain their status as principal participants in the primary market and market-makers in the secondary market for government securities.

A system of satellite dealers was simultaneously promoted with the main objective of retailing government securities. Since the system has not been functioning effectively, following a recent review an in-principle decision was taken to eliminate this tier.

More recently, the RBI has initiated measures to set up an electronic trading system and has actively catalysed the setting-up of a Clearing Corporation (CCIL) to act as a central counterparty for more efficient clearing and settlement of transactions in money, forex and government securities markets, including the repos market. CCIL became operational in February 2002. In this case, in view of the maturity already attained in the financial system, the RBI decided to depart from its previous practices, and not to directly promote the CCIL or even hold a minority share so as to avoid even any remote implications of an implicit guarantee by the central bank.

4. The Reserve Bank of India and financial markets

The primary interest of the RBI in the development of financial markets, especially the money and government securities markets, arises out of their critical role in the transmission of monetary policy, especially with the move towards reliance on indirect instruments. The money market is the focal point for the payment and settlement system and the equilibrating mechanism for short-term liquidity flows, with greater linkages with the foreign exchange market. Globalisation requires efficient market integration, in particular of money and foreign exchange markets. The government securities market becomes the focal point for the entire debt market due to the following considerations:

- it is the largest debt market and the fiscal deficit continues to be fairly high,
- it serves as a benchmark for pricing in other debt markets, and
- it provides an efficient transmission channel for monetary policy.

Several initiatives towards the development of money and government securities markets in the 1990s, and especially since 1997, have taken them into a high growth trajectory in terms of depth, liquidity, turnover, participants, instruments, etc. These initiatives have assisted large government borrowings, besides contributing to increasing depth in other debt market segments in recent years.

The growth in the government securities market, however, has perhaps not been adequately reflected in the depth of the market as the main investors continue to be commercial banks, insurance companies and provident funds. Consequently, the retail segment of the market has not developed. At present, many non-bank finance companies and urban cooperative banks are required by law to maintain a certain portion of their deposits in government securities. Although the government's market borrowing programme each year exceeds the requirements of the statutory pre-emptions of institutions, the above institutions are experiencing difficulties in acquiring government securities because of an inadequate distribution mechanism. In order to facilitate this mid-retail segment, a scheme for non-competitive bidding up to a certain proportion within the notified amount has been introduced. Specialised gilt funds have been promoted to provide the ideal vehicle for small retail investors. With the commencement of the CCIL and the national dealing system in February 2002, the technological infrastructure has been in place to facilitate large-scale nationwide retailing.

The RBI is both debt manager and regulator, and the current challenge is to evolve mechanisms by which it encourages the development of the debt market while at the same time crafting appropriate roles as manager of public debt. In that process, the RBI faces challenges, issues and often dilemmas in ensuring the transition process is smooth, stable and less vulnerable to problems such as moral hazard, conflicts of interest and regulatory forbearance and arbitrages. An attempt is made here to trace such issues and experiences.

5. The money market vis-à-vis the debt market

A well functioning money market is critical for the development of the debt market. In addition to the importance of the money market for equilibrating liquidity flows among surplus and deficit units, it is also important for the development of the debt market because it prices liquidity through an inter-bank short-term yield curve. Widening and deepening of the money market received an impetus in the late 1980s after the Chakravarthy and Vaghul Committee reports. An integrated approach to market development initiated in early 1997 encompassing money, government securities and foreign exchange markets provided the impetus for the money market to become a critical vehicle in the transmission channel of monetary policy. Measures relate to phasing out quantitative restrictions and prescriptions and increasingly relating risk-taking to capital, easing barriers to entry and exit, broadening the base of the market in terms of participants to include non-banking entities, and refining available instruments (certificate of deposits, commercial paper, money market mutual funds, T-bills). The debt market in general has developed in sophistication with appropriate regulatory safeguards, such as a delivery versus payment system, improvements in accounting, valuation and disclosure norms, and trading in dematerialised form.

The medium-term objective is to make the call/term money market purely interbank, including primary dealers, while non-bank participants, who are not subject to reserve or other major regulatory requirements, could have free access to other money market instruments and operate through repos

in a variety of debt instruments. The completion of documentation and certain other operational details with regard to repos is critical to keeping up with the announced time schedule and the final phase-out will coincide with the implementation of the real-time gross settlement system (RTGS). The RBI is actively encouraging the market through the Fixed Income Money Market and Derivatives Association of India to prepare the documentation on the lines of the International Swaps and Derivatives Association but to suit the unique circumstances of the Indian market. Introduction of the Liquidity Adjustment Facility has been one of the significant steps in the money market in recent times. It has given the RBI the necessary flexibility for liquidity operations as well as signaling interest rates in the short-term money market. The LAF operations combined with strategic open market operations consistent with market liquidity conditions have evolved as the principal operating procedure of monetary policy of the RBI. Bank Rate remains the principal signaling instrument of the RBI, providing directional guidance, to the extent feasible, to the general level of interest rates. The LAF rates operate around the Bank Rate, with a flexible corridor, as a more active operating instrument for day-to-day liquidity management and steering short-term interest rates. A market for interest rate swaps and forward rate agreements as hedging instruments is growing, although further depth in volume and operations would be desirable.

The absence of a benchmark in terms of an interbank term money market yield curve has been a shortcoming in the Indian money market. A number of measures have been taken over the years, including greater interest rate flexibility for banks, exemption of interbank deposits from cash reserve requirements, reduction in the minimum maturity of deposits, and the phasing-out of non-bank participants from the call money market. The new LAF procedures coupled with discontinuance of assured liquidity support through standing facilities and a reduction in cash reserve requirements are expected to pave the way for banks to take slightly longer positions than overnight or a fortnight and create a robust interbank term money market curve as in advanced financial markets. This is particularly vital to integrating the money and foreign exchange markets.

6. Monetary versus debt management: challenges

The major dilemma has been that, given the huge fiscal deficit and large capital flows, arresting volatility in markets and maintaining macroeconomic stability calls for close coordination between monetary and debt management, with due consideration of both short-term requirements and the need for reform in the medium term. The challenge has been to move over gradually to an environment where the RBI divests its function as a debt manager and will operate only in the secondary market for government securities.

Given the size of the government deficit, debt management policy aims at completing government borrowing in a cost-effective manner and enabling smooth recycling of debt with an appropriate maturity structure. The RBI currently executes the gross borrowing programme, decides the maturity of debt, type of instruments, method of issue and timing of issue of all marketable debt of the government, participates as a non-competitive bidder in all the auctions, subscribes to fixed coupon flotations when necessary, and accepts primary issues on a private placement basis at coupons/prices determined by it.

Combining the roles of monetary management and debt management, the RBI endeavours to balance the objectives in a manner that ensures completion of government borrowing without undue pressure on interest rates but, at the same time, the monetary policy goals of price stability and flow of credit to productive sectors are adequately met. However, there are inherent conflicts in playing this dual role.

Conflicts arose in the pre-reform period since a large part of the deficit was automatically monetised, and the excessive monetisation was reversed by hikes in the cash reserve ratio and SLR and administered interest rate and credit controls. As government borrowing was at below market rates and from captive groups of investors, the government securities market remained totally dormant, rendering indirect instruments of monetary control irrelevant. The active debt management policy pursued during the post-reform period since 1992 has mostly alleviated the fundamental conflicts.

Recently, as the economy has opened up and capital flows begin to dominate, the RBI has had to manage such flows and moderate their impact on the foreign exchange market through both direct interventions and monetary measures. Use of monetary measures, however, implies that there could be a sharp rise in yields on government securities which imposes undue pressure not only on the

interest cost for government but also across the system, as these yields are increasingly becoming the market benchmarks. Where it is perceived that such tightening is temporary, until conditions normalise, the RBI has had to resort to devolvement and private placement of government debt and appropriate open market operations and liquidity management techniques so as to stabilise the interest rates in the entire system. On such occasions, the RBI has also at times "talked down" volatilities in exchange or interest rates through press statements. For example, in June 1998 the RBI announced its readiness to sell foreign exchange to meet supply-demand mismatches. In May 2000, it indicated its readiness to meet foreign exchange requirements on account of crude oil imports and government debt service payments. After the 11 September 2001 events, it announced that it did not intend to shift its monetary policy stance of keeping interest rates stable with adequate liquidity.

The coordination between monetary and fiscal policy is desirable, but it is also important that the monetary authority is not burdened with functions that may conflict with its specific mandate. The RBI is the debt manager for both the central and state governments. So far, management of the liquidity and interest rates in the context of large government borrowings has necessitated the RBI's participation in the primary market through private placement as well as devolvement and subsequent unloading of securities through open market operations when liquidity conditions are favourable. With the opening-up of the economy, monetisation of the deficit has to be weighed against the monetary impact of capital flows and the liquidity needs of the commercial sector. Against this background, separation of debt management from monetary management has, therefore, been proposed. The existing statute makes it mandatory that the debt management function is undertaken by the RBI. In the monetary policy statement of April 2001, the RBI acknowledged that although it is desirable in principle, separation of the debt and monetary management functions is a medium-term process that is dependent on the fulfilment of three conditions; development of financial markets, reasonable control over the fiscal deficit, and necessary legislative changes.

7. Challenges in liquidity management

The major dilemma relates to ensuring adequate liquidity in the context of developing the government securities market, given the continued high fiscal deficit, fiscal slippages, large ways and means advances and capital flows, all of which affect liquidity management. While monetisation of the government deficit could provide primary liquidity to the market, liquidity creation could also take place through other channels, such as the central bank enlarging its holding of foreign currency assets, expanding its lending to the commercial sector, and conducting open market operations divested from the government's budgetary considerations.

Liquidity in the government securities market, especially in the short-term T-bill market, is of critical importance in the move towards indirect instruments of monetary policy. The secondary market in government securities is quite active with annual turnover of four times the outstanding stock of securities. The repo market is growing in volume and the number of participants and variety of instruments are increasing, except in the overnight call market. However, the short-term yield curve is yet to emerge. There are several reasons for this. There are large unpredictable and volatile government cash flows which are accommodated by a standing Ways and Means Advances facility from the RBI and a system of cash credit for withdrawals requires banks to be prepared for large and sudden deposits or withdrawals by large corporate customers. A system of short-term asset/liability management is yet to be fully developed in terms of monitoring and adherence to the tolerable levels of mismatches. Finally, there is a continued orientation towards longer-term fixed rate products. Even the repo market is mostly on an overnight basis and there are few longer-term repos. Term money volumes are also much smaller than for overnight money. Measures such as longer-term repos by the RBI have been introduced to develop the short-term yield curve. The constraints faced are also related to more active management of cash and debt by the government agencies, public sector bodies and corporates.

The development of the repo market, on sound lines with transparency and DvP, facilitated the introduction of the LAF in 2000. It has become the most important tool for management of short-term liquidity and facilitating the transmission mechanism from the short end of the term structure to the longer end and to other debt instruments, which use the short-term rates as a benchmark. The replacement of the RBI's standing facilities with assured rates by using the LAF for absorbing/injecting short-term liquidity will further ensure the efficacy of targeting short term interest rates.

While recognising that intervention in the price discovery process can distort and stunt the development of markets, during the transition period from completely administered rates to market-determined rates, the RBI has had to consciously moderate sharp movements in yields that could emerge in the auctions by accepting devolvement wherever felt necessary. This is necessary as the markets are still developing and large segments of savers and investors do not participate in the debt markets. On some occasions, either due to sudden, large increases in the government's requirements or sharp volatility in other markets such as foreign exchange markets, part of the government's borrowing needs to be absorbed through private placement with the RBI and the securities subsequently offloaded through open market operations when conditions are more conducive. This is essentially a intra-year smoothing process for managing liquidity and avoiding too sharp a movement in yields.

The events of 11 September 2001 have clearly demonstrated the need to ensure liquidity in the markets to arrest undue volatilities. The RBI stepped in to provide liquidity to the market across the spectrum of the yield curve without taking on the role of a market-maker itself. The operations were gradual, in a phased manner and through auctions appropriately pricing securities in tune with the market bids.

Developing deep and liquid secondary markets in government securities has been the main objective of the RBI in the recent period. To that end, the RBI has initiated legal, regulatory and taxation reform, infrastructure and technology improvement, safe settlement systems, and market dissemination of information on all trades in the wholesale market. It also improved methods of issuance such as reopenings and price-based auctions thereby improving fungibility, introduced derivatives such as interest rate swaps and enlarged the repo markets. Liquidity support facilities to the primary dealers and timely open market operations have also been felt necessary to prevent the drying-up of liquidity in the secondary markets. In all these areas, the dilemmas have been resolved through a phased sequencing towards a clear ultimate objective.

8. Bank regulation and supervision and debt markets: dilemmas

Major policy issues in this regard relate to valuation norms for debt instruments, putting in place asset liability management, insisting on sophisticated risk identification and measurement systems, enabling a liquid secondary market for central and state government securities as well as non-government debt, etc. Given the SLR requirements and the current preference of banks to hold government debt, the maturity profile of new debt issues is carefully calibrated, allowing for the asset-liability mismatches of banks on account of long-dated debt instruments and the related interest rate risk, the bunching of maturities and the preferences of other players such as insurance companies and provident funds. In fact, with the progress achieved in the money market and T-bill market, it has been possible to evolve a credible benchmark rate facilitating launch of a floating rate government bond linked to the 364-day T-bill.

The Indian banking system's assets and liabilities are still largely based on original contractual obligations and by and large are not securitised. This is particularly so on the liabilities side; the most important funding source is deposits from households. On the assets side, the investment portfolio (government and non-government debt), which is becoming more dominant, accounts for almost half of total assets. The regulatory and supervisory reforms in the initial stages focused more on credit risk and on the prudential recognition of income, classification of loans and adequate provisioning in line with international norms.

Regarding investments in government securities, the initial concern was to recognise in a phased manner the marked-to-market (MTM) losses on the earlier investments acquired at low and below market yields. This was achieved in a gradual manner by making it mandatory for banks to MTM initially 40% of their investment portfolio (1994), with the proportion raised in stages to 75%. This is consistent with the move towards international best practices. Banks now divide their investments into three categories; core (those held to maturity), available for sale, and held for trading. Banks are permitted to classify up to 25% of their investments in the "held to maturity" category, which is exempt from the MTM requirement. The unrealised gains on the "available for sale" category is not recognised while depreciation is provided for. This move to MTM has enabled banks to be more active in managing their investment portfolio. Currently, banks are holding almost 35% of their assets in government securities.

The concern of the authorities has now turned to the liquidity and market risks of these investments, especially as interest rate movements are more volatile, particularly in response to external factors. The interest rate risk, however, is a matter of concern as most of the banks' liabilities are short-term (up to three years) while the duration of their government securities is increasing because of the elongation of the maturity profile of government debt. The LAF has minimised the liquidity risk on these assets. Banks are being sensitised to the need for building up investment fluctuation reserves to guard against adverse movements in interest rates. Interest rate swaps are permitted, but are yet to take off in the longer-term segment. STRIPS are being introduced and are expected to enable banks to undertake better asset/liability management. Other hedging instruments such as interest rate futures and options are being examined for their market, regulatory and policy implications. Sensitisation of the boards of banks to best practices in risk management has been accorded a high priority.

The corporate bond market has grown over the years and currently accounts for about 15% of banks' assets. In the corporate bond segment, the RBI's concern, as a supervisor, has been the large number of private placements/unlisted bonds where the disclosure and documentation standards may be less than satisfactory. As the major investors in such bonds are banks and financial institutions, the RBI has taken an active interest in introducing uniform and prudential norms for their classification and valuation. This has led to better disclosure, requiring the boards of the banks to have a conscious policy of limiting their investments in unrated and unlisted bonds and taking suitable risk containment measures. A major dilemma faced in the reform of this market was that, with the Securities and Exchange Board of India (SEBI) being the regulator for corporate bonds, and in view of certain legislative constraints, the RBI preferred the route of directing major investors such as banks and financial institutions under its supervisory framework to invest and hold commercial paper, bonds and debentures only in dematerialised form. This directive has brought about the necessary transparency and enabled monitoring of privately placed and unlisted debt instruments. As recently as October 2001, the RBI followed this up with comprehensive guidelines on investments by banks and financial institutions in the private placement market for debt instruments.

The availability of sovereign guarantees, especially at the state level, has also facilitated the issuance of large amount of bonds where due diligence may not be sufficiently exercised. This is an area where the RBI has been cautioning the state governments about the need for fixing a ceiling on guarantees and also cautioning the banks and the financial institutions about the need for proper appraisal and monitoring of projects especially in the infrastructure sector. Given the sensitivity of political leadership at the state level, the RBI appointed a committee of state finance secretaries, which recommended the imposition of a legislative ceiling on guarantees. Further, the demonstration effect of a few state governments imposing limits on guarantees has been felt by many other states.

9. The Reserve Bank of India as a regulator of debt markets: dilemmas

The regulatory responsibility for the securities market is vested in an overlapping manner among the RBI, SEBI, Department of Company Affairs, Department of Economic Affairs and the Ministry of Finance. The regulatory jurisdiction between the RBI and SEBI was clarified by an amendment to the Securities Contract Regulation Act in 2000 which gave RBI the regulatory jurisdiction over the money and government securities markets and SEBI jurisdiction over the corporate debt markets.

With the increasing integration of the financial markets, there are more instances of the same participants coming under the purview of multiple regulatory bodies. These features have raised the potential for regulatory gaps and overlaps, thereby underpinning the need for greater coordination among various regulators. A major dilemma here is between regulating entities and regulating activities. Major entities in the government securities markets such as the insurance companies, the mutual funds and the provident funds are outside the regulatory purview of the RBI, although it is the regulator of the government securities market. Stock exchanges on which government securities could be traded are under the purview of SEBI. On the other hand, there is a regulatory gap as regards the private placement of debt. Coordination mechanisms are required for resolving these dilemmas. Any move to regulate the private placements market has to be made with minimum impact on the balance sheets of banks and financial institutions and the transition should be gradual. At present, formal consultations among domestic regulators are undertaken through the High-Level Committee on Capital Markets comprising the RBI, SEBI, the insurance regulator and the Finance Ministry.

In the context of the work relating to international financial standards and codes, an Advisory Group on Securities Market Regulation has evaluated the existing regulatory framework using the principles laid down by the International Organisation of Securities Commissions and pointed out important issues and lacunae that need to be addressed. Some of these issues relate to giving legal status to the HLCCM constituting self-regulatory organisations (SROs) for mutual funds, giving necessary enforcement powers to regulatory bodies under Securities Commission and Regulatory Authority, etc.

While the RBI promotes, recognises, encourages and interacts closely with SROs such as Primary Dealers Association and Fixed Income Money Market and Derivatives Association for purposes of evolving best practices, it does not provide them with delegated regulatory functions, since they are rightly not recognised as an integral part of the regulatory process under the umbrella of a regulatory system. Another dilemma was whether RBI should be actively involved in boards of institutions such as Clearing Corporation Ltd. The issue was resolved by keeping RBI as a special invitee.

Contract enforcement has been another area in need of special attention. Outdated laws and legal procedures not only create uncertainties for the lenders but also lead to higher costs for the borrower. Laws on stamp duty, registration of assets and taxation would impose additional costs to the system and there is a need to rationalise these in terms of the benefits on account of revenue generation vis-à-vis the costs to the financial system in terms of higher transaction costs and market inefficiency. The debt markets would no doubt benefit from securitisation of debt. While some headway has been made with regard to mortgage securitisation, a number of legislative measures are required and have duly been suggested to the government.

10. Implementation processes in financial markets reform

The general approach to financial sector reform in India is a transparent, collaborative and consultative process which helps resolve very many possible dilemmas. The reform process itself is characterised by caution with a tilt towards preserving stability, careful sequencing of measures, mutually reinforcing monetary measures and ensuring consistency and complementarity with other policies. Further, reform in this market has always been undertaken within the overall monetary policy framework and is coordinated with reforms in money and foreign exchange markets. Many of the major reforms have been implemented in phases, allowing for transition so as not to destabilise market conditions or any group of participants or the financial system in general.

The entire process of structural reform has been facilitated through a collaborative approach imparting transparency of intentions. Before finalising important policy changes, especially on operational aspects, draft guidelines are circulated as consultative papers to market participants and their comments are given due consideration before issuing final guidelines. The RBI and the government have closely coordinated on all major issues. At an overall policy level, this involves, inter alia, legislative changes and regulatory coordination. A working group on cash and debt management consisting of senior officials from the RBI and the government helps the process of consultation in the management of government debt. In fact, the RBI has initiated a process of periodical meetings with state finance secretaries which has helped treasury management as well as debt management operations at the state level. A formal consultative mechanism with market participants established by the RBI through the Technical Advisory Committee on Money and Government Securities Markets ensures technical discussions on important proposed policy and operational changes. The Technical Advisory Committee also appoints working groups from time to time to examine more closely the technical and analytical details of policy proposals. This Committee has representation across the spectrum of the financial market. The RBI also holds separate consultations with the Primary Dealers' Association on important issues concerning the money and government securities markets. At an operating level, there is a Financial Markets Committee in the RBI that is responsible for guiding day-to-day management of market liquidity.

At the same time, in the actual announcement of monetary measures or open market operations, or changes through repos affecting prices or sentiment in financial markets, an element of surprise has been invoked as appropriate. In fact, in the face of considerable uncertainties in the domestic and international financial markets, several unorthodox measures have been adopted. However, in all cases, the framework of uncertainties and the logic of actions, including the dilemmas faced, have been articulated, either at the time or in later policy announcements.

Coordination with SEBI is ensured both at a policy level and at operational level. In particular, at a policy level coordination is ensured through a High-Level Committee on Capital Markets presided over by the RBI Governor, and at an operational level through a technical group of officials, both of which include nominees of the Ministry of Finance. International best practices are constantly reviewed in interdepartmental working groups within the RBI before designing and implementing changes. In all these processes, the interests of investors and intermediaries are kept in view and these include a liquid market to facilitate easy entry and exit, tools for hedging, transparency in operations, an efficient settlement system, an enabling legal environment, and a clear and simple, but robust, regulatory framework. Development of technological infrastructure is at present being given the highest priority to facilitate these objectives.

11. Outlook

The outlook for developing debt markets depends on the pace of the following reforms:

- Further improvements in the money market with the call money market being a pure interbank market, and the CCIL, NDS and RTGS firmly in place. It may be possible to achieve this in about two years.
- The market for government securities having a greater retail base and being more transparent, efficient and liquid with CCIL, NDS, PDO computerisation and RTGS in place, in the next two to three years.
- Separation of the debt management function from the monetary authority, conditional on the passage of the Fiscal Responsibility and Budget Management Bill in parliament. The separation is possible in the next three to five years, assuming improvements in the overall fiscal situation.
- The regulation of debt markets coming under a single regulator like SEBI. The RBI would then be essentially regulating the money market. At that point of time, enabling legislative amendments would be required.
- No firm policy decision on the separation of banking supervision from the RBI is envisaged in the foreseeable future. The choice between single and multiple regulator is a larger issue and an appropriate model will have to evolve over a period.
- Further steps in capital account liberalisation will depend on the efficiency of the banking sector and the health of financial markets. With the reforms envisaged fully in place, conditions in the financial sector should eventually be suitable for opening up the capital account, though currently a definitive time frame cannot be visualised.

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