Y V Reddy: Developing debt markets in India – review and prospects

Remarks by Dr Y V Reddy, Governor of the Reserve Bank of India, at a meeting of Central Bank Governors of Asia, Latin America and the Caribbean, Washington DC, 18 October 2007.

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Governor Julio Velarde and fellow Governors,

I am thankful to Governor Amando for giving me this opportunity to participate in the meeting of Central Bank Governors of Asia, Latin America and the Caribbean.

I am conscious of the fact that the conditions prevalent in our economies are varied, and yet the sharing of country experiences provides us valuable insights into the effectiveness of public policy as well as the functioning of financial markets.

The debt-market in India comprises of two segments, namely, government securities market and corporate debt market, but the size of the latter is currently very small, at about 14 per cent of the total debt market. This is reflective of both, the relatively high recurrent fiscal deficits and the underdeveloped status of the corporate debt market.

Foreign Institutional Investors (FIIs) are allowed to invest in the Indian debt markets subject to quantitative limits that are reviewed on an ongoing basis. Currently the ceiling is USD 2.6 billion[1] in government securities and USD 1.5 billion in corporate bonds. The access provided to the FIIs in the debt market is to facilitate liquidity management arising from their operations in the equity market since they have liberal access to equity markets in India. The sovereign has not issued any foreign currency denominated bonds.

Development of government securities market

Before the 1990s,the government securities market was characterised by administered interest rates, high Statutory Liquidity Ratio (SLR) requirements that led to the existence of captive investors in banks, and the absence of a liquid and transparent secondary market. The coupon rates offered on government securities were not market related.

Reforms in the government securities (G-Sec) market were undertaken as a part of the overall structural reform process that was initiated in 1991-92 and were aimed at redressing many of these infirmities. There are broad discernible phases before the recent initiatives in the development of the G-Sec market in India. The early initiatives in the reform of the G-Sec market were aimed at creating an enabling policy environment and included (i) the elimination of automatic monetisation; (ii) transition to market-related interest rates and (iii) reduction in SLR requirement to the then statutory minimum level of 25 per cent.

The second phase of reforms in the G-Sec market was directed towards institutional development to enhance market activity, settlement and safety. These reforms included (i) establishment of a Delivery versus Payment system, to reduce settlement risk; (ii) institution of the system of Primary Dealers (PDs), and (iii) formation of market bodies such as Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI). Instrument persification was also seriously attempted during this phase of reforms. Prior to the 1990s, most of the government bond issuances were in the form of plain vanilla, fixed coupon securities. In order to meet the perse funding and hedging needs of participants, various types of instruments such as zero coupon bonds, capital

[1] RBI has already announced enhancement of this limit to USD 3.2 billion. SEBI is in the process of notifying the same.

indexed bonds, floating rate bonds and bonds with call and put options, were introduced. Floating Rate Bonds (FRBs) introduced during this phase did not evoke much response. Capital Indexed bonds (CIB) were first issued in 1997 but there were no further issuances mainly due to the lack of an enthusiastic response from the market participants, both in primary and secondary markets. Hence, plain vanilla bonds continue to be predominant in the issuances of government securities.

The third phase of reforms in the G-Sec market is aimed at enhancing liquidity and efficiency. Some of the important initiatives that were taken during this phase are: (a) introduction of repo/reverse repo operations in government securities to facilitate participants to manage short-term liquidity mismatches; (b) operationalisation of the Negotiated Dealing System (NDS), an automated electronic trading platform; (c) establishment of the Clearing Corporation of India Limited (CCIL) for providing an efficient and guaranteed settlement platform; (d) introduction of trading of G-secs in stock exchanges; (e) introduction of OTC and exchange-traded derivatives to facilitate hedging of interest rate risk; (f) introduction of Real Time Gross Settlement System (RTGS) which addresses settlement risk and facilitates liquidity management; (g) adoption of a modified Delivery-versus-Payment mode of settlement which provides for net settlement of both funds and securities legs; and (h) announcement of an indicative auction calendar for Treasury Bills and dated securities.

Recent initiatives

Several initiatives have been taken in recent years. First, initiatives have been taken to widen the investor base for the government securities. Traditionally, commercial banks and insurance companies have been the largest holders of government securities. Major part of the holdings of these investors is generally in the nature of statutorily mandated investments. The entry of mutual funds and non-banking finance companies in recent years has broadened the base. In addition, the entry of 100 per cent Gilt Mutual Funds has broadened the potential for retail investor base. To enable small and medium sized investors to participate in the primary auction of government securities, a “Scheme of Non Competitive Bidding” was introduced in January 2002, which is open to any person including firms, companies, corporate bodies, institutions, provident funds, trusts, and any other entity prescribed by RBI. The scheme provides for allocation of up to 5 per cent of the notified amount at the weighted average rate of accepted bids.

With a view to further promoting liquidity in the secondary market and to strengthen the emergence of a benchmark yield curve across maturities, re-issuances of benchmark securities have been in place for quite some time. In furtherance of the objective, a scheme of active consolidation of government securities through buy-backs was finalized. This is expected to be implemented during the current financial year.

The settlement system for transactions in government securities was standardised to T+1 cycle with a view to provide the participants with more processing time at their disposal and therefore, to enable better management of both funds as well as risk.

In order to provide banks and other institutions with a more advanced and more efficient trading platform, an anonymous order matching trading platform (NDS-OM) was introduced. The NDS-OM is an additional facility available to the participants and the participants continue to have the option of using the current telephone-trading platform. The settlements of both types of transactions are, however, integrated.

Recently, in 2006, short sale was permitted in dated government securities to provide an opportunity to market participants to manage their interest rate risk more effectively. This measure is expected to further improve liquidity in the secondary market. “When issued” (WI) trading in Central government securities was also introduced in 2006. This is expected to contribute significantly to distributional efficiency in primary issuance, in addition to permitting PDs to manage their auction risk more effectively.

There is a fairly active interest rate derivative market in India. The market started with RBI permitting interest rate swaps and forward rate agreements (IRS/FRA) in 1999. Average daily volumes in IRS are about two times that in the government securities market. A reporting platform for OTC derivatives has been set up recently. This will enhance transparency and price discovery in the market. Interest rate Futures were permitted in 2003 but has not taken off. RBI has now constituted a Group to suggest measures to activate the interest rate futures market.

Current status of government securities market

As a result of the gradual reform process undertaken over the years, the Indian G-Sec market has now become increasingly broad-based, characterised by an efficient auction process, an active secondary market and a fairly liquid yield curve up to 30 years. An active Primary Dealer (PD) system and electronic trading and settlement technology that ensure safe settlement with Straight Through Processing (STP) and central counterparty guarantee support the market now.

The outstanding stock of G-Secs is about fourteen times the level in 1992. Outstanding stock of G-Secs as a ratio to GDP has nearly doubled to around 26 per cent over this period. Annual turnover of G-Secs has been placed at nearly 300 per cent of GDP in recent years as against 34 per cent in 1996.

The weighted average maturity of outstanding stock has increased consistently from 6.5 years in 1997-98 to 10.4 years in 2007-08. The elongation of maturity profile has been made possible largely on account of increase in market appetite from non-bank market participants, particularly insurance companies and provident funds and improved market maturity. It is notable that despite substantial increase in the weighted average maturity, between 1997-98 and 2003-04, the weighted average yield of the dated securities issued during the period declined from 12.01 % (1997-98) to 7.9 % (2006-07). However, in the subsequent years the weighted average yields have been increasing with increasing weighted average maturity. In 2006-07, the weighted average maturity of new loans was 14.7 years with a range of 4 to 30 years and the weighted average yield of new loans was 7.9 per cent.

The Reserve Bank's efforts to elongate the maturity profile resulted in a smooth and reliable yield curve, which acts as a benchmark for the other markets for pricing and valuation. Market liquidity today compares well with other emerging economies with bid-offer spreads in benchmark securities at 1-2 bps.

The holding of G-Secs among financial institutions has been more persified, particularly, with the emergence of insurance and pension funds as a “durable” investor class for the long-term securities. This became possible due to the sustained efforts devoted to elongation of the maturity profile of government securities.

Corporate debt market

The development of a corporate bond market in India has lagged behind in comparison with other financial market segments owing to many structural factors. While primary issuances have been significant, most of these were accounted for by public sector financial institutions and were issued on a private placement basis to institutional investors. The secondary market, therefore, has not developed commensurately and market liquidity has been an issue.

The Government had constituted a High Level Committee on Corporate Bonds and Securitisation (Patil Committee) to identify the factors inhibiting the development of an active corporate debt market in India and recommend necessary policy actions. The Committee made a number of recommendations relating to rationalising the primary issuance procedure, facilitating exchange trading, increasing the disclosure and transparency standards and strengthening the clearing and settlement mechanism in secondary market. The recommendations have been accepted in principle by the Government, RBI and SEBI and are under various stages of implementation.

The two stock exchanges, namely, the Bombay Stock Exchange (BSE) and the National Stock exchange (NSE), as well as the industry body Fixed Income, Money Market and Derivatives Association of India (FIMMDA) have since operationalised respective trade reporting platforms. While all the exchange trades in corporate bonds get captured by concerned exchange's reporting platform, OTC transactions can be reported on any of these platforms. The aggregated trade information across the platforms is being disseminated by FIMMDA on its website. BSE and NSE have also started order driven trading platforms in July 2007. In practice, however, trading still continues to be largely OTC.

SEBI has also implemented measures to streamline the activity in corporate bond markets by reducing the shut period in line with that of G-sec, reducing the size of standard lots to Rs. one lakh and standardising the day count convention. Further, to streamline the process of interest and redemption payments, Electronic Clearing Services (ECS), Real time Gross Settlements (RTGS) or National Electronic Funds Transfer (NEFT) are required to be used by the issuers.

Further progress is anticipated in regard to rationalising the primary issuance procedures, which is a critical step for moving away from the pre-dominance of private placements.

To reduce the settlement risk and enhance efficiency, the Patil Committee has also proposed setting up of a robust clearing mechanism. The settlement was proposed to be initially on DvP I basis (i.e. trade by trade basis) to address the counterparty settlement risk and gradually migrate to DvP III (net settlement of funds as well as securities) to impart enhanced settlement efficiency. (The delivery versus payment (DVP) modules can be broadly classified into three broad categories viz. DVP I, DVP II and DVP III. Under DVP I, the funds leg as well as the securities leg are settled simultaneously on a contract-by-contract basis. Under DVP 2, while the securities leg is settled on a contract-by-contract basis, the funds leg is settled for the net amount). Under DVP III, both the funds and the securities legs are settled for the net amounts.)

Outlook for development of corporate debt market

Patil Committee has recommended two important measures to be initiated by the Government, namely rationalization of stamp-duty, and abolition of tax deduction at source, as in the case of government securities. Hopefully, these would be acted upon soon.

As the corporate debt markets develop and RBI is assured of availability of efficient price discovery through significant increases in public issues as well as secondary market trading, and an efficient and safe settlement system, based on DvP III and STP is in place, RBI is committed to permitting market repos in corporate bonds.

In the medium term, considering the overall macro-economic situation, the ceiling for foreign investment in both government securities and corporate debt will continue to be calibrated as an instrument of capital account management. In particular, a more liberalized access to foreign investment would be appropriate when, among other things, an efficient and safe settlement system is well entrenched, aggregate consolidated public debt to GDP ratio reaches a reasonable level, say less than 50 per cent, and the corporate debt market acquires depth and liquidity with significant role for insurance and pension funds in India.

In the past, the government securities dominated the debt market in India, partly on account of the fiscal dominance and the absence of contractual savings. In the absence of contractual savings only banks tended to deploy their funds in the corporate bond market, mainly through private placement. RBI is hopeful that the recent slow but steady development of insurance sector, mutual funds etc. coupled with the existence of a reliable government securities market and the availability of robust reporting, trading and settlement mechanisms would lead to a rapid development of a vibrant corporate debt market. A framework for the development is already available through the recommendations of the Patil Committee, the implementation of which has already been taken up by the various agencies.

In support of my optimism in this regard, let me quote from a recent Working Paper of OECD:

> *"…Well functioning government securities markets give public support to private fixed-income market (both cash and derivatives) in the form of pricing benchmark, while they also provide a tool for interest rate risk management.*
>
> *For these reasons, the development of a well functioning government bond market will often precede, and very much facilitate, the development of a private-sector corporate bond market…"*
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> (New Strategies for emerging Domestic and Sovereign Bond markets, Working Paper No.260, OECD Development Centre, April 2007)

As regards, policy challenges in India, they may be similar to those identified by a recent report of the Committee on Global Financial Stability (CGFS).

> *"Three important policy challenges that remain are: to improve market liquidity of the new markets; to encourage greater private sector issuance; and to spread the risks of bond investment more widely."*
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> (Financial Stability and Local Currency Bond Markets, CGFS Paper No.28, Bank for International Settlements, June 2007)

Let me conclude with this optimistic note on the development of the corporate debt market also in India, sooner than the expectations of many in the financial markets.

Thank you.