[Academic Script]

Debt Market in India

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Academic Script

1. Debt market in India

In the previous session, we learnt about Money Market in India. In this session we are going to discuss Debt Market in India.

Let us first understand the meaning of Debt Market:

The Debt Market is the market where fixed income securities of various types and features are issued and traded. Debt Markets are therefore, markets for fixed income securities issued by Central and State Governments, Municipal Corporations, Govt. bodies and commercial entities like Financial Institutions, Banks, Public Sector Units, Public Ltd. companies and structured finance instruments.

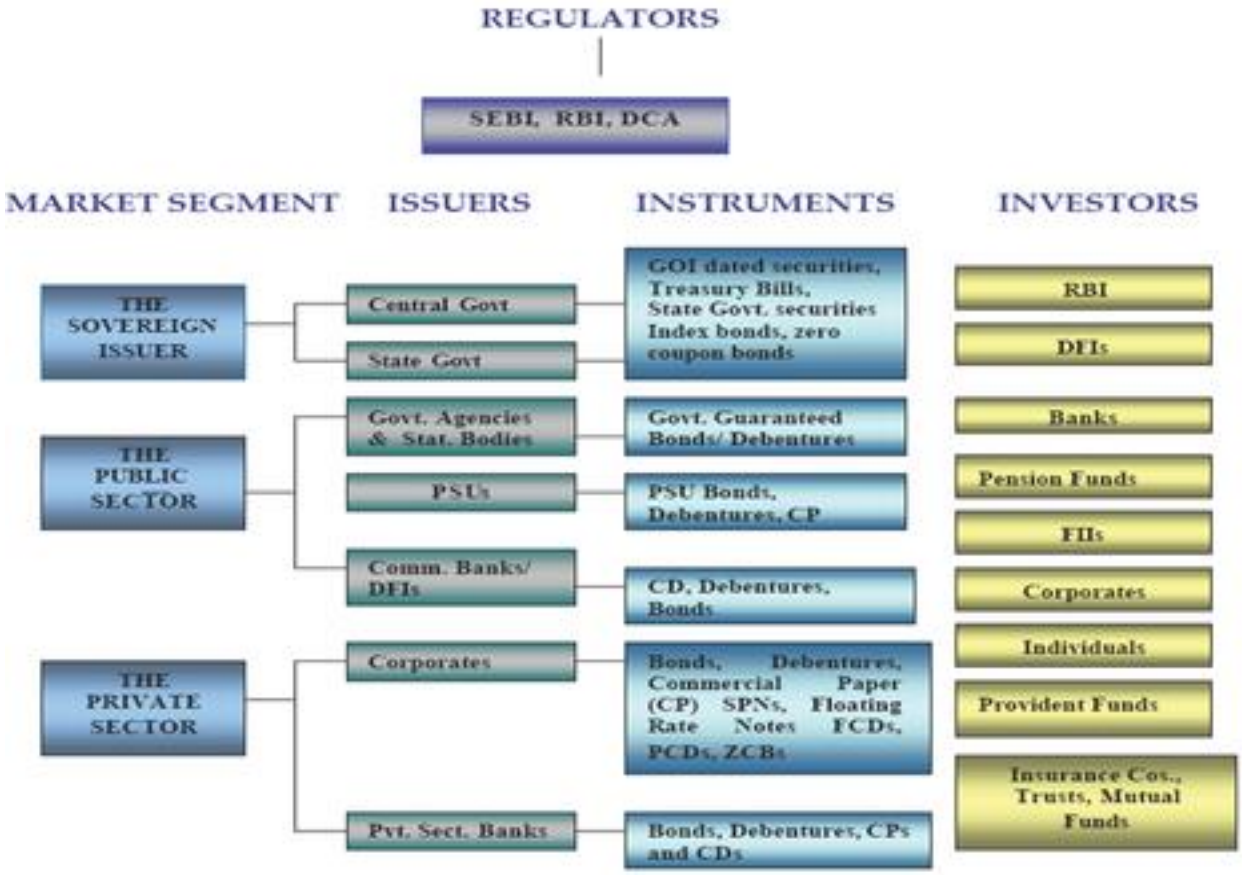
Here, in the meaning we had gone through the two important words they are **securities** and **fixed income securities**. First, understand both the term in detail.

Securities are financial instruments that represent a creditor relationship with a corporation or government. Generally, they represent agreements to receive a certain amount depending on the terms contained within the agreement.

Fixed-income securities are investments where the cash flows are according to a predetermined amount of interest, paid on a fixed schedule.

2. Structure of debt market in India

Indian Debt Market Structure



• In order to understand the structure of the debt market we will look at it through a framework based on its main participants. These participants are as follows:

• Regulators - The Debt regulators are RBI, SEBI and Department of Company Affairs (DCA).

• Issuers - are entities, which issue these instruments and are primarily corporate or the Government.

• Instruments - the instruments are the certificates issued in tradable form.

• Investors - are entities, which invest in these instruments or trade in these instruments. Investors in Debt Market are:

1. Wholesale Debt Market
2. Banks,
3. Financial Institutions,
4. RBI,
5. Insurance Companies,

6. Mutual funds,
7. Corporates and FIIs,
8. Retail Debt Market ,
9. Individuals,
10. Pension funds,
11. Private trusts,
12. Non-banking financial companies (NBFCs) and other legal entities

3. Various debt market instruments

The instruments traded can be classified into the following segments based on the characteristics to the identity of the issuer of these securities:

Main categories of securities	**Who issued these types of securities?** **They are….**	**Types of debt instruments**
Government Securities	Central Government	Zero Coupon Bonds Coupon Bearing Bonds Treasury Bills STRIPS
	State Governments	Coupon Bearing Bonds
Public Sector Bonds	Government Agencies / Statutory Bodies	Govt. Guaranteed Bonds, Debentures
	Public Sector Units	PSU Bonds Debentures Commercial Paper
Private Sector Bonds	Corporate	Debentures, Bonds, Commercial Paper, Floating Rate Bonds, Zero Coupon Bonds, Inter-Corporate Deposits
	Banks	Certificates of Deposits, Debentures, Bonds

	Financial Institutions	Certificates of Deposits, Bonds

There are three sectors in which Debt instrument can be issued they are Government securities, Public sector Bonds and Private Sector Bonds. So, let us understand each one of them in detail.

4. Government securities, Public sector Bonds and Private Sector Bonds

First main segment is Government Securities (Government Securities)

- A government security is a tradable instrument issued by the central government or the state governments. It acknowledges the government's debt obligation.
- Such securities are short-term (usually called treasury bills, with original maturities of less than one year) or long-term (usually called government bonds or dated securities with original maturity of one year or more).
- RBI issues Government Securities On behalf of the Government Of India . Government Securities offer fixed Interest rates where interest is payable semi-annually.
- For short term, there are T-Bills which are issued by RBI for 91 days, 184 Days and 364 Days.

They are of two types: central government securities and state government securities.

Next question is who are the main investors of Govt. Securities in India?

Traditionally, the Banks have been the largest category of investors in Government Securities accounting for more than 60% of the transactions in the Wholesale Debt Market.

The Banks are a prime and captive investor base for Government Securities as they are normally required to maintain 25% of their net time and demand liabilities as statuary liquidity ratio(SLR) but it has been observed that the banks normally invest 10% to 15% more than the normal requirement in Government Securities because of the following requirements:

- Risk free nature of the Government Securities
- Greater returns in Government Securities as compared to other investments of comparable nature

Who are the main issuers of Government Securities?

- In India, the central government issues T-bills and bonds or dated securities, while the state governments issue only bonds or dated securities, which are called State Development Loans (SDLs).

- Government securities carry practically no risk of default, and, hence, are called risk-free gilt-edged instruments. The Government of India also issues savings instruments such as Savings Bonds, National Saving Certificates (NSCs) and special securities (oil bonds, Food Corporation of India bonds, fertilizer bonds, power bonds, and so on).

Trading in Government securities

- **There is an active secondary market in government securities.** The securities can be bought/sold in the secondary market.
- The secondary market allows debt instruments to be sold by an existing investor prior to maturity at the prevailing market yield. An active secondary market is an important ingredient in the successful promotion of primary issues. They are traded on:

(i) **Over the Counter or Telephone Market**

In this market, a participant who wants to buy or sell a government security may contact a bank/ primary dealer/financial institution either directly or through a broker registered with SEBI, and negotiate for a certain amount of a particular security at a certain price.

Such negotiations are usually done over the telephone, and a deal may be struck if both the parties agree on the amount and rate. In the case of a buyer, such as an urban co-operative bank wishing to buy a security, the bank's dealer (who is authorized by the bank to undertake transactions in government securities) may get in touch with other market participants over the telephone and obtain quotes.

All trades undertaken in the Over the Counter (OTC) market are reported on the secondary market module of the Negotiated Dealing System (NDS).

(ii) **Negotiated Dealing System**

The Negotiated Dealing System (NDS) for electronic dealing and reporting of transactions in government securities was introduced in February 2002.

It allows the members to electronically submit bids or applications for the primary issuance of government securities when auctions are conducted. The Negotiated Dealing System (NDS) also provides an interface to the Securities Settlement System (SSS).

(iii) **Negotiated Dealing System-OrderMatching(NDS-OM)**

In August 2005, the RBI introduced an anonymous screen-based order matching module on the NDS, called the Negotiated Dealing System-Order Matching (NDS-OM).

This is an order-driven electronic system where the participants can trade anonymously by placing their orders on the system or accepting the orders already placed by other participants.

The NDS-OM is operated by the Clearing Corporation of India Ltd. (CCIL) on behalf of the RBI. Direct access to the NDS-OM system is currently available only to select financial institutions such as commercial banks, primary dealers, insurance companies, and mutual funds.

Other participants can access this system through their custodians, i.e., those with whom they maintain Gilt Accounts.

Next question arise is that what to do when Over-subscription and development of Government Securities in India

Retention shall be done for the over-subscription limit. In addition, now I am going to state different regulations to the over-subscription of government securities:

a) In general, issuers shall be allowed to retain the over-subscription money up to the maximum of 100% of the Base Issue size or any lower limit as specified in the offer document. However, for the issuers filing a shelf prospectus, they can retain oversubscription up to the rated size, as specified in their Shelf Prospectus.

b) The issuers of tax free bonds, who have not filed Shelf Prospectus, the limit for retaining the oversubscription shall be the amount, which they are authorised by CBDT to raise in a year or any lower limit, subject to the same being specified in the offer document.

c) Currently, in respect of public issue of NCDs, SEBI Regulations does not specify any maximum cap on the retention of over-subscription.

Second segment is Public Sector Bonds:

They are those bonds, whichare issued by public sector units in India. They are divided into two parts: Government agencies/ statutory bodies and Public Sector Units.

Third and the last segment is Private Sector Bonds:

Private Sector Bonds (Corporate Bonds CBs)

Private Sector Bonds are debt instruments which are issued by private companies to fulfill their financing needs.

5. Sub-types of bonds

- **Government guaranteed bonds** are debt security that offers a secondary guarantee that interest and principal payment will be made by a third party, should the issuer default due to reasons such as insolvency or bankruptcy. A guaranteed bond can be municipal or corporate, backed by a bond insurer, a fund or group entity, or a government authority.
- A **debenture** is a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer. Both corporations and governments frequently issue this type of bond to secure capital.
- **Corporate Bonds** are private sector debt instruments .These bonds come from PSUs (Public Sector Units) and are offered

for an extensive range of term up to 15 years. There are also some perpetual bonds.

- As compared to Government Securities, Corporate Bonds carry higher risks which depend upon the corporations, the industry where the corporation is currently operating, the current market conditions and the rating of the corporation.

- **Certificate of Deposit:**These are short term instruments issued by commercial Banks and Specialized Financial Institutions. These are negotiable money market instruments.
  - CDs usually offer higher returns than Bank Term Deposits, are issued in Electronic form and use as a Promissory Notes. Banks offer CDs which have maturity between 7 days to 1 Year.
  - CDs from Financial Institutions have maturity between 1 to 3 years.
- **Commercial Papers:** These are popular instruments for financing working capital requirements of Companies. They are short term securities ranging from 7 to 365 days. CPs are issued by corporate entities at a discount to face value. They are issued in the form of promissory notes.
- Some bonds, called Zero Coupon Bonds, do not pay out any interest prior to maturity. These bonds are sold at a discount because the value from the bond occurs at maturity when the principal is returned to the bondholder along with the interest.
- One type of Zero Coupon Bond is a “Strip”. A strip bond is a bond where both the principal and regular coupon payments--which have been removed--are sold separately. Also known as a "zero-coupon bond."

6. How is the price determined in the debt markets?

The price of a bond in the markets is determined by the forces of demand and supply, as is the case in any market.

The price of a bond in the marketplace also depends on a number of other factors and will fluctuate according to changes in:

- Economic conditions
- General money market conditions including the state of money supply in the economy
- Interest rates prevalent in the market and the rates of new issues
- Credit quality of the issuer

There is however, a theoretical underpinning to the determination of the price of the bond in the market based on the measure of the yield of the security

Each debt instrument has three features:

Maturity,

Coupon and

Principal

Maturity: Maturity of a bond refers to the date, on which the bond matures, which is the date on which the borrower has agreed to repay the principal. Term-to-Maturity refers to the number of years remaining for the bond to mature. The Term-to-Maturity changes everyday, from date of issue of the bond until its maturity. The term to maturity of a bond can be calculated on any date, as the distance between such a date and the date of maturity. It is also called the term or the tenure of the bond.

Coupon: Coupon refers to the periodic interest payments that are made by the borrower (who is also the issuer of the bond) to the lender (the subscriber of the bond). Coupon rate is the rate at which interest is paid, and is usually represented as a percentage of the par value of a bond.

Principal: Principal is the amount that has been borrowed, and is also called the par value or face value of the bond. The coupon is the product of the Principal and the coupon rate.

The name of the bond itself conveys the key features of a bond. For example, a GS CG2008 11.40% bond refers to a Central Government bond maturing in the year 2008 and paying a coupon of 11.40%. Since Central Government bonds have a face value of Rs.100 and normally pay coupon semi-annually, this bond will pay Rs. 5.70 as six- monthly coupon, until maturity.

The key role of the debt markets in the Indian Economy stems from the following reasons:

- Efficient mobilization and allocation of resources in the economy
- Financing the development activities of the Government
- Transmitting signals for implementation of the monetary policy
- Facilitating liquidity management in tune with overall short term and long term objectives.

Since the Government Securities are issued to meet the short term and long term financial needs of the government, they are not only used as instruments for raising debt, but have emerged as key instruments for internal debt management, monetary management and short term liquidity management.

What are the benefits of an efficient Debt Market to the financial system and the economy?

1. Reduction in the borrowing cost of the Government and enable mobilization of resources at a reasonable cost.

2. Provide greater funding avenues to public-sector and private sector projects and reduce the pressure on institutional financing.

3. Enhanced mobilization of resources by unlocking illiquid retail investments like gold

4. Development of heterogeneity of market participants

5. Assist in the development of a reliable yield curve.

7. Fiscal responsibility act

The Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) is an Act of the Parliament of India to institutionalise financial discipline, reduce India's fiscal deficit, improve macroeconomic management and the overall management of the public funds by moving towards a balanced budget.

The main purpose was to eliminate revenue deficit of the country (building revenue surplus thereafter) and bring down the fiscal deficit to a manageable growth of GDP.

Objectives

The main objectives of the act were:

1. To introduce transparent fiscal management systems in the country
2. To introduce a more equitable and manageable distribution of the country's debts over the years
3. To aim for fiscal stability for India in the long run
4. Additionally, the act was expected to give necessary flexibility to Reserve Bank of India(RBI) for managing inflation in India.

Fiscal management principles:

The Central Government, by rules made by it, was to specify the following:

1. A plan to eliminate revenue deficit by 31 Mar 2008 by setting annual targets for reduction starting from day of commencement of the act
2. Reduction of annual fiscal deficit of the country
3. Annual targets for assuming contingent liabilities in the form of guarantees and the total liabilities as a percentage of the GDP

Content of the Act

Since the act was primarily for the management of the governments' behaviour, it provided for certain documents to be tabled in the Parliament annually with regards to the country's fiscal policy. This included the following along with the Annual Financial Statement and demands for grants.

The Act further required the government to develop measures to promote fiscal transparency and reduce secrecy in the preparation of the Government financial documents including the Union Budget.

Switch deals:

It’s option which can be practiced by the buyer/ seller to switch the deal into another market. Debt instrument can be converted into any other financial instruments. Some debt instruments possess these type of characteristics of switching the deal into other financial market.

8. Summary

Let us summarizes the lecture that we have learnt about debt market. The Debt Market is the market where fixed income securities of various types and features are issued and traded. They are of short term. Its, structure include government securities, Public Sector Units and Private Sector Units. These all sector units issues various types of debt instrument to full fill the financial need of the market.

There are various bonds like corporate bonds, Government Guranteed Bonds, Debentures, PSU bonds, CPs (Commercial Paper), CDs (Certificate of Deposit) and many more. They ,are priced according to the demand and supply forces acting in the market. The feature of debt instrument is Maturity, Coupon and Principle amount.

Debt market is much beneficial to the government because it provide financial assistance to full fill the short term objective.