The Development of Bond market in India

The debt market is much more popular than the equity markets in most parts of the world. In India the reverse has been true. Nevertheless, the Indian debt market has transformed itself into a much more vibrant trading field for debt instruments from the rudimentary market about a decade ago.
The sections below encompass the transformation of government and corporate debt markets in India along with a comparison of the developments in equity market.

Developments in Government Bond Market

Prior to 1992, money was collected and lent according to Plan. Lacunae in institutional infrastructure and inefficient market practices characterized the government securities market. In fact the sole objective pursued was to keep the cost of government borrowing as low as possible. If planning went awry, the government sent word to its banker. The central bank made a few phone calls to the heads of banks and bonds were issued and the money arranged. No questions asked, no explanations given. The GOI bond market did not use trading on an exchange. It featured bilateral negotiation between dealers. The market thus lacked price-time priority and the bilateral transactions imposed counterparty credit risk on participants. This narrowed down the market into a "club" with homogeneous credit risk. This was the state of the government debt market in India ten years ago.

The major thrust of Financial Reforms commenced in 1992. This was when the contours of the debt market began taking shape. The idea of the financial reform movement was to have more and more different markets and not necessarily have whole financial intermediation left to the banks. The reform process attempted at doing away with regulations in favour of controls based on market forces i.e. an era where the interest rates are governed more by the market forces of demand and supply and less by centralized supervision. Slowly, but steadily, the market grew, adding fresh players and novel instruments. Several measures have added greater transparency and have brought the issuances closer to the market levels.

The major reforms that took place in the 1990's were:

- Introduction of the auction system for sale of dated government securities in June1992. This signaled the end of the era of administered interest rates.
- The RBI moved to computerize the SGL and implement a form of a 'delivery versus payment' (DvP) system. The DvP enabled mitigating of settlement risk in securities and ensured the smoothness of settlement by synchronizing the payment and delivery of securities.
- Innovative products in form of Zero Coupon Bonds and Capital Indexed Bonds (Ex. Inflation Linked) were issued to attract a wider gamut of investors. However, the pace of innovation suffered due to non-sophistication of the markets and lack of persistence with some of the new bonds like Inflation Indexed bonds after the initial lukewarm response.
- The system of Primary Dealers was established in March 1995. These primary dealers have since then acquired a large chunk of share in the GOI bond market and have played the role of market makers.
- The RBI setup "trade for trade" regime, a strong regulatory system which required that every trade must be settled with funds and bonds. All forms of netting were prohibited.
- Wholesale Debt Market (WDM) segment was set up at NSE, A limited degree of transparency came about through the WDM at NSE, where roughly half the trading volume of India's GOI bond market is reported.
- The Ways And Means agreement put an end to issuance of ad hoc treasury bills, the governments favourite instrument of funding its profligacy.
- Interest Income in G-Secs was exempted from the purview of TDS.
- FIIs with 100% Debt Schemes were allowed to invest in GOI Securities and T-Bills while other FIIs were allowed 30% investment in these instruments.

- Dematerialised forms of securities in G-Secs was done through the SGL and Constituents SGL accounts.

The above-mentioned measures have served in bringing about greater market orientation of the sovereign issues. This is particularly important as the sovereign borrowing parameters have a direct bearing on the cost of capital for other non-sovereign issuers. The Primary market for G-Secs registered an almost ten-fold increase between 1990-91 and 1998-99. The broadening of the market was also apparent from the fact that RBI's participation, as reflected by absorption of primary issues, came down from 45.90% in 1992-93 to 0.74% in 1994-95.

Though significant improvements have been made in the primary market, the secondary market continued to be plagued by certain shortcomings like dominance of a few players (acted as a deterrent to lending width in the market), strategy of holding to maturity by leading players (prevented the improvement in the depth of the market), the pre-1992 "telephone market" continued to exist (prevents information dissemination and hence price discovery is limited) and low retail participation in G-Secs continues to exist even today. Experts believe that there is tremendous potential for widening the investor base for Government securities among retail investors. This requires a two-pronged approach, increasing their awareness about Government securities as an option for investment and improving liquidity in the secondary market that will provide them with an exit route. Also infrastructure is seen as the vital element in the further development and deepening of the market.

Corporate Bond Market

In the last decade, market related borrowings by the corporate sector have remained depressed as a plethora of Financial Institutions were available for disbursal of credit. These Institutions managed to mobilize a significant amount of domestic savings and route them for corporate consumption.

Also the reforms abolished the office of the Controller of Capital Issues (CCI), which meant that companies were free to price their equity issues as per the market appetite. This led to a slew of primary issue of equity and the relative attractiveness of issue of debt yielded way to equities. In fact, even debt issues were made with attached sweeteners like convertible portion of the fixed income instrument. In addition, several relaxations in regulations post 1992 have encouraged Indian corporates to raise debt from overseas capital markets leading to further shunning of the domestic debt market by creditworthy issuers. Therefore, the corporate debt market in India has continued to be dominated by the PSU's.

In the recent past, the corporate debt market has seen high growth of innovative asset-backed securities. The servicing of debt and related obligations for such instruments is backed by some sort of financial assets and/or credit support from a third party. Over the years greater innovation has been witnessed in the corporate bond issuances, like floating rate instruments, zero coupon bonds, convertible bonds, callable (put-able) bonds and step-redemption bonds. For example, step bonds issued by ICICI in 1998, paid progressively higher rates of interest as the maturity approached while the IDBI's step bond was issued with a feature to pay out the redemption amount in instalments after an initial holding period. The deep discount bond issued by IDBI in the same year had two put and call options before maturity.

What these innovative issues have done is that they have provided a gamut of securities that caters to wider segment of investors in terms of maintaining a desirable risk-return balance. Over the last five years, corporate issuers have shown a distinct preference for private placements over public issues. This has further cramped the liquidity in the market. While private placement has grown 6.23 times to Rs. 62461.80 crores in 2000-2001 since 1995-96, the corresponding increase in public issues of debt has been merely 40.95 percent from the 1995-96 levels.

The dominance of private placement in total issuances is attributable to a number of factors. First, the lengthy issuance procedure for public issues, in particular, the information disclosure requirements, provide a strong incentive for eligible entities to opt for the private placement route. Secondly, the costs of a public issue are considerably higher than those for a private placement. Thirdly, the amounts that can be raised through private placements are typically larger than those that can be garnered through a public issue. Also, a corporate can expect to raise debt from the market at finer rates than the prime-lending rate of banks and financial institutions only with a AAA-rated paper. This limits the number of entities that would find it profitable to enter the market directly.

Thus the public issues market has over the years been dominated by financial institutions, which is exemplified by the fact that ICICI and IDBI accounted for the entire debt offerings in 1998–99 and all but one issue in 1999–2000[1]. Another interesting fact is that inspite of dominating the public issues market even financial institutions have raised significantly larger amounts through the private placement route.

Further the secondary market for non-sovereign debt, especially corporate paper remains plagued by inefficiencies. The primary problem is the total lack of market making in these securities, which consequently lead to extremely poor liquidity. The biggest investors in this segment of the market, namely LIC, GIC and UTI prefer to hold the instruments to maturity, thereby truncating the supply of paper in the market.

[1] Source: ADB report on debt market in India

The secondary market for corporate did receive a boost with the waiver on stamp duty payment on transfer of debt securities, as long as they are dematerialized debentures, in the Finance Bill 2000.

Development of Equity Market vs. the Debt Market

During this decade of financial reforms development in equity market has been striking as compared to relatively minor changes in the debt market. In terms of sheer market size, the equity market saw a drop from 42% of GDP in 1993–94 to 28.6% of GDP in 2000-01. Over the same period, the GOI bond market saw an increase in market size, fueled by large fiscal deficits, from 28% of GDP in 1993–94 to 36.7% of GDP in 2000–01. Other things being equal, this should have generated an improvement in liquidity of the GOI bond market and a reduction in liquidity in the equity market. Instead, changes in market design on the equity market over this period gave the opposite outcome, where the improvement in liquidity on the equity market was superior to that observed on the GOI bond market. The reasons for this have been manifold:

- Foreign capital inflows into the GOI bond market are relatively undesireable to policy-makers. This is in contrast with capital inflows into the equity market, where policy-makers seek to have the largest possible capital inflows. Hence, infirmities in the market design on the GOI bond market do not generate an important opportunity cost as far as harnessing foreign capital inflows are concerned.
- In the presence of “development finance institutions” and banks, firms in India are seen as having access to debt financing, access to debt finance was therefore not seen as a major bottleneck hindering investment. Hence, the lack of a liquid bond market was not keenly seen as a constraint in investment and growth.
- In the case of the GOI bond market, the benefits from a non-transparent market with entry barriers accrue primarily to banks and PDs. The PDs are largely the creation of RBI and public sector banks have extremely close ties with RBI. The RBI is the regulator for G-Secs market.

Thus the development of equity markets took precedence over development of debt market in India but the future does seem promising for the debt market.

References

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Glossary

- **Bond:** Bonds are debt and are issued for a period of more than one year.

- **Convertible Bond:** Bonds that can be converted into common stock at the option of the holder.

- **Corporate Bond:** Debt obligations issued by corporations.

- **Debt Market:** The market for trading debt instruments.

- **Equity:** The portion in an account that reflects the customer's ownership interest.

- **Equity Market:** Also called the stock market, the market for trading equities.

- **FII:** Foreign Institutional Investors

- **G-Secs:** The Reserve Bank of India (RBI) issues bonds known as Government of India Securities (G-Secs) on behalf of the Government of India.

- **Inflation-Indexed Bonds:** When one buys Inflation-Indexed securities, the interest is paid on the inflation-adjusted principal amount.

- **Redemption:** The retiring of a debt instrument by paying cash.

- **Secondary Market:** The market in which securities are traded after the initial (or primary) offering. Gauged by the number of issues traded. The over-the-counter market is the largest secondary market.

- **Step-up Bond:** A bond that pays a lower coupon rate for an initial period which then increases to a higher coupon rate.

    - **Zero Coupon Bonds:** Such a debt security pays an investor no interest. It is sold at a discount to its face price and matures in one year or longer.